Think Ahead ACCA

Draft plan and budget and proposed levies 2016/17

A consultation issued by the Financial Reporting Council

Comments from ACCA

February 2016

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ACCA welcomes the opportunity to comment on the proposals issued by the Financial Reporting Council (FRC). Members of ACCA's Global Forums have considered the matters raised, and the views of those members are represented in the following. The Global Forums represented include those for Audit and Assurance, Corporate Reporting, and Governance, Risk and Performance.

OVERALL COMMENTS

1. We welcome the tone of engagement with stakeholders, including professionals and professional bodies, with focus on the outcomes of supporting them by 'reinforcing best practice and [challenging] them through an effective and proportionate regulatory framework'.[1]

2. We also support the recognised need to allow new structures and oversight processes to settle, as suggested by the statement that the FRC 'will avoid further changes to [its] codes and standards during the new strategy period as far as possible [and] will also seek to remove regulatory burdens wherever possible.'[2]

3. However, we have concerns relating to the lack of certainty regarding the FRC's responsibilities as the UK competent authority for audit regulation, and the means by which it will delegate regulatory tasks 'so far as is possible to the existing Recognised Supervisory Bodies'.[3] This uncertainty gives rise to complications and further uncertainty in respect of costs and their funding, and is an impediment to being able to consider the FRC's proposed priorities and indicators.

4. The proposals paper proposes transferring all the funding of the FRC's audit activities (including the 'rebalancing' amount) to the audit profession. This was confirmed by the FRC's chief executive, at its recent open meeting. However, the benefits of proportionate, effective regulation are enjoyed by a community far wider than the audit profession, and ultimately the benefits accrue to investors. The FRC should seek to apportion the costs of regulation accordingly.

5. We believe that responses to the FRC's proposals paper generally will indicate that there is a strong case for greater financial accountability by the FRC.

[1] Draft Plan & Budget and Levy Proposals 2016/17, page 4
[2] Draft Plan & Budget and Levy Proposals 2016/17, page 4
[3] BIS Consultation on the technical legislative implementation of the EU Audit Directive and Regulation, October 2015

SPECIFIC ISSUES

In this section of our response, we answer the seven specific questions set out in the consultation paper.

REGULATORY APPROACH

Question 1: Do you have any comments on the regulatory approach we are proposing for our new three year strategy?

6. Effective regulation inspires confidence, and transparency plays an important part in this respect. However, the FRC should exercise caution in responding to requests from investors for information to better understand the findings of inspection programmes. Maintaining confidence in the accountancy profession requires information to be published responsibly. There is value in positive communication where appropriate. A specific example is the reports issued by the AQR team, in which the FRC sets out how each firm has innovated and sought to deliver audit quality, in order to explain identified weaknesses in context. Even so, these positive messages tend to be overlooked in favour of comprehensive lists of audit weaknesses.

7. We urge the FRC to seek to balance the benefits to stakeholders of additional transparency against the risk that it may undermine the FRC's activities to support audit quality and confidence in audit. Similarly, when audit committees report on the outcomes of the FRC's audit quality and corporate reporting reviews, this should not amount to a second audit opinion, as that would risk confusion and uncertainty.

8. The objectives set out on pages 4 and 5 of the proposals paper are not the same as the objectives in the strategy for 2016/19. In particular 'Promote… high quality and relevant standards coming from international standard-setters'[4] is missing from the 2016/17 draft plan.

Question 2: Are there areas of our work where we could reduce the regulatory costs we impose without compromising the quality of corporate governance and reporting in the UK?

9. We recognise the value of the work of the Financial Reporting Lab, and note that the FRC intends to develop 'similar approaches in other areas'.[5] We also support an approach that pays due regard to promoting best practice, as such guidance encourages positive and fruitful engagement.

10. However, we would question (in this age of austerity, combined with lack of Government funding) whether guidance around best practice is the role of the oversight regulator, rather than professional bodies. Given the differences between the professional bodies, it is reasonable to assume that they are able to produce appropriate guidance for their members more efficiently than the FRC. Therefore, we would question the logic of levying any charge on professional bodies for activities that are more efficiently and effectively performed by those bodies themselves. To achieve the best value for money in an era where funding

[4] FRC's Strategy for 2016/19, page 7
[5] Draft Plan & Budget and Levy Proposals 2016/17, page 6

remains constrained, we urge the FRC to make use of the work of (and collaborate with) the professional bodies in seeking to produce best practice guidance.

