



FINANCIAL REPORTING COUNCIL CONSULTATION: STRATEGY 2018/21 AND DRAFT BUDGET AND LEVY PROPOSALS 2018/19

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ICAEW welcomes the opportunity to comment on the Financial Reporting Council Consultation: Strategy 2018/21 and Draft Budget and Levy Proposals 2018/19 published by the Financial Reporting Council on 19 December 2017, a copy of which is available from this [link](#).

ICAEW's more detailed comments on the FRC's budget and levy proposals for the coming year and its strategy for the next three years are set out in this representation. However, an overarching observation is that the FRC's strategy needs to more fully address and reflect the context of the significant challenges that are emerging for UK businesses and the accountancy profession. In particular, the next three years will be a period of critical change and challenge for the audit profession. Given this environment of change we would encourage the FRC to include in its strategy statements of intent covering, for example, building trust in the audit profession, encouraging competition in the PIE audit market, the opportunities and challenges arising from Brexit, the future of UK GAAP and the potential change in the governance and production of international auditing standards.

ICAEW is a world-leading professional body established under a Royal Charter to serve the public interest. In pursuit of its vision of a world of strong economies, ICAEW works with governments, regulators and businesses and it leads, connects, supports and regulates more than 149,000 chartered accountant members in over 160 countries. ICAEW members work in all types of private and public organisations, including public practice firms, and are trained to provide clarity and rigour and apply the highest professional, technical and ethical standards.

This response reflects the views of ICAEW as a regulator. ICAEW is the largest Recognised Supervisory Body (RSB) and Recognised Qualifying Body (RQB) for statutory audit in the UK, registering approximately 2,950 firms and 7,900 responsible individuals under the Companies Acts 1989 and 2006.

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MAJOR POINTS

Implications of public body status for the FRC

1. The impact on the organisation of the FRC's imminent change in status to a non-departmental public body (NDPB) needs to be more fully addressed or acknowledged in the document. A full analysis of the implications of change, particularly in terms of the FRC's governance, accountability, budgetary requirements and operating model, would be helpful to assist the regulated population to understand how the FRC will change going forward. The presentation and coverage of the consultation document appears similar to previous versions when the FRC was a private company.

Cost of regulation

2. ICAEW continues to have concerns over the increasing costs of FRC audit regulation in terms of the FRC operational and Audit Quality Review (AQR) levies that are by law required to be collected by ICAEW on behalf of the FRC from audit registered firms. Levies are ultimately a cost to UK business and affect competition in the audit market. Several audit regulated firms have highlighted this to ICAEW as an issue during the course of the year. Two mid-tier firms are withdrawing from the public interest audit (PIE) market and others are contemplating their future commitment.

Charges relating to the implementation of the EU Statutory Audit Directive

3. The FRC has previously cited (both in 2016 and in 2017) the implementation of the EU Statutory Audit Directive and its consequent competent authority status as a reason to increase both audit regulation staff and costs. Therefore, citing this in 2018/19 as a reason to again increase costs will be the third year that the FRC has used this reason. This is in the context of a reduction in the number of PIE audit firms in the UK (see the next two points).

Correlation between budget requirements and market shrinkage

4. The audit market and number of audit registered firms is shrinking – which is at odds with the continuing increase in the FRC's budget requirement. This places an increasing financial burden on a smaller number of firms.

Encouraging competition in the PIE audit market

5. A significant and timely addition to the key deliverables and priorities would be the need to encourage competition in the PIE audit market and its relationship to improving audit quality across the sector.

Lack of clarity over FRC's reserves requirements

6. The requirement which the FRC places on its reserves and lack of clarity on its reserves policy continues to be an issue, particularly in light of the imminent reclassification of the organisation as a NDPB. We would encourage a review of whether the current level of reserves is now justified or should be used to reduce the regulatory cost burden.

Proactive regulatory preparations in advance of the UK's exit from the EU

7. In a recent speech, Andrew Bailey, Chief Executive of the Financial Conduct Authority (FCA) was clear on the importance of regulators working now to ensure a functioning regulatory regime to provide certainty and confidence to business at the time of UK exit from the EU. He emphasised that the worst approach would be to leave it to the firms themselves to work out 'the solutions'. We endorse this view in terms of the accountancy profession too and therefore encourage the FRC to increase the proactive nature of its work on Brexit preparations towards a mutually agreed solution for continuity in audit regulation as part of the exit agreement.

