

TRANSITIONS

THE NEW REGULATORY ENVIRONMENT



REGULATION AFFECTS EVERY ORGANISATION. IN THIS THIRD REPORT IN OUR TRANSITIONS SERIES WE CONSIDER ITS FUTURE IN THE BATTLEGROUND OF FINANCIAL SERVICES, IN THE KEY FIELDS OF TAXATION AND EMPLOYMENT AND IN THE FINANCIAL REPORTING ARENA.

PRESSURES AND PREDICTIONS

We believe that the causes and consequences of economic turmoil will drive regulatory reforms. But, will our recessionary recovery be enabled or endangered by the nature of that reform?

For many in Government, the media and among investors, the common understanding is that the perceived failure of the prevailing regulatory regimes will inevitably lead to increased regulation. Others see answers in enforcing current regulation more effectively, or in 'better' regulation. In sorting out the future from the past it's difficult to see through a thicket of self-interest and wishful thinking.

The pressure for change is evident – the trouble is that it is coming from all sorts of quarters, much of it conflicting.

- Many blame lack of regulation for the economic crisis and the behaviour of financial institutions in particular. Others are worried that too much regulation will slow down our recovery.
- The change of Government in the UK, triggered in part by the economic crisis, brings with it a public expectation and appetite for change.

- Much of the last Government's regulation agenda – for example the Legal Services Act and employment law changes – has yet to bite.
- Big business is wrestling with a revised corporate governance code and a new investor stewardship code.
- The Government needs to restock an empty Treasury and is actively adopting new approaches to taxation and public spending.
- Public attitudes to authority are changing. Citizens are becoming more vocal and, through social networks, more influential. Transparency is now an expectation.

A number of trends will emerge as a response to these pressures. We predict that:

- **Regulation based on principles rather than on detailed rules will prevail over the longer term.**
- **Financial services regulation will be less affected by this trend.**
- **The tax system will, at last, move towards simplification.**
- **Auditing and financial reporting requires some major rethinking.**
- **In the longer term, there will be more global convergence of regulation.**
- **Transgression of regulation will bring bigger penalties.**

These trends will provide major challenges to businesses, which will have to respond to a fast-changing environment.

James Roberts
Partner, BDO



In the regulation of business affairs... it is always tempting to try to translate general principles... into specific rules. But the world is rarely sufficiently clear and certain for this to be possible”

JOHN KAY, THE FINANCIAL TIMES – JANUARY 2011

INTRODUCTION

IS IT TIME FOR PRINCIPLES OR MORE RULES?

THERE IS NOW A SHARP CONTRAST BETWEEN THOSE WHO FAVOUR PRINCIPLES-BASED REGULATION, AND THOSE WHO WANT REGULATION TO BE BASED ON A RULE BOOK.

Our clients tell us that regulation often hampers decision making and entrepreneurship, particularly regarding taxation and employment law. They feel rules have become overly complex. We believe regulation leads to red-tape regimes that can shackle sound businesses and subdue entrepreneurial flair – leaving UK plc with little firepower in the battle for post-recession recovery.

On the other hand, regulation that is based on a requirement for ethical behaviour, but which is easy to operate, can encourage transparency and market growth. It is in no-one's best interest to interfere in the operation of the market, save to do what is necessary to produce a competitive environment and protect consumers adequately. It seems to us that corporates in almost any industry are best served by regulation that is simple and based on principles.

We need regulation that protects, but doesn't prevent business progress. Principles-based regulation does not necessarily mean 'light touch' regulation. Principles need to be enforced, perhaps more so than rules. In this context, we question whether a lack of proper enforcement, rather than a lack of regulation, was a contributory factor in the credit crisis.

However, with so many vested interests in the regulation 'industry', and with competing regulators, it is critical that market participants make their voices heard and demand the type of regulation that will foster enterprise, whilst protecting against dishonesty and genuine conflict of interest.

In this supposed era of 'citizen power' and the associated decline of some large institutions, corporate UK must demand what it needs to be able to operate effectively and efficiently, whilst recognising emerging desire to promote moral principle.

In the sections that follow we consider some key areas of regulation.

We examine financial services regulation, an area where the debate has moved on from principles or rules. We look back and contrast the current position with that of the Great Crash and go on to ask whether the debate over regulation is based on a rational approach, or reflects knee-jerk reactions.

We consider the Government's approach to, and priorities for, the regulation agenda.