11. Our response to question 3 below also suggests areas in which regulatory costs could be reduced. In all areas, cost reduction will follow the FRC's (and Government's) stated aim of removing regulatory burdens.

12. We support the statement: 'We will direct our audit quality review activities in line with our new regulatory approach – focusing more strongly on identifying and promoting good practice; and on supporting innovation by the profession'.[6] We consider it vital that the FRC should move away from publishing predominantly negative findings, and pay due regard to the benefits of commending good practice.

13. Proposed increases in costs apparent in section 4 of the proposals paper have been addressed under questions 5 and 6 below.

PRIORITIES FOR 2016/17

Question 3: Do you have any comments on the FRC's proposed projects and activities in 2016/17?

14. As a general point, we should like the plan for 2016/17 to provide visibility of the FRC's working relationships with the Prudential Regulation Authority and the Financial Conduct Authority. To the extent that all of these organisations impact the regulation of PIEs, there might be efficiencies to be gained from identifying areas of regulatory overlap.

Corporate governance

15. We are pleased to note that the planned changes to the UK Corporate Governance Code ('the Code') linked to the implementation of the EU Audit Regulation and Directive (ARD) are described as 'limited changes', and also that the FRC will try to avoid further changes to codes and standards during the 2016/2019 strategy period. We anticipate that the necessary changes in respect of the ARD will, therefore, be kept to a minimum.

16. We note, on page 9 of the paper, that the FRC proposes to remain influential internationally, and this is described as an 'important element' in respect of corporate governance and reporting, with specific reference to the 'comply or explain' approach. Therefore, we perceive a gap in the proposed priorities (pages 10 and 11) in respect of leadership in the context of the EU and international environment.

17. With regard to the culture project, we welcomed the fact that the FRC offered an open invitation for interested parties to be involved in the debate. Since then, there does not appear to have been an update on the project on the FRC's website. Questions exist around, for example, how the FRC identified the stakeholders to work with, and the different project streams arising. Therefore, it is difficult to see how the project has developed from its inception, and how it will progress to the delivery of identified outcomes. The lack of transparency – particularly in an area such as this – is a concern.

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[6] Draft Plan & Budget and Levy Proposals 2016/17, page 16

Investor stewardship

18. It is unclear how the FRC defines the role of investors. We understand that the proportion of investments in the hands of institutional investors has declined, while the different types of investors have increased in number and diversified in nature.

19. There appears to be an assumption that investors are important influencers and 'gate-keepers' when it comes to corporate governance. However, we believe that this assumption should be reconsidered. Investors are important beneficiaries, and therefore stakeholders, but can we continue to assume that they have a significant impact on corporate governance?

20. We welcome the proposal to undertake surveys and to reflect on the evidence, but it is unclear whether the evidence will reveal the effectiveness of the Stewardship Code. Is it possible to assess the impact of an investor complying with the Stewardship Code? The production of case studies could generate some useful discussion.

Corporate reporting

21. We welcome the proposed increase in transparency of the FRC's work to encourage improvements in the quality of reports and accounts.

22. We consider the proposed targeted review of tax disclosures to be important for many reasons. Evidence gained, and published, could form the basis for a number of studies covering areas such as ethics and taxation policy, as well as corporate reporting.

Audit and assurance

23. We note that the objectives set out under the heading of 'Our 2016/19 strategy and objectives' include, in respect of high quality auditing, 'using our powers and influence as the UK competent authority for audit regulation'.[7] The term 'influence' is not mentioned in this context in the FRC's Strategy document.

24. Two elements of the FRC's overall objectives for 2016/19 are set out on page 15 of the proposals paper, namely:
    - to successfully implement the ARD, and
    - to secure improvements in audit quality.

    These are two quite different objectives, the former being clear from the FRC's position as the sole competent authority for audit regulation in the UK. The latter, however, is not clear. Audit quality is important to the FRC's mission to promote high quality corporate governance and reporting, and serves the public interest. However, audit quality serves to enhance trust in corporate reports, rather than improve the quality of corporate reporting directly. This point supports our earlier claim that it is the responsibility of the professional bodies to provide guidance to their members, and to take other appropriate measures, to maintain and enhance the quality of audit.

