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Dear Sir

PwC comments on the Financial Reporting Council's (FRC) Discussion Paper 'Cost Effectiveness of FRC regulation'

We welcome the opportunity to comment on the FRC's discussion paper on the 'cost effectiveness of FRC regulation'. The timing of this paper is particularly appropriate when considering the aim of the UK Government to reduce the administrative burden on UK business by at least 25%.

It is very important that legislators and regulators should regularly review the administrative burdens imposed on business to assess whether the benefits outweigh the costs. The question 'is FRC regulation cost effective?' is an interesting one. It implies that regulation takes place and is then assessed for cost effectiveness. We believe this is a fundamental flaw in the FRC's approach; namely that it first produces initiatives and then measures cost-effectiveness afterwards.

There will always be an increase in costs resulting from changes in the business environment, whether as a result of a regulatory or best practice change. The increases in cost may extend over a varying period of time. However, a proper assessment for 'cost effectiveness' must include an assessment of the detailed benefits and costs of the proposal. This should always be prepared prior to any proposal being brought forward rather than being a generic historic assessment.

We consider that the failure to produce properly formulated impact assessments for all areas of the FRC's work has had the effect of imposing disproportionate costs for UK business.

In support of this view we would by way of example draw your attention to one area where we disagree with the FRC's view on its cost effectiveness - page 4 of the discussion paper and strategic outcome three.

The paper suggests that action on imposing new AIU reporting arrangements are designed '*to enhance the transparency of inspection findings in a cost effective manner*'. The paper provides a rationale for this change as '*easier/less costly compliance with current requirements*'. We are surprised that the FRC has reached this conclusion when one considers the findings identified in page 15 of the Professional Oversight Board's 'Reporting on Audit Quality Monitoring – Implementing a New Approach' (4 December 2007). Regarding the costs and benefits of these changes we would direct you to paragraph 2.64 of the report that says '*The Oversight Board recognises that the prospective benefits to be achieved through greater transparency are not easily quantified and accepts that the consultation document did not attempt to do so in any detail*'. This needs to be assessed with the contents of paragraph 2.58 where 60% of respondents suggested that the increase in costs identified by the POB were too low. Therefore, the effect of this proposal was increased costs with no identifiable benefit. This result is at odds with the conclusion found in the discussion paper that this was a cost effective change.

As this discussion paper duplicates areas raised in the recent 'FRC draft plan and budget' consultation paper we are attaching our 14 March response at Annex A.

FRC Approach to regulation

The FRC proposes changes to the regulatory environment, for business and the accountancy profession, either under powers delegated to it by Government (legislative requirements), as guardian of the Combined Code on Corporate Governance (regulatory requirements), and as the accounting and auditing standards setter.

In addition, the FRC also brings forwards 'initiatives' that will form either a regulatory requirement, an example being the proposed changes to the Smith guidance resulting from the 'competition and choice in the audit market' project, or as 'best practice', an example being the 'key drivers of audit quality' resulting from the 'Promoting Audit Quality' project.

In all instances, the FRC argues that change is required in the UK based on a perceived weakness as identified in the strategic outcomes. However, as we identified in our response to the consultation paper on the FRC draft plan and budget the outcomes have been drafted in such a way (*largely achieved, significant concerns and serious shortcomings*) that there is no capacity for full achievement as each definition has a rider that more could be done.

We suggest that this approach produces disproportionate and costly action. However, the production of properly considered impact assessments will concentrate, we believe, the attention of the FRC on those areas where action is required rather than perceived to be required and that the cost and resultant action will be proportionate to the benefits achieved.

The FRC approach to Impact Assessments

We are encouraged that the FRC is committed to preparing impact assessments (Annex A of the discussion paper) that follow Better Regulation Executive (BRE) guidelines for the implementation of new regulatory requirements. However, we are concerned that there is also an indication that *‘the work that goes into the production of an impact assessment should be proportionate to the importance of the proposal that it covers’*. We do not believe that the FRC should be judging whether an impact assessment should, or should not, be prepared for its proposals. We suggest that the importance of a proposal can only be assessed after evidence has been obtained within an impact assessment.