Corporate governance principles for large private companies

8. We note that the FRC is planning to partner with other organisations to develop a set of corporate governance principles which would be applicable to large private companies. It is encouraging that a chair has recently been appointed and we trust that work on this can now progress efficiently. However, further clarity is needed on how this private company code would work in practice.

RESPONSES TO SPECIFIC QUESTIONS

Question 1: Comments on the FRC's proposed strategic priorities: are they in line with your expectations or are there other issues on which the FRC should focus?

Proactive Pre-Brexit engagement at EU level

9. The UK's imminent exit from EU membership presents obvious and pertinent challenges for the profession. At this crucial influencing stage the FRC has a vital and pivotal role to play in supporting the future of the profession in the UK and its status within Europe. There is an indication of an intent to 'respond effectively to the implications of Brexit' (page 4), however this isn't expanded on elsewhere in the document.
10. At this vital juncture, the profession would benefit from a more proactive (rather than responsive) approach and we would therefore encourage the FRC to continue with and indeed to expedite its engagement with EU departments and professional bodies to ensure service continuity. This engagement should be comprehensive and include areas such as the continued recognition of statutory auditors and holders and trainees of/for other professional qualifications.
11. A negotiated solution is preferable and an imperative to avoid the situation where firms put in place 'work-arounds' which would be costly, fragmented and disruptive and of course ultimately damaging to the profession and to the public interest. We emphasise the importance of the negotiation process now and the role of the FRC in this towards easing the burden on the regulated firms in this regard.

The costs of regulation and the consequent impact on the public interest

12. Overall, ICAEW remains disappointed that addressing the burden of the cost of oversight/regulation is not considered a priority for the FRC and that there are no measures apparently planned to focus on this.

13. There is a point at which high regulatory costs will impair market fundamentals and negatively impair outcomes, particularly if regulatory costs cause participants to drop out of the PIE market (of which ICAEW has recent evidence). Regulatory costs ultimately form a financial burden on businesses and the end consumer.
14. We acknowledge the presence of the FRC in the Schedule of “relevant regulators” under the red tape provisions of the Small Business, Enterprise and Employment Act 2015 published in SI 344 in March 2017. This places statutory obligations on these regulators with Section 24A requiring the publication of an impact assessment of the new rules/regulations. Further, BEIS has a responsibility under section 23(4) of the act to mitigate the business impact of new regulations.

The scope of investigations and case costs

15. We have a number of questions with reference to the paragraph under the heading ‘Effective enforcement’ (page 14):

‘As competent authority for audit, we now pursue matters relating to inadequate audit under a new audit procedure which gives us greater powers to obtain information and documents from certain audited entities. It also provides that a greater range of conduct is potentially capable of attracting a sanction.’

- What control measures will the FRC pursue to manage the scope of investigations and limit the potential growth of case costs? Is there a role for a risk based approach?
- Is the £5m projected case cost budget challenged by this revised approach and what assurance can be given as to the strength of this assessment?

Cross-regulator collaboration across borders

16. We draw attention to the evident need for the FRC to enhance its collaboration with at least two organisations to improve regulatory outcomes:

Irish Auditing and Accounting Supervisory Authority (IAASA)

17. We would advocate more attention in the FRC’s plan to work more closely with other regulators, in particularly IAASA, in the interests of efficiency and cost control. There is an increasing degree of duplication in the RSB and RQB monitoring carried out by the FRC and IAASA as well as in their allied management reporting and statistical requests. In addition, there is evidence of differences in terms of how each regulator interprets the requirements of the EU Statutory Audit Directive. In particular there are aspects of over interpretation of the requirements. These issues could well be ironed out if there was closer and active collaboration and dialogue between the two regulators and/or the concept of a ‘primary regulator’ was introduced.
18. Given the geographical closeness of the countries, and the joint nature of certain audit regulations, the present situation seems unnecessarily burdensome and inefficient. This also brings into sharp focus how the situation may be exacerbated post Brexit. But Brexit clearly presents an opportunity for regulatory alignment and mutual market access to exist between the two countries.