We then tackle a number of key regulation reform areas including taxation, financial reporting, employment and corporate governance, and reflect on broader trends which are affecting us all.

Finally, we draw out the emerging themes to make our predictions for the future of regulation.

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FINANCIAL SERVICES: IF YOU WANT TO SEE THE FUTURE, LOOK TO THE PAST

MAN HAS EVOLVED BY LEARNING FROM HIS MISTAKES. WHILE LOOKING TO THE FUTURE OF FINANCIAL REGULATION, POLICY MAKERS, BUSINESSPEOPLE AND COMMENTATORS WILL HAVE ALREADY LOOKED TO THE PAST FOR GUIDANCE AND EXPERIENCE – NOTABLY THE WALL STREET CRASH.

F.D. Roosevelt had no doubt in his mind about the role regulation – or rather the lack of it – played in the 1929 crash and the ensuing depression: “We require... safeguards against a return of the evils of the old order – there must be a strict supervision of all banking and credits and investments.”

The reaction to 2008 echoes the 1929 reaction and in the next few years regulators will continue to be haunted by the ghosts of 1929.

In 1933, the Glass-Steagall Act prohibited investment bankers betting deposits on the buying and selling of tradable financial securities – in effect separating banking and investment banking. The Securities and Exchange Commission (SEC) created in 1934 was designed to address the free market anarchy that existed in the run-up to the Wall Street Crash – a commercial freedom used by sophisticated investors to further their own interests at the expense of those less knowledgeable.

GIVE A MAN ENOUGH ROPE...

It is ironic to note how many of the regulations and rules Roosevelt introduced in the 1930s were relaxed and repealed in the last decades of the 20th century – when they were apparently no longer needed.

The Big Bang in the City of London in 1986 was one of the most important moves towards deregulation. In the United States in 1987, the Glass-Steagall prohibitions against bank deposits being used for investment banking were relaxed, watered down further in 1996 and abolished altogether in 1999. The bull market leading up to the crash of 2008 ran in parallel with the fashion for deregulation sponsored by successive administrations, culminating in those led by George W. Bush and Gordon Brown.

Unsurprisingly, since 2008 re-regulation of financial institutions has become a popular cry. Basel III, the global framework of banking regulations, has sought to impose more stringent capital requirements on banks. In the US, the Dodd-Frank bill showed signs of reimposing some of the key provisions of Glass-Steagall, including the separation of 'utility' and 'casino' banking. Particular attention continues to be paid to the 'shadow banking' sector – with financial institutions and hedge funds on the perimeter, if not outside the regulatory framework – which grew so fast in the lead up to the 2008 crunch.

...OR TOO MUCH SLACK, OR THE WRONG TYPE OF ROPE...

But the truth is that, as 2008 turned into 2009 and then 2010, the world's economies have showed signs of pulling back from the brink. Calls to re-regulate have become less strident.

Share prices around the world rose sharply when it was announced that the provisions of Basel III required banks to more than triple their core tier one capital ratios from 2% to 7%, but the new rules won't be fully implemented until 2019.

Other calls for regulatory change have been getting quieter too. In the dark days after the Lehman Brothers collapse and the near failure of RBS, much heat was generated over weak corporate governance. Many claimed chief executives had been exposed as leaders of teams of over-paid senior managers, incentivised to deliver short-term gain at the expense of longer-term security. But, by the autumn of 2010 the governance re-regulation tone was changing.

In October, The Economist noted that banks that seemed to have survived the crisis the best, had actually paid least attention to accepted governance best practice. Santander had a familial culture and a powerful executive chairman, for example. On the other hand, some banks that suffered the most had appeared to exhibit good practice. Both Citigroup and Lehman seemingly had powerful outside directors on their boards – RBS's acquisition of ABN AMRO was approved by its shareholders.

Research by the University of Southern California on the 2007-8 performance of 296 financial institutions, now suggests that none of their usually accepted approaches to good governance were worth much come the storm. With such stories doing the rounds, a more prescriptive approach to governance is arguably unlikely to win much support.

...AND GENUINE CONTROL CAN BECOME DIFFICULT

The Congress' buffeted and bruised Dodd-Frank Act that actually hit the law books in the United States in July 2010 attracted more comment for what was left out than what was left in. Most stark was the omission of any separation between investment and retail banking.

Investment bankers are becoming far from separated from the rest of the banking sector. Investment banker Bob Diamond has recently become the new CEO of Barclays. He's not the only example.

