



Grant Thornton

Our Ref NJJ/SAM/FRC COST EFFECTIVE REGULATION
Your Ref COST EFFECTIVENESS OF FRC REGULATION

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Dear Sirs

Discussion paper - cost effectiveness of FRC regulation

We are pleased to comment on the Financial Reporting Council's (FRC) discussion paper on cost effectiveness of FRC regulation as the UK enters what we know will be a challenging period for the capital markets, the wider business community and the audit profession. This discussion paper comes at a time when the FRC, together with its Operating Bodies, will to some extent be moving away from making rules and issuing guidance, into an era where its role will encompass discussing with market participants the key strategic risks that face the capital markets in order to determine priorities for further consultation and action. We acknowledge that the FRC does try to consider the cost effectiveness of its work and we welcome the FRC openly discussing the issue on a periodic basis.

The FRC's approach to regulatory cost effectiveness

Grant Thornton strongly supports a principles-based, proportionate approach to regulation, with the aim of preserving, promoting and enhancing confidence in corporate reporting and governance. We also support the Principles of Good Regulation established by the Better Regulation Commission, those principles being proportionality, accountability, consistency, transparency, and targeting.

The FRC generally seeks input from stakeholders in a timely and appropriate manner. We also acknowledge that at times the FRC is reacting to rules that are outside its control, and we observe that generally the FRC and its constituent bodies seek to implement regulation in an efficient and effective manner.

We agree with some of the comments made in the discussion paper about how the FRC has sought to be conscious of cost effectiveness, for example through initiatives with regard to smaller entities. However, we do not believe that some of the projects listed in the tables in section 1 of the paper are primarily based on an attempt to reduce the burden of regulation as might be inferred from the paper. For example, we are concerned that the proposed consultation on auditor training might lead to unnecessary additional regulatory burdens when in fact its genesis, the IFAC Training & Education Standards, are not directed towards the UK's auditing profession, which is generally held in high regard internationally. We are also concerned that the proposals to amend the AADB scheme (on which we have provided substantive comments separately) do not appear to be proportionate.

We suggest that a key area of focus for the FRC should be to reduce unnecessary costs arising from UK additions to International Standards on Auditing (ISA pluses) and in the application of IFAC's Code of Ethics in the UK. While individually such additions might not seem to be

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unduly onerous in aggregate they are a considerable drain on stakeholder energy and resources. However, we do recognise that it will be difficult for the FRC to eliminate certain UK additions where they have the strong support of the UK investor community.

High quality is the key factor

The FRC plays a vital role in maintaining confidence in the UK's capital markets and in influencing the international debate on issues such as complexity of standards. We recognize that a feature of cost effective regulation is that it is overseen by appropriately skilled and experienced personnel and that minimizing the regulatory budget should not be the sole aim. Therefore we understand that the FRC will need to pay appropriate salaries to ensure that it has access to high quality people with the requisite skills and experience within its own organisation and its operating bodies, which on occasion might require budgetary increases to exceed normal inflation. We would have less sympathy should the FRC request funding from stakeholders for a large number of discretionary initiatives or to increase the range of activities or functions of operating bodies unless these derive from clear and widespread concerns of market participants.

A strategic approach to future work program based upon the key risks to the capital markets identified in consultation with market participants

With the FRC's work program in mind, we believe that the FRC could improve its engagement with key market participants to gauge the key strategic risk to the capital markets. We perceive a danger that the FRC and/or its operating bodies could launch ad hoc projects without due regard to the responsibilities and goals of the FRC. A key aspect of cost effective regulation must be that the regulator's work and its policy proposals are based upon a thorough assessment of market risk and the needs as well as views of key market participants, including institutional investors.

We believe that the FRC has generally sought to consult before bringing forward policy initiatives such as the market participants approach to competition and choice in the audit market. However, we believe that in the future the FRC should be seeking to engage earlier and more directly with market participants to ascertain where there is a consensus for change or consultation. Direct engagement would also enable the FRC to intercept early indications of a problem, and be receptive to significant concerns of one or more market participants. Such market participants might include but not be restricted to the Association of British Insurers; the National Association of Pension Funds; the Confederation of British Industry; the Institute of Directors; the accounting institutes; and the Consultative Committee of Accountancy Bodies. There is concern from some market participants that too often policy initiatives or proposals emerge from the FRC where the market demand for the initiative is unclear. In particular we believe that the FRC should seek actively to increase its interaction with institutional investors.

Cross border problems require cross border solutions

The FRC should ensure that where an issue has to be addressed cross border that it engages with market participants overseas before launching its own projects independently. We believe there are some matters on the FRC's agenda that can only be solved on a cross border basis and that therefore the FRC should be liaising with international market participants before launching UK studies.

That said, we agree that the FRC has a role to play in presenting the UK view as part of the international debate on issues such as financial reporting complexity.

The FRC has an important role to continue to promote audit choice

The FRC has shown itself to be a leader internationally in seeking to reduce concentration in the audit market, which concentration represents a material risk to the capital markets and both Grant Thornton and many other market participants continue to believe to be undesirable.

There are occasions, however, where a lack of care in phraseology can reinforce institutional prejudices in favour of the largest audit firms. For example, in this discussion paper the FRC says that "the Big 4 are all inspected annually [by the Audit Inspection Unit]" whereas "certain of the Other Larger Firms are subject to an extended inspection cycle (every 18-24 months)". We believe that such phrases can create an impression that the largest four firms are subjected to a higher degree of scrutiny than a firm such as Grant Thornton, whereas our firm is subject to annual review by the AIU in the same way as the big 4 firms.

In summary, we support the FRC's principles-based approach to regulation and believe that in its early years there have been a number of examples where the FRC has adopted a cost effective approach . However, we believe the time is now right for the FRC to re-examine its approach to its future work programme, by engaging with market participants to identify key strategic risks to the capital markets, and only initiating fresh projects and initiatives where there is a clear and widely held concern by one or more market participant groups.

If you have any questions on this response, please contact Steve Maslin (phone: 020 7728 2736; email Steve.Maslin@gtuk.com) or Nick Jeffrey (phone: 020 7728 2787; email Nick.Jeffrey@gtuk.com).

Yours faithfully



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Appendix - consultation questions

Approach to regulatory cost-effectiveness

Question 1: Do you have any comments on our approach to improving the cost-effectiveness of FRC regulation whilst preserving confidence in corporate reporting and governance?

Grant Thornton response: We note the FRC's desire to make it easier/less costly for regulated entities to comply with current arrangements, and we remain happy to point out where FRC actions give rise to cost implications for audit firms. We believe that there are broader opportunities for the FRC to make compliance with rules and regulations easier or less costly for companies, for example the FRC commitment to reducing the burden on SMEs, where appropriate.

The most important opportunity at present for the FRC to improve cost effectiveness is to issue guidance for companies on implementing liability limitation agreements. Appropriate guidance will save costs for companies, particularly listed companies. However, we believe the cost effective goal will only be achieved if this guidance includes:

- a clear statement about the willingness of the majority of institutional investors to support proportionate liability
- a single proposed liability limitation clause for inclusion in audit engagement letters
- a clear legal view that confirms that recommending a liability limitation agreement will have no impact on the personal liability of directors where directors follow the guidance.

A very helpful development in recent years has been the wider use by regulatory bodies around the world of impact assessments. When done well, these assessments can be influential and informative. On occasion, and this is not just a comment with reference to the FRC, impact assessments could be better. One specific example for the FRC occurs in the revised Smith Guidance for Audit Committees where the impact assessment considers the costs of the paper's four proposals in isolation, with no reference to the other proposals which aim to facilitate wider choice or the benefits from increased choice in the public company audit market.

Strategic outcomes

Question 2: 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?

Grant Thornton response: We have nothing to add to our comments in the main letter.

Question 3: 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?

Grant Thornton response:

Strategic outcome one - corporate governance

We believe that UK corporate governance is well respected around the world and is used as a reference point in emerging markets. The appropriateness of current practice in the UK is evidenced by the few relatively minor changes proposed in the last review of the Combined Code. The respect for the UK framework is largely due to the principles-based framework, coupled with the comply or explain approach. We also note that the last review of the

guidance on internal control held that the UK approach was robust, with no perceived need for change.

Strategic outcome two - corporate reporting

On accounting standards, we acknowledge that the Accounting Standards Board has an important role to influence the development of IFRS, and Grant Thornton will participate fully in the project to review the complexity and relevance of corporate reporting requirements.

On enforcement of good corporate reporting we observe that the Financial Reporting Review Panel is one of the FRC's success stories, being widely regarded as a proportionate regulator which successfully implements a targeted, risk-based approach.

Strategic outcome three - auditing

A regulatory principle on page 9 of the discussion paper says that the FRC aims to "Recognise the importance of professional judgement in the way in which standards and rules are applied and enforced". It has long been said that auditing is an art and not a science, which in large part reflects that auditors make independent professional judgements in nearly all elements of their work. In our view achieving this regulatory aim represents a major challenge for the FRC's enforcement mechanism in the coming years. Auditing is ultimately about expressing an opinion on financial statements, and therefore the regulators should not examine implementation of the rules, but focus on the application of experience, judgement and professional skill.

On oversight of the auditing profession, page 19 of the discussion paper says that "...incremental costs incurred by the regulated entities should be considered to result from the initial regulatory requirements", as opposed to resulting from enforcement. In our view the manner of enforcement potentially has a significant impact on the costs of the regulator, preparers and regulated entities. It is widely held that global markets benefit from global accounting, auditing and ethical standards. However, it is also widely held that the positive impact of global standards risks dilution if those standards are applied, enforced and overseen inconsistently from one jurisdiction to the next. This is because the way rules and regulations are enforced has a significant impact on how rules and regulations are implemented.

Strategic outcome four - actuarial practice

We have no comments to make on this section.

Strategic outcome five - professionalism of accountants and actuaries

We support the POB in maintaining a watching brief on regulatory activities of the professional bodies. We are not aware of any systemic concerns on the part of investors about the professionalism of accountants and so there appears to be no need for any regulatory activity at this time.

On the disciplinary system for accountants we await the outcome of the AADB consultation with interest. The potential impact of the AADB's proposals will be greatest on directors who are accountants, and on individuals who are practicing accountants.

Strategic outcome six - FRC effectiveness

We agree that the FRC is an accountable and independent regulator. We stress the importance that as a general statement of governance principle we believe that the strategy of the FRC at the highest level should be determined by the FRC Board, and that the operating

bodies should be accountable to the FRC Board.

We observe that the investor community is now engaging with other stakeholders in capital markets, perhaps more so than it has been able to do in the past, and if not already in place we would encourage the FRC to actively seek regular dialogue with investors, perhaps for input to the FRC's work programme and other thought processes. In general, we believe that there is room for more transparency and earlier robust discussion on new projects and budgets. As the economy moves through a difficult period the markets will benefit from as much stability as possible.

Question 4: 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?

Grant Thornton response: On page 16 of the discussion paper, in the section on Auditing and Ethical Standards, the paper says that "it is far from clear that a reduction in standards would change the methodologies of the audit firms and that, therefore, any cost saving would result". Audit methodologies are intended to provide a sound structure around which an audit team will build a body of work to support the audit opinion. That structure is benchmarked to auditing standards, but is also influenced by the way that implementation of auditing standards is enforced. For example, ISA 580 on Management Representations is regarded by some to require more detailed work than is necessary, and ISA 540 Audit of Accounting Estimates is often regarded as being difficult to implement in the field.

As we state in the main letter, we believe that the FRC generally consults on a timely basis, in an appropriate manner. However, on occasion the FRC and its Operating Bodies can make statements in consultation papers or elsewhere that give the impression that there is an identified problem, when the problem is perhaps only perceived or is an unsubstantiated opinion. As a small example, on page 18 of this paper the FRC says that "...the APB intends to promote with the accountancy professional bodies improved training of auditors...". This statement implies that training of auditors needs improving, whereas we believe this initiative is part of the continuing process to ensure that auditor training remains relevant to market needs of the future.

APB and other Operating Bodies of FRC will often issue guidance in response to demand from stakeholder groups, for example the forthcoming guidance for directors on implementing liability limitation agreements, and the Reporting Statement on good practice for content of the Operating and Financial Review. However, when that guidance relates to implementation or application of standards or rules, the Operating Bodies should be wary of issuing "guidance" for auditors and preparers where issuing guidance has the effect of being interpreted by oversight bodies and others as if they were standards, such as guidance paragraphs added to ISAs (UK & Ireland).

The FRC acknowledges in the regulatory principles on page 9 that consistency with international standards is important "as far as it is appropriate to do so". We support the sentiment, but Grant Thornton will continue to challenge the FRC where we believe that the FRC has diverted from or appended international standards for use in the UK. For example the UK audit partner of a listed company must rotate every five years, but IFAC's Code of Ethics refers only to a seven year rotation period. There is no clear evidence that rotation every five years results in increased audit quality when compared to a seven year rotation period, and some commentators argue that in certain circumstances a shorter rotation period can impair audit quality.

Question 5: Do you have any comments from the perspective of smaller enterprises subject to FRC regulatory requirements?

Grant Thornton response: We have nothing to add at this stage to our comments in the main letter.