The International Forum of Independent Audit Regulators (IFIAR)

19. In the context of the current survey and work of the IFIAR, the FRC could include, as part of its planned strategy, working as part of IFIAR to develop audit recognition across borders other than just the EU (for example, but not solely, with Canada and Australia).

The status of IFRS post Brexit

20. The paper suggests that the UK should seek to have a separate endorsement mechanism for IFRS after the UK has left the EU (page 10). In our view this is a very important issue which requires separate consultation to ensure a full and thorough debate with stakeholders.

UK GAAP

21. We are surprised that neither the FRC's strategic objectives nor key deliverables refer to UK GAAP. We would have liked some reference to the next review of the UK GAAP standards. Additionally, we had hoped for a reference to the FRC's plan to monitor the implementation of the new IFRS on financial instruments, revenue and leases in order to consider if and how they might be incorporated into UK GAAP at a later stage.

Technology for auditors

22. ICAEW agrees with the FRC's focus on the transformative importance of AI and technology. It is therefore important for the FRC to clarify its intentions (page 13) with regard to any relevant review of the audit qualification.
23. However, it would be helpful if the strategy document could be clearer on whether the FRC's thoughts are to abandon or replace the audit qualification or to make recommendations about the syllabus with particular regard to how technology for auditors is addressed.

FRC proposals for a set of corporate governance principles for private companies

24. In relation to the FRC's plans to partner with other organisations to develop a set of corporate governance principles which would be applicable to large private companies (page 8), further clarity is needed on how this private company code would work in practice.
25. For example, it is not clear how oversight would operate, which companies are expected to be within scope, or whether these companies will be obliged to use the new code or can continue to refer to existing codes.

Question 2: Comments on the FRC's proposed audit firm monitoring approach

A new audit firm monitoring and supervisory approach

26. The proposed new audit firm monitoring approach (page 11) for the 'Big Six' audit firms makes the assumption that new activity requires additional budget (page 25). Taken together, the increased costs of AQR and audit firm supervision increase by £1.1m compared with the 2017/18 funding requirement.
27. On assuming competent authority status, the FRC passed back to the RSBs, mainly to ICAEW, responsibility for monitoring the audit firms responsible for 12,000 private companies and charities, plus all AIM quoted companies with a capitalisation of less than €200m. No efficiency gains appear to have been demonstrated by the FRC as a result.

28. As there is a cycle of FRC project work, audit monitoring and continuous improvement across a period of years, the impact of a ‘new’ approach would reasonably be expected to be absorbed within the ongoing operational costs of the FRC. In particular, aspects of the ‘new’ approach such as ‘leadership and governance’, ‘values and behaviours’ and ‘evidence on audit quality’ should already be covered by the FRC’s AQR reviews of whole firm procedures based on ISQC 1.

Question 3: Comments on the FRC’s key deliverables

29. Generally speaking, we would appreciate greater clarity on the key deliverables as set out in the paper. In our view, more detail would be helpful on what the FRC is seeking to achieve in each area in terms of outcomes and how success will be measured.

Encouraging competition in the PIE audit market

30. A significant and timely omission from the key deliverables and priorities is the need to encourage competition in the PIE audit market, reflecting the real or apparent role of competition in increasing audit quality across the sector. It is noted that the FRC’s Chief Executive referred to this as an issue whilst giving evidence at the recent Joint BEIS/DWP Select Committee hearing on Carillion (February 2018).
31. Implementation of the Competition and Markets Authority (CMA) recommendations arising from its review of the audit market (effective from 1 January 2015) has not altered the size of the market. In fact we see the market contracting. This points to the need for a more fundamental review and it should therefore be timely for the FRC to look at the issue as one of its key deliverables, to include a focus on two aspects:
- firstly the role regulatory costs play in the decision whether new participants enter this market and
 - the impact of the lowering of the standard for disciplinary action by the FRC against auditors from misconduct to ‘breach of any standard or regulation’ (since 2016).

It is likely that these two factors have led to more firms pragmatically considering whether they wish to remain in or enter the PIE audit market.