Regulatory hawks may want to tighten up the industry, but they are also now nervous about scaring away big financial institutions altogether. It is less likely that major structural reform will now take place.

In 1933 the world was a much smaller place. The Glass-Steagall Act was never going to scare banks away from the US or the UK. But it is rumoured that HSBC, Standard Chartered and Barclays have all indicated they would leave London for easier, less fiercely regulated climes if the UK pushed ahead unilaterally with a Glass-Steagall equivalent. Unlike the 1930s, today's banks have global options.

We believe regulatory change in the financial services sector has a difficult course to steer to avoid rocking any more boats than is absolutely necessary. It will use the tools it needs whether they be principles – or rules – based, and it will be more tightly enforced (as no regulator can be seen to fail in its duty in this sector so soon after such a major crisis).

However, overleaf, we do question whether too much attention can be paid to reform itself and too little to the root causes of the crisis and the impact of potential reform.



We require... safeguards against a return of the evils of the old order – there must be a strict supervision of all banking and credits and investments. ”

F.D. ROOSEVELT

FINANCIAL SERVICES: A BLUEPRINT FOR THE DEBATE ON REFORM

by Tim Kirk, Head of Financial Services, BDO LLP

GIVEN THE SHOCK CAUSED BY THE FINANCIAL CRISIS AND THE PIVOTAL ROLE OF FINANCIAL SERVICES IN THE OVERALL SUCCESS OR FAILURE OF THE ECONOMY, IT IS, IN OUR VIEW, CRITICAL THAT THE DEBATE ON REGULATION FOCUSES ON THE ROOT CAUSES OF THE CRISIS, AND DOES NOT IGNORE THE WIDER CONSEQUENCES OF SILO-BASED REGULATORY INTERVENTIONS.

In directing any reform of financial services regulation, we believe the answers to five key questions should be sought:

WHAT WERE THE ROOT CAUSES OF THE FINANCIAL CRISIS?

Much of the debate around the causes of the financial crisis has focused on identifying a dominant single cause, the most prevailing views being that it was due mainly to either reckless bankers or feckless regulators. This form of analysis is unhelpful and we urge greater policy-maker attention be given to understanding the full causality of the crisis. While mistakes were clearly made, it is often overlooked that, in many cases, the actions taken by bankers that may have made the crisis worse, were rational in the light of wider macro-economic, interest rate, liquidity and regulatory conditions. Mark-to-market accounting rules, for example, are blamed by some for forcing banks mid-crisis to report large write-downs as asset prices fell in volatile

and illiquid markets. This made balance sheets appear worse than may have been a real reflection of value.

Understanding the root causes of the crisis, and identifying appropriate policy responses requires a full and critical assessment of the relationships between factors, including: global macro-economic policy and liquidity conditions, interest rates, asset price inflation, consumer behaviour, regulatory policy and bank behaviour. It is also important to accept that not everything that went wrong during the crisis caused the crisis. The crisis should not therefore be used a cover for regulation to drive out activity and behaviours that may not be popular, but neither are they detrimental to effective financial markets.

DO THE PROPOSED SOLUTIONS FIX THE PROBLEMS?

The test of whether proposed policy solutions are necessary or adequate is whether they will address the root causes of the

crisis. It is not clear whether some of the regulatory reform being proposed, or already undertaken, passes this test. This includes, for example, the justification for:

- The Hedge Fund Directive.
- Breaking up the FSA.
- Changes to banker remuneration.
- Any potential moves to separate investment banking from retail banking activities.

While there may be merits in each of these moves, it is not clear that they are solutions to the problems that caused the crisis, and they should not be offered as such. The risks of implementing these changes are high – not just on financial services, but on the wider UK economy. If financial services companies decide to relocate to less regulated jurisdictions they will be welcomed with open arms.

Likewise, although highly relevant in other spheres, in the financial services sector debate over whether we need rules, principles or outcome based regulation are of secondary importance: banks failed under each form of regulation, and any regulatory system will most likely have a mixture of each.

Mistakes were clearly made by financial services management – there are areas of regulation that need to be tightened, and we support moves to increase sanctions where regulation is flouted. But let's be clear about what problems are being fixed by which solutions.

WHAT IS THE ROLE OF FINANCIAL SERVICES REGULATION?

We fully support the need for regulation of financial markets. The risks posed to overall economic well-being by another financial crisis, and the asymