Dear Sir

Draft Plan & Budget and Levy Proposals 2016/17

We welcome the opportunity to comment on the FRC’s Draft Plan & Budget and Levy Proposals 2016/17 (“the Plan”), issued in December 2015. We have read it with great interest. Rather than answer each question, we set out our points below using the general headings in the Plan.

We make these comments in the spirit of constructive feedback. We would be happy to elaborate on some or any of our points if the FRC would find that useful.

Draft Plan

Regulatory approach

We are supportive of the FRC’s new regulatory approach and the recommendations identified in the recent independent effectiveness review. We have the following specific comments:

We support the FRC’s aim to "enhance the degree of investor involvement in [its] work" given that investors are the ultimate beneficiaries of its work. Recognising that the investor community is a broad church with many different priorities and interests; and often challenging to reach, one way of increasing their involvement would be to increase the number of investors represented on the Board, the Committees and the Councils. Currently, membership is relatively low. Another way to seek greater engagement from investors might be through the FRC’s funding (more details below).

We welcome the FRC’s aim to establish “a regulatory stance that promotes continuous improvement in standards of reporting and auditing” in circumstances where the FRC recognises that the standard of both is generally good.

We share the FRC’s view that this approach will increase its ability to drive standards even higher by more routinely sharing examples of good practice which preparers and/or auditors can seek to emulate. This would be in stark contrast to a “fault finding” approach which, rather than encouraging improvement generally, can lead those regulated to focus narrowly on avoiding incurring regulatory sanctions by making the same mistake again. The 2015 Australian academic study entitled “Public Oversight of Audit Firms: The Slippery-Slope of Enforcing Regulation” is a useful contribution to this point.

In a similar vein, as well as celebrating best practice, we would also encourage the FRC to consider how in its public and private audit inspection reporting it might better clarify the gravity of the issues it
identifies in terms of their seriousness together with a point of view on what the audit teams should have done instead; ie explain what “good would have looked like”.

On promoting greater transparency in the way the FRC operates, we note that audit committees will be expected to report on outcomes of FRC’s audit quality and corporate reporting reviews. This is a welcome initiative but it will require careful thought as it is put into practice. Audit committees have their own responsibility to oversee and assess the quality of corporate reporting and audit but they themselves are not subject to the same direct FRC oversight as preparers and auditors.

In view of this, we believe there is merit in the FRC reviewing the quality of audit committee reporting periodically in the same way it has reviewed audit reports in the last few years. The feedback provided is extremely useful and will enhance the quality of audit reports in the future. In our view, the quality of audit committee reporting is variable and looking for ways it can be improved should be an FRC priority.

Reducing regulatory costs

We would observe that generally speaking the FRC works efficiently across its activities with the resources it has at its disposal. We have the following suggestions:

► Corporate reporting – there is scope to streamline activities per the FRC’s independent effectiveness review and at the same time provide even more help to preparers. Between October and December 2015, FRC issued four publications on corporate reporting. These publications are useful and welcome. However they could be even more useful if they were published earlier in the year and consolidated into one publication to reduce length. This would maximise preparers’ ability to assimilate the FRC’s feedback, tips and guidance. In our experience companies with December year ends (the majority) will have started thinking about their annual reporting before October. Come December and beyond companies get into year-end accounts preparation. Their capacity for reading guidance etc and acting on it becomes much more limited at that point.

In relation to the FRC’s annual programme of reviews of corporate reports, consistent with the FRC’s new regulatory approach, it would be helpful for stakeholders to understand the reasons that FRC has identified its priority sectors for review (see page 13/14 of the Plan).

Given that the feedback received by the IASB on its Conceptual Framework ED highlighted substantial differences of view as to what is meant by ‘prudence’ and ‘stewardship’, the objective to promote these concepts as cornerstones of the IASB’s work would benefit from further explanation. As worded, different constituents may have significantly different views on what they will expect the FRC to do by way of promotion. It may also help to link ‘stewardship’ with the development of wider forms of stakeholder communication, such as integrated reporting.

► Audit Quality Reviews - we believe there is merit in the FRC examining how Thematic Reviews might provide greater value to FRC, audit committees, investors and auditors. The reviews can work well and are more efficient than examining some specific issues at the individual file level. It is important however that the themes identified provide useful messages to stakeholders. In that regard, when planning a programme of reviews, we would encourage the FRC to consult with preparers, audit committees, investors and auditors about what themes might be most useful. We would also like to discuss with AQRT how it might seek to place greater reliance on our own
internal quality controls; this would allow AQRT teams to focus on how the audit team addressed the significant issues identified in the audit itself.