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[7] Draft Plan & Budget and Levy Proposals 2016/17, page 5

25. The recommendation of the Competition and Markets Authority (CMA) is that '[t]he AQR team should review every audit engagement in the FTSE 350 on average every five years, with each individual audit engagement in the FTSE 350 reviewed at least every seven years.'[8] If the FRC is to prioritise the riskiest audit engagements, it is assumed that, in years 4 and 5 only the least risky audit engagements will remain. However, there will already be a need to monitor some audits a second time (based on risk). What is the strategy for reviewing the riskiest audit engagements more frequently than every five years and, if the five-year average is to remain a target, will that mean that more than 350 audits will be reviewed over each five-year period?

26. We note that the CMA recommendation that the AQR team should review every audit engagement in the FTSE 350 on average every five years is to be implemented. However, we suggest an additional work stream is required to review the impact of this review process.

27. Among the proposed priorities for 2016/17 is 'Consider the most effective and proportionate way to respond to the challenge of delivering high quality audit of SMEs'. This is extremely vague. The final plan should be much more explicit concerning the problem the FRC is proposing to address and what steps are proposed to address it. This is important in respect of the need for effective planning, transparency and the control of costs.

28. On page 17 of the proposals paper, there is mention of the non-statutory oversight of the accountancy profession and the disciplinary scheme. The consequential impacts of ARD implementation on these areas are unknown. Furthermore, the proposals paper does not indicate the potential impact of such uncertainty on the draft budget. Overall, it is our view that the FRC's regulatory activities in respect of the profession should be focussed tightly on those matters where it has statutory obligations to fulfil and that, in line with the statement on the implementation of the ARD by the Minister on 20 July 2015, regulation of accountancy should be left to the professional bodies. Were the FRC to make a case for going against the Ministerial statement, we would expect to see clear objectives set out and a clear articulation of the benefits which might accrue to the public interest. With the possible exception of the public interest disciplinary scheme, we have seen no evidence to date to suggest that the FRC is well placed to add value in this non-statutory area.

29. We note the reference to the FRC undertaking the monitoring of smaller audit firms that audit PIEs. In this respect, the new regulatory approach of 'focusing more strongly on identifying and promoting good practice; and on supporting innovation' will be welcomed.

Professional discipline

30. From the proposals paper, it is not possible to assess the performance of the FRC in closing and concluding cases, nor the implications for closing and concluding cases in the future. This, combined with uncertainty concerning the implementation of the ARD, makes it impossible to relate the draft plan to section 4 of the paper on budget and funding.

[8] Competition Commission, 'Statutory audit services for large companies market investigation: A report on the provision of statutory audit services to large companies in the UK

31. We note the plan to 'consider the implications [of the implementation of the ARD] for accountancy disciplinary cases that do not involve audit'.[9] We would expect the FRC's final plan to explain clearly why items such as this are included, with reference to the Statutory Auditors and Third Country Auditors Regulations 2016 ('the Regulations'), which are currently in draft.

Question 4: Are the proposed indicators helpful in assessing progress towards the FRC's objectives; and are there other indicators that should also be taken into account?

Corporate governance

32. To a large extent, the indicators on page 11 of the proposals paper appear to represent the measures available to the FRC, rather than the outcomes that *should be* measured. The qualitative indicators will be difficult to measure objectively (eg 'the quality of reporting …')

33. With regard to culture, the FRC must focus on what can be done to impact corporate culture through governance. What is achievable through codes and standards should be a priority, and will be measurable if there is positive engagement with the Code. What is best achieved through guidance should be accomplished through engagement with the professional bodies. Positive outcomes will arise from a combination of these activities.

Investor stewardship

34. In respect of the satisfaction of asset owners, how does the FRC define 'owners'? If portfolio owners are to be surveyed, it would be of little relevance to consider their level of satisfaction with the standard of reporting from asset managers.

35. We propose a rethink of objectives and possible outcomes in this area. The proposed priorities and indicators are based on the idea that asset managers/owners would act to facilitate good corporate governance. However, in reality, we are unaware of how often shareholders exercise their newly-obtained rights on remuneration, etc.

Corporate reporting

36. Many of the proposed priorities in respect of corporate reporting seem to represent 'business as usual' activities, although we acknowledge that the work of the Financial Reporting Lab is highly valued and responsive to changing demands. The relevance of the indicators suggested will depend on the transparency with which those indicators are made public, as the indicators are all qualitative.

37. We suggest that the indicators could focus more on the financial statements of smaller companies, especially as this would be compatible with the broader objectives of enhancing confidence in audit generally. Reporting by small entities has become very complicated, with a large number of options now available to them, and the complications associated with change.