In reviewing previous FRC consultation documents, impact assessments generally consist of one page of text with very little information regarding the cost of the action proposed. Therefore, we suggest that stakeholders can only draw two conclusions from this approach:

- That FRC does not consider that its proposals are that important; or
- That the FRC is paying ‘lip service’ to the better regulation principles.

We note that the Financial Services Authority has taken a different approach with a clear commitment to prepare cost benefit analysis:

“The restrictions we impose on the industry must be proportionate to the benefits that are expected to result from those restrictions:

In making judgments in this area, we take into account the costs to firms and consumers. One of the main techniques we use is cost benefit analysis of proposed regulatory requirements. This approach is shown, in particular, in the different regulatory requirements we apply to wholesale and retail markets.”¹

Before bringing forward any proposals we would encourage the FRC to produce an initial impact assessment. An example where this process would have assisted the FRC is with regards to its paper ‘The Audit Quality Framework’ (February 2008). In this document the FRC invites stakeholder comments by 30 June 2008 (with a review in the autumn 2008) on how audit firms are reporting against ‘the key drivers of audit quality’. The paper includes an indication that the FRC expects firms to report on ‘the drivers’ in their annual transparency reports.

Had an initial review been performed prior to the publication of this document, the FRC would have realised that:

- There is no legal requirement for audit firms to produce an annual transparency report until 5 July 2009 at the earliest; and
- The ‘Big 6’ audit firms, who are the primary focus of the FRC paper, financial years do not end until 31 May, at the earliest.

¹ <http://www.fsa.gov.uk/Pages/About/Aims/Principles/index.shtml>

Therefore, the FRC has asked for comments where stakeholders will have no evidence on which to comment.

We consider that initial impact assessment will prevent unnecessary, disproportionate and costly action and will focus the FRC's attention onto important issues – areas a legislator or regulator should only be considering.

The importance of Impact Assessments

We consider that the FRC should be adopting the following principles when considering whether to publicly consult on proposed action:

- What is the purpose and intended effect of the proposal;
- What are the risks the proposed action is attempting to address;
- What are the benefits of different approaches, including 'doing nothing';
- What are the costs of the proposal, including indirect cost;
- What is the impact on small business from the proposal;
- What is the impact on business operating in the global markets.

With respect to an assessment of the costs and benefits we consider that the FRC should commence work on an initial impact assessment, which follows the format recommended by the BRE. An example can be found on pages 53 to 56 in the report on the UK Governments implementation of the 8th Company Law Directive on statutory audit.²

We believe that the assessment should also be considering the impact and costs the proposed actions will have on those entities that operate within the global markets. As was clear from the implementation of section 404 of the Sarbanes Oxley Act in America, a national regulator acting in isolation of the global markets can have a significant adverse impact on their local markets.

We accept that the FRC will need to engage with market participants in the completion of this assessment. This has many benefits – it will ensure an early dialogue with all stakeholders, it will assist the policy making of the FRC and it will clearly identify those proposals where benefits outweigh costs that will assist in the support of stakeholders for change.

We also believe that this change will focus the FRC on only public consulting where change has been clearly identified and evidenced as being required. This is, in itself, a cost effective step the FRC should take.

Finally, we consider that 'post implementation impact assessments' should be undertaken on all regulatory actions brought forward by the FRC. We suggest that a suitable time to carry out these assessments would be three or four years after implementation to provide for a proper assessment of the costs and benefits.

This assessment would give market participants and the FRC confidence either that the costs and benefits identified in the impact assessment were correct or that the costs of the

² <http://www.berr.gov.uk/files/file40555.pdf>

regulatory measures were disproportionate to what was intended to be achieved. This would provide evidence to allow for either the amendment or withdrawal of the regulatory action.

Our responses to the questions asked in the discussion paper are attached at Annex B.

Please contact Peter Wyman if you wish to discuss the contents of this letter.

We are content for this response to be published.

Yours faithfully

Annex A

The Planning Manager
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14 March 2008

Our ref C199a/EP4.015/RT/PLW

Dear Sir/Madam

PwC Comments of the Financial Reporting Council's (FRC) Draft Plan and Budget for 2008/2009.

We welcome the opportunity of commenting on the FRC's 2008/2009 draft plan and budget. We fully support the FRC's overall aim of promoting confidence in corporate reporting and governance in the UK, and agree with the FRC's assessment that this has been largely achieved.

Rather than address the specific questions asked in the consultation document, we have the following observations with respect to the FRC draft plan and budget.

Defining the FRC's forward agenda

The FRC is an important element of the overall regulatory structure in the UK, and critical to the reputation of the audit profession both here in the UK and overseas.

Determining the FRC's future agenda, and its short-term plans and budget, are therefore important components which, if got right, can enhance oversight of the profession and reinforce the important leadership role it has to play in creating an investor climate of trust throughout the world.

This context we believe to be of critical importance as we have some serious misgivings about the FRC's current direction of travel and certain specific agenda items which, rather than enhancing oversight and the reputation of the profession, appear, rightly or wrongly, to be undermining the profession's position both in a UK and a global context.

Accountability and transparency

Government has recently signalled that it no longer intends to contribute one third of the FRC's budget, relying on market participants to pay the majority of the FRC's costs.

Whilst we realise that there will be a public consultation on future FRC funding, we consider that, with the removal of this "government lever", the FRC will need to consider what mechanisms are needed to ensure that its accountability and transparency are sufficient to maintain market participants' confidence in the regulatory process. One way in which confidence could be maintained is by the independent assessment of the cost and effectiveness of the FRC's work plan by the National Audit Office (an observation we make on the FRC Budget later in this response).

Clearly, in this regard, the FRC has the final say in determining its agenda. We believe, however, that in the long-term its effectiveness and value will in large part be determined by the quality of its engagement with its key stakeholders and its ability to create a truly collaborative regulatory model.

We would also suggest that the FRC will need to assess its future agenda and plans by considering the balance, more closely, of the costs and the benefits of its proposed programme – a test which the FRC does not appear to use at present. As an example, we fully support the FRC in its aim of promoting confidence in corporate reporting, but believe that an important element of that aim is the application of a rigorous test in assessing whether action is required, and whether any benefit which may be achieved is proportionate to the cost.

These comments will, we hope, put into context our more detailed observations on the draft plan and budget.

1. The Plan

General Comments

(a) Presentation of plan

We consider that the contents of the plan could have been presented in a more effective, logical and succinct way by combining the content of two documents, which cover nearly 60 pages. This would, we suggest, assist interested parties to focus on areas of particular interest. A product of this approach would have been a shorter clearer document, removing unnecessary duplication.

(b) Regulatory tone and the calibration of performance

The FRC proposes three tests to assess whether an outcome has been achieved – *largely achieved*, *significant concerns* and *serious shortcomings*. In all instances, there is no capacity for 'full achievement' as each definition has a rider that more could be done.

Whilst we support the principle that improvements should always be sought, we would refer to the statement on page 15 of the report that states:

‘There is a risk that aspects of the current regulatory regime for corporate reporting and governance for which the FRC is responsible impose disproportionate costs on regulated entities. If this risk materialises we would have significant concerns about the achievement of this supporting outcome’.

One of the results of setting a bar that can never be met is the potential imposition of disproportionate cost. Even more damaging is the effect this approach can have on business confidence in the UK’s ‘light touch’ regulation in corporate reporting, governance and auditing.

Whilst we accept that there is no room for complacency, a positive ‘tone from the top’ message from the FRC, that UK corporate reporting, governance and auditing systems are operating to a high level, will, we suggest, promote confidence.

One way in which this message could be relayed would be for the FRC to apply positive rather than negative tests to its outcomes.

Outcome Two – Corporate Reporting (Page 12).

There is an increasing call amongst stakeholders for the simplification of financial reporting. The removal of complexity, which results in reports that have little relevance to the majority of shareholders, has become the key area of concern in corporate reporting. It appears that this complexity has built up over a number of years from regulatory intervention resulting in a more rule based system of financial reporting.

This firm, along with others, has been at the forefront in seeking ways to make corporate reporting more relevant and reliable as we believe it is a major public policy issue at the heart of the effective working of the capital markets and the societies in which they operate.

In 2006, along with CIMA and RadleyYeldar (a communication consultancy firm), we started the Report Leadership project³. The aim of the project is to develop simple, practical yet effective ways to improve narrative and financial reporting.

To demonstrate how this could be done we published an annual report for a fictitious company, in November 2006, using a new reporting model⁴. This approach identified how companies could simplify their annual accounts. Since that time the group has published further advice aimed at assisting an improvement in executive remuneration reporting.

In December 2007, the Prince of Wales Trust project on Accounting for Sustainability also published its findings on reporting. This project, with which we were also actively involved, called for a recasting of the reporting model to recognise the convergence which is currently taking place between financial, corporate and sustainability reporting.

³ Link to website: www.reportleadership.com

⁴ Link to document:

www.reportleadership.com/files/page/608/GENERICO_RandA_07.pdf

In January 2008, the CEOs of the six largest global accounting firms published a white paper on principles based accounting standards⁵. The paper was developed to promote debate on the issues that should be discussed and considered as the global capital markets move towards a single set of high-quality accounting standards (IFRS) based on principles and not rules. The approach adopted in this paper has been widely supported by stakeholders and standard setters.

We consider that the factors identified at Outcome Two are only part of the solution to providing relevant, reliable and understandable reports that underpin the importance of a true and fair view. We would urge the FRC to lead a debate in the UK, in which we would wish to play an active role, with the aim of simplifying financial reporting and enhancing corporate reporting.

Outcome Three – Auditing (page 13).

In pursuit of the FRC's overall objective of 'promoting confidence in corporate reporting', we are surprised by two elements of paragraph (b) - 'Implementation'.

First, we suggest there are two unrelated areas that have been treated as related, namely, choice in the audit market and the ability of audit staff to audit appropriately entities affected by current credit market conditions.

(a) Choice in the audit market

From the supporting text it appears that the area of 'significant concern' (albeit that the text also states that 'there is an efficient market for audit services in the UK') is the level of concentration in the audit market.

In 2007, the Market Participants Group carried out extensive work on the area of choice in the audit market that resulted in a number of recommendations for companies, shareholders, auditors and the regulator to consider. However, there was recognition that any changes to the current position may not take effect until the medium or long term.

If the FRC considers that this is an area on which it wishes to expend resource, we suggest this is identified as a separate issue in the Plan so commentators can gauge whether this will be an effective use of resource.

(b) Auditor competence

We are concerned by the tone of the final paragraph on page 13. As previously identified, the role of the FRC is 'to promote confidence' and we consider that suggesting 'that auditors may not adequately address the risks arising from credit market conditions' does not promote confidence but rather calls into question the ability of auditors to perform independent audit in a professional way without any evidence to support such an allegation.

With the aim of promoting compliance with financial reporting standards, the 'Big 6 Accountancy firms' published, in December 2007, a paper titled 'Determining Fair Value of Financial Instruments under IFRS in Current Market Conditions'. The purpose of this paper was to assist preparers of financial reports by enhancing awareness of the requirements of International Financial Reporting Standards (IFRS) in relation to the determination of fair value of financial assets and financial liabilities and related disclosures in the context of current market conditions.

⁵ Link: www.globalpublicpolicysymposium.com/GPPC_PBS_White_Paper.pdf

Although there have been a number of problems within the financial sector this year, early indications are that these have been as a result of market conditions or rogue members of staff. To date, there is no evidence that auditors have failed to address the risks from current market conditions, and we would suggest that the FRC should be supporting the audit profession at this time rather than seeking to question its ability.

Outcome 6 – FRC Effectiveness (Page 20).

We support the FRC's engagement with IFIAR (supporting outcome 6b) as important to ensure that the UK can influence global and regulatory organisations and authorities with the aim of achieving regulatory harmonisation so far as possible. However, IFIAR has not yet achieved the level of transparency that the FRC has and we consider it important that the FRC accurately reports on its IFIAR related costs, with respect to financial, staffing and other resources, so that a proper assessment of the cost and benefits of this organisation can take place.