32. As our Chief Executive commented recently in a letter to the Joint BEIS/DWP enquiry, ICAEW has long supported increased competition, as seen in our evidence to the Competition and Markets Authority (CMA) in 2012. The changes to auditor independence requirements resulting from the new European Audit Reforms were designed to improve audit quality and restore investor confidence, as well as to increase competition in the market. Some measures to encourage new entrants were considered but not pursued at that time, so it may be time to think about these again.

The Financial Reporting Lab and outcomes

33. Whilst we fully acknowledge the Financial Reporting Lab as an innovative tool for encouraging best practice, we would emphasise the importance of renewing efforts to demonstrate the outcomes and impact arising in terms of the tangible and demonstrable improvements in reporting and audit quality which have flowed through. For example, whether there is any evidence that risk premiums on listed shares have been influenced positively for a company adopting one of the key recommendations.

Question 4: Comments on the draft budget and funding requirements for 2018/19

The implications on the FRC's operating model of its status as a non-departmental public body

'As a public body we will follow the principles and guidance set by HM Treasury and Cabinet Office in managing our expenditure and funding'.

34. It would be helpful to understand in more detail what will be the implications of the FRC's status as a NDPB. More clarity as soon as possible would be welcome, particularly in terms of changes to the FRC's governance, appointments to its Board, accountability, budgetary requirements, operating model and the financial implications for the organisation and therefore the resulting impact on the regulated population. The only mention is at page 4 of the consultation document but no further detail is given.
35. The presentation and coverage of the consultation document is similar to previous versions when the FRC was a private company. As a NDPB, more disclosure would be anticipated. To avoid conjecture and uncertainty, a fuller analysis would be welcomed. We highlight below three areas where more disclosure would be helpful, namely reserves, staffing levels and remuneration for non-executive directors:

Clarity on the FRC's approach to reserves

36. We understand that there are varying types of public body status which in turn can affect the level of reserves. This is not discussed in the FRC's draft budget. However two points arise:
- As a public body, it is likely that there will be no longer be need for the c£12m of reserves (page 24) as we assume that the FRC and its activities will be underwritten by Government (which makes no general contribution to the FRC's running costs).
 - We would suggest that consideration be given to using these reserves to offset any budgeted cost increase and/or be returned to funders.
37. The proposal last year saw an addition of £0.7m to general reserves (£1.1m in 2016/17). In our response to the consultation on the FRC's 2016/17 budget we queried the rationale for the proposed increase in reserves to six months' expenditure and we again queried the addition last year in our consultation response (ICAEW Rep 24/17).

FRC staffing levels

38. The plan and budget statement does not indicate the number of staff currently employed by the FRC or planned levels of staffing. As a key item of expenditure and as a NDPB this level of detail should be included in the FRC's consultation to allow funders to assess the effectiveness with which the FRC is running its operations. In particular, the £1.1m increase in the 'new' approach to audit firm monitoring and supervision is not related to any discrete increase in staff numbers.

Non-executive director fees

39. In our view fees paid to non-executive directors (NEDs) at the FRC are relatively high – on both an individual level and in terms of the total amount. On a benchmark basis, this is in comparison to fees paid to individual NEDs at other organisations, including a sample of listed companies as well as comparable regulators, for example the FCA.

40. Given the FRC's change to a NDPB it is probably timely for a review of such fees in comparison to other NDPBs and public bodies.

Local public audit

41. There is mention (page 4) of the need for an overall increase in the funding requirement of 1% and one aspect of this increase is towards the FRC's new role in local public audit. However the plan and budget does not give detail on how much it will cost to deliver this particular role and function and what element of the 1% increase will fund it.

Question 5: Comments on the levy proposals for 2018/19

Spending transparency and performance measurement

42. In our response to the FRC's plan and budget last year we said (point 15, page 4, ICAEW REP 24/17) that it would be 'pragmatic and forward thinking of the FRC to focus on the organisation itself demonstrating value for money in its activities, as a priority for 2017/18. More information on staffing levels, key cost drivers and relevant metrics-based KPIs would assist transparency in this respect'.
43. We would continue to encourage the FRC to make progress in this respect.

Local public audit

44. In terms of the increase in the FRC's funding requirement for its new role in monitoring local public audit in England, it is unclear from the table on page 25 as to how much funding Government departments, local authorities and other public sector organisations falling within the FRC's operational remit are providing.