We note positively that AQRT is trialling a more interactive inspection approach which we anticipate will be not only more efficient than the existing file review model but also of greater value for both the AQRT and our firm.

Proposed priorities for 2016/17

We are supportive of the general direction. We have several comments on the priorities before moving onto KPIs.

Corporate Governance

We support the FRC’s work programme on governance and welcome the desire to avoid making further changes to the Corporate Governance Code in the short term – there have been significant amendments since 2010 and companies need more time to bed these down.\(^1\)

Topics such as culture and succession planning are very relevant. They come up regularly in our conversations with boards as matters they grapple with. We also support the use of market-led initiatives (e.g. culture) which bring together a broad and diverse group of stakeholders to consider how practically to address the particular topic in hand. Solutions identified this way are more likely to be successful because they will enjoy broader stakeholder support. We encourage the FRC to use this approach wherever possible.

At the same time, we wonder whether the FRC could do more to monitor application of the Code and its Guidance than it does at present by looking beyond governance reporting. We accept that this is not straightforward and could risk deemphasising shareholders’ stewardship responsibilities to “police” the Code. Nevertheless we believe more could be done by the FRC to look behind the reporting for the benefit of all market participants. A way (but not the only way) might be the Corporate Reporting Review team seeking evidence to support governance reporting in the same way it asks for evidence on financial reporting. To be clear, this should be as much about celebrating good practice as it would be about being ahead of the curve in identifying potential problem areas.

Investor Stewardship

Although we support the FRC’s plan to scrutinise more closely adherence to the Stewardship Code by publicly naming those who have not met Code requirements, we believe there is merit in also celebrating good practice, and even identifying exemplars, as a way of driving up standards. It seems to us that the best way of motivating investors to improve standards of stewardship is to make it more of a competitive issue; where asset owners who value stewardship are more readily able to identify those who are best in class and award mandates accordingly. The current system does not facilitate that. Input could be sought from both asset owners, companies and indeed asset managers on this point.

\(^1\) Although see the points made in our response to the FRC’s consultation on enhancing confidence in audit dated 14 December 2015 where we identified a number of areas where the Code might be “tidied up” when the FRC next reviews it.
Audit and Assurance

As the FRC observes, implementation of the EU Audit Directive and Regulation is taking up a lot of FRC time. We recognise that this is a complex task for the FRC and the Government. We would reiterate the high level points we made in our response to the Consultation dated 14 December 2015 including the need to avoid adding further complexity to the standards where possible (e.g. not incorporating ESRA into the Ethical Standards and making it easier for users to identify how the Ethical Standards apply to different companies) as well as the need for consistency of interpretation in relation to the prohibitions on non-audit services.

Audit committees play a very important role in the quality of risk management, corporate reporting and audit. We believe the FRC should give thought as to how it might obtain greater visibility over the performance of audit committees. To be clear, we are not advocating formal regulation and oversight rather the identification of feedback mechanisms that could give FRC more insight into how audit committees are performing. The FRC could also review audit committee reporting as we mention above.

Finally, we would like to see more explicit reference in the FRC’s plan to the future of audit and assurance. The pace of technological change is increasing rapidly yet auditing standards were designed at a time when emerging technologies (especially as to how they relate to big data) were not in contemplation. Yet these advances have the potential to improve significantly the quality and usefulness of audit and assurance. We anticipate that analytics and future innovations will require much closer collaboration between auditors and the FRC to ensure that auditors can take advantage quickly of new technologies while at the same time giving comfort to FRC that audit quality will be maintained and even enhanced.

The need for FRC to give greater focus to the increased pace of technological change applies equally to the FRC’s other focus areas.

Actuarial work

Our actuarial colleagues have noted an apparent link between the FRC’s thinking on the (soon to be revised) standards on actuarial information and the information that is needed by boards to make the long term viability statement under the UK Corporate Governance Code. This link is something that might be picked up in the FRC’s Guidance on Risk Management at the next review in the sense that the standards on actuarial information may be helpful to preparers in making the long term viability statement.

International Work

The FRC’s international work is extremely important not least to help protect the FRC’s regulatory approach. We believe it would be helpful to the understanding of the FRC’s stakeholders if it set out in its objectives and strategy for its International work in a discrete section explaining the issues, risks and what the FRC intends to do about them.
Planning for Brexit

It would also be helpful to understand whether FRC is doing any analysis in relation to the future EU referendum and how the outcome might affect its work.

Key Performance Indicators

We are wholly supportive of the FRC using KPIs to measure the effectiveness of its work based on the maxim "what gets measured gets done". We recognise though it is challenging to identify hard measures in much of FRC's work.

FRC effectiveness

As the FRC is committed to implementing effectiveness review points on pages 7 and 8 of the Plan, we would suggest establishing some KPIs in respect of the actions identified e.g. number of investor representatives on FRC governance bodies, survey results from regulated about the extent to which improvement areas are being identified, etc.

Corporate Governance

We believe there is merit in including some KPIs about the quality of explanations more broadly and not just the quality of audit committee reporting. Such qualitative measures might also include the identification and sharing of good practice across the market.

Corporate Reporting

It is unclear to us whether the KPIs mentioned include seeking feedback from investors.

We support a KPI in respect of the Lab's activities but would suggest some harder measures e.g. number of companies that have changed their reporting on matters covered by the Lab initiatives.

Audit and Assurance

As we identify above, we believe audit committees play a vital role in audit quality. Accordingly, we would suggest a KPI on the performance of audit committees through survey feedback.

Professional discipline

We welcome the FRC's stance that it will hold people to account where it is in public interest to do so while at the same time seeking to take enforcement action in timely and cost-effective way – long running cases do not enhance the reputation of either the professions or the FRC. They also place more strain than might be necessary on those individuals subject to the action; whatever the end result.

The FRC sets out an aspiration at page 8 that it aims to complete investigations under the actuarial and audit schemes after no more than two years on average. Cases should be prosecuted expeditiously but we are not convinced that focussing on two year deadlines will produce the right behaviours. In our view the focus needs to be on prosecuting strong claims, sharp execution and remaining firm about decisions made on whether or not to investigate or prosecute. The FRC might give some thought to KPIs that support this focus eg percentage of successful claims brought.
Budget and funding 2016/17

We have the following comments:

► It is in the interests of all market participants that the FRC is properly funded so it can carry out its important work to a high standard.

► We acknowledge that the FRC’s responsibilities for audit oversight have expanded through the recent Audit Directive and Regulation and the UK Competition and Markets Authority Order. On the face of it, it is to be expected that costs would increase. That said, it would be helpful to understand in the plan what efforts FRC is making to achieve efficiencies so that these cost increases are kept to a minimum.

► The FRC is seeking to rebalance the costs of audit regulation so that it is met only by the audit profession. We are confident that the FRC will agree that audit quality is driven by a number of factors not just the audit profession and its oversight body. Company management and audit committees also play a vital role. We would like to understand more about how the FRC came to the conclusion that the audit profession should bear the entire cost.

► Further realignment of unspecified amounts are mentioned for the second and third years of the strategy. For planning purposes, it would be helpful to understand more about the total costs to be borne by the profession in the second and third years and how those costs are broken down. This would include the realignment amounts.

► In relation to the planned increase to the FRC’s reserves to cover 6 months operating costs in the event that a statutory levy became necessary, we would expect this increase to be funded by the levy payers rather than all those funding FRC costs. Such an approach would be consistent with the FRC’s corresponding desire to realign contributions in relation to audit.

► On the levy, we have a number of observations. The FRC contributes significantly to the strong reputation of the UK’s capital markets, and all companies listed in the UK (wherever incorporated) 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 CRRT’s oversight. It is therefore important that these entities contribute to the FRC’s funding.

► Shareholders also benefit from the FRC’s work not only through the companies in which they invest but more recently through the FRC’s development and monitoring of the Stewardship Code. It seems to us reasonable that that community too should be asked to contribute to the FRC’s costs. Requiring a specific financial contribution from the industry may well increase its engagement on the basis the investor community will have more “skin in the game”.

► We are content to continue to pay our contribution to the FRC’s funding through the ICAEW.
Conclusion

We commend the FRC for publishing the Plan. 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. We look forward to reading the results.

Yours faithfully

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