[9] Draft Plan & Budget and Levy Proposals 2016/17, page 20

Audit and assurance

38. Three of the five indicators proposed are survey-based. In our opinion, surveys often deliver misleading answers, and the quality of evidence provided depends upon the design of the survey and many other factors. Therefore, the plan should explain the safeguards put in place to ensure that misleading results are not relied upon. We suggest there is a need for complete transparency in this area and a will to supplement outputs from surveys with other quantitative and qualitative data, to ensure that the information being relied upon is representative.

39. We are concerned that the FRC states its aim that, by 2019, at least ninety per cent of FTSE 350 audits will require no more than limited improvements as assessed by the FRC's own monitoring programme. The FRC is responsible for monitoring improvement, setting standards and influencing (as the UK competent authority for audit regulation), and so the goal articulated through this proposed indicator could act as a threat to the objectivity of the monitoring process. Moreover, the use of the words 'progress towards our aim …' in the proposed indicator seems a low (or vague) target for which to aim.

BUDGET AND FUNDING 2016/17

Question 5: Do you have any comments on our proposed budget for 2016/17?

40. From the information provided, it is not obvious what are the costs of delivering 'business as usual' and what are the incremental costs of carrying out new activities. The need for rigorous budgetary planning is now as great as ever. Therefore, we would generally expect the FRC to be seen to be exercising prudence, and not to seek above-inflationary increases in areas in which a requirement is not obvious.

41. The FRC and the professional bodies will exist within a new framework following implementation of the ARD. Therefore, we would question any proposed activities and responsibilities assumed by the FRC that are beyond the scope of the statutory instrument or that are not appropriately delegated (ie 'so far as is possible') to the Recognised Supervisory Bodies. This will include activities previously regarded as 'business as usual'.

42. On page 21 of the paper, the proposed expenditure for core operating costs (audit) and Audit Quality Review total £15.7 million, compared with £14.0 million budgeted for 2015/16. The narrative explains that 'the budget provides additional resources of £0.9m needed to support our new role as the UK competent authority for audit regulation and to implement the recommendations of the recent review of the effectiveness of our monitoring activities'.[10] The split between the two areas is not given, but this leaves, at best, an increase of £0.9 million in core operating costs (audit) unexplained. (This represents 10.5% over the 2015/16 budget.)

43. The analysis on page 22 of the paper raises more questions. For example, while we acknowledge the importance in investing in staff, the proposed increase in staff costs of 8% seems out of line with the increase in recruitment costs of 67%. Although it appears there is the intention to 'recruit additional staff in our Audit Quality Review and Professional

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[10] Draft Plan & Budget and Levy Proposals 2016/17, page 21

Oversight teams',[11] the proposed increase in headcount is not given, and the need is not related to the additional resource needs brought about by the implementation of the ARD.

Question 6: Do you have any comments on our proposed funding requirement for 2016/17?

44. The explanation given on pages 23 and 24 of the proposal paper does little to enhance clarity concerning the funding summary. The following sentence appears crucial:

'We therefore believe that our general reserve should be increased to a level equal to six months operating costs to cover any period while the Government is taking any necessary steps.'

But what 'necessary steps' are envisaged, and why are six months' operating costs considered appropriate? Presumably, operating costs include more than the 'core operating costs', and so six months' costs would amount to 50% of £33.5 million, ie £16.75 million. The case for this level of reserves (or indeed for any increase) has not been made out. Furthermore, the FRC has, purely for legacy reasons, operated as a company limited by guarantee to date and, given the apparent uncertainties this causes with regard to its reserves position, we would suggest that the time is right (particularly given that FRC will become the sole competent authority under the ADR) for the FRC's status to be reviewed with a view to it becoming a statutory body. This would have the additional benefit of bringing about a framework of spending and red-tape reduction disciplines to the FRC's work.

Although unclear from page 23 of the proposals paper, the rebalancing amount of £1.5 million also appears to be a building up of reserves. If so, we might expect the increase in reserves by the end of 2016/17 to be around £2.6 million, giving total reserves of £10.1 million. Even at this assumed rate of increase in reserves, the projected level of reserves at the end of the 2016/2019 strategy period would fall short of £16.75 million. We are not generally convinced by the arguments offered to date for re-balancing the FRC's finances. This approach risks potentially creating inflexible, silo-like compartments of activities and matched funding. This potentially diminishes the FRC's credentials as an integrated standard-setter and regulator covering audit, financial reporting and corporate governance, and cuts across previous internal FRC governance reforms which removed a number of separate sub-boards. We believe the FRC needs to think carefully about the track it is potentially taking; the logical end-state to the approach set out would be a complete split of the FRC into, on the one hand, a focussed sole competent authority for audit purposes and, on the other, a financial reporting and corporate governance standard-setter.

45. The manner of funding the FRC's activities is not prescribed by the ARD or the draft Regulations. In light of the actual responsibilities of the FRC as the sole competent authority for audit regulation in the UK, now is surely the time for a wholly new approach to funding. As well as meeting the test of fairness, funding must recognise the practical impact of there being fewer firms registered to conduct audit work. The majority of future funding of audit regulation will ultimately be borne by a small population of firms with PIE audits. The current funding model belongs to a previous era and is not sustainable. FRC should engage directly with the firms holding PIE audits to put in place a new funding model.

[11] Draft Plan & Budget and Levy Proposals 2016/17, page 22

46. The FRC's mission is 'to promote high quality corporate governance and reporting to foster investment', and this is, to a large extent brought about through '[encouraging] companies to produce the trustworthy information necessary for informed investment decisions'. The value of audit, and confidence in audit, in bringing about high quality reporting and trustworthy information is felt by the UK economy and the significant business entities within it. Those entities, therefore, expect to meet the costs incurred in enhancing their perceived trustworthiness.

47. Where the Audit Quality Review process specifically enhances trust, most costs should be met by those entities gaining most benefit; where firms attract greater attention from the AQR team, costs are most fairly allocated according to a 'polluter pays' principle. The same is true in respect of those firms and individuals who are the subject of disciplinary cases that are proven.

48. Therefore, a fair allocation of costs would levy the majority of the costs against significant businesses, and a significant proportion of the remainder on those audit firms demanding most Audit Quality Review time.

49. Before the allocation of costs can be reasonably considered, the total costs to be incurred must be assessed. As already explained, we believe that those costs should be the minimum necessary for the FRC to be able to fulfil its obligations under the Regulations. Funding decisions should be informed by the aim to 'remove regulatory burdens wherever possible'.

PROPOSED LEVIES 2016/17

Question 7: Do you agree with our proposed levy rates for 2016/17?

50. Historically, the FRC has had three levies, as set out on page 25 of the proposals paper. In view of the responsibilities of the FRC in respect of PIEs and their auditors, we believe there is a strong case for a levy on those audit firms that have PIE audit clients. This would be a fair mechanism, which would result in those PIE audit clients bearing the final cost.

CONCLUDING COMMENTS

51. ACCA has developed this response following an internal due process involving those with expertise and experience in audit and assurance, corporate reporting, corporate governance and regulation. This input, such as from our Global Forums, has informed the whole of this response.

52. The argument for exercising strict control over costs has been made out already in this response, and we believe this will be reiterated in the responses of other bodies. Fundamental considerations include the burden of costs and the regulatory principle of proportionality. However, an equally valid consideration is that of reducing the regulatory burden on business. With this in mind, we are against any attempt by the FRC to extend its PIE remit to AIM market companies.

53. Following implementation of the ARD, the FRC and the professional bodies will find themselves in a ‘new world’, in which a fresh view of responsibilities and cost management will be appropriate. As the UK competent authority for audit regulation, the FRC will have a new and clearly defined role, and the proposed atmosphere of engagement between the FRC and the professional bodies, combined with proportionate regulation and support for best practice is very welcome. Hence a distinction is made between the FRC’s statutory responsibilities and any additional work it might undertake in the public interest. The latter should be particularly evident in the FRC’s support for guidance issued by the professional bodies.

54. Among the proposed priorities for audit and assurance for 2016/17 is ‘Consider the most effective and proportionate way to respond to the challenge of delivering high quality audit of SMEs’.[12] The proposals paper does not explain the problem the FRC is proposing to address and what steps are proposed to address it. It is important that the FRC is seen to be a responsible regulator – both in terms of its regulatory strategy and its control of costs. Given the new framework in which the FRC will operate following implementation of the ARD, it must be prepared to justify all its activities beyond those set out in the Regulations.

55. Generally, there is a strong case for greater financial accountability by the FRC. It is currently a company limited by guarantee, but an agent of the Secretary of State. As the sole competent authority in the UK, with ultimate responsibility for audit regulation, it is time to ask whether the FRC should be a statutory body, bringing its existence (and financial accountability) onto a firmer footing. We suggest this, as greater levels of accountability will be appropriate in future. This point is also of relevance in relation to our earlier comments concerning the building up of a general reserve.

[12] Draft Plan & Budget and Levy Proposals 2016/17, page 17