2. The Budget

We fully support the desire of the FRC to employ 'high quality people', and recognise that this may necessitate above inflation rises in the FRC's budget. However, the draft budget includes just three lines to justify this increase and we consider that more detail should be included.

The Financial Services Authority (FSA) 2008/09 Business plan⁶ (pages 39 to 41) contains detailed information justifying a 4.5% increase in staff costs, and we would suggest the FRC may consider this a useful template.

On 6 February 2008, Gareth Thomas (the Parliamentary under Secretary of State for Trade and Consumer Affairs) announced in a written statement that the Government had concluded that 'the FRC should in future be funded largely by market participants'. The effect of this decision will be that the majority of the costs of the FRC will fall on business and the accounting and actuarial professions.

Whilst there is a statutory duty for the Professional Oversight Board to report to the Secretary of State on those activities that have been delegated to it, there is no such requirement on the FRC. Whilst we fully welcome the changes to the Board structure and the improved level of independent scrutiny, the FRC must recognise that it is carrying out a significant number of activities on the public's behalf.

Taking into account the public interest and the changes in the funding structure, we consider it important that the FRC is subject to an additional level of independent scrutiny and accountability. In coming to this conclusion, we note that the basis of the FRC's funding is similar to that of Government – it sets its own budget and imposes a direct charge on those subject to its functions.

One way that greater accountability could be achieved would be with an assessment carried out by the National Audit Office. This independent organisation seems well placed to fulfil this role. We suggest that the FRC considers inviting the NAO to carry out a financial assessment of the FRC on a periodic basis.

Another way in which the FRC could be providing greater visibility and transparency in its decision making process would be by making public responses to the consultation documents published by the FRC and its Operating Bodies available as soon as the Consultation has closed, for example published on the website within seven days of the closing date of the consultation

⁶ Link: http://www.fsa.gov.uk/pubs/plan/pb2008_09.pdf

process. This would allow market participants to assess the views of other interested parties and assist in ensuring that any FRC proposals are viewed as having the consensus support of respondents.

In considering the added financial burden the Government's funding decision will have on UK business, we do not believe that it is desirable or efficient for the FRC to be publishing a draft budget a few months before it takes effect. We would suggest that producing a two or three year rolling budget would allow the FRC to consider its longer term aims whilst assisting contributors to prepare properly their own budget.

We accept that the FRC may need to react to unplanned issues but consider that sufficient contingency could be built into the budget to provide for these eventualities.

Please let us know if you wish to discuss the contents of this letter.

We are content for this response to be published.

Yours faithfully

PricewaterhouseCoopers LLP

Annex B

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?

As identified in our covering letter, we believe that the FRC should always produce an initial impact assessment prior to bringing forward any proposals that may, or may not, result in regulatory action. The better regulation principles must be followed in all cases.

We believe that the production of an impact assessment will identify where action is appropriate in that it will clearly show cost burdens and the benefits from such action. This will, we suggest, result in the FRC focussing on those issues where action is evidenced rather than re-acting to areas where little evidence for action exists.

We do not accept that some of the areas identified within the discussion paper demonstrate the ‘cost effectiveness of the FRC’. We would draw your attention to our comments on the changes to AIU reporting arrangements in support of this assertion.

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?

Whilst some of the actions that have already been implemented are taking the FRC in the right direction we do not consider that they go far enough. We would draw your attention to our answer to question 1 regarding the importance of producing an initial impact assessment prior to bringing forward any proposals for public consultation.

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?

We consider that the over-riding aim of the FRC in bringing proposals forward is that benefit outweighs cost. Only this will result in the cost effectiveness of the FRC’s work and ensure that the FRC has the confidence of market participants that will, in turn, preserve confidence in the UK’s corporate reporting and governance.

We suggest that the proposals we have identified in our covering letter and in our response to question 1 will remove the ‘potentially’ from this question – an aspiration we suggest should be at the forefront of the FRC aim in acting in a cost effective manner.

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?

We would direct you to our response to question 1.

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

A properly considered and evidenced impact assessment will clearly identify those areas where disproportionate burdens are likely to fall on smaller enterprises. This should result in those actions not being pursued with the result that confidence in the regulatory environment will be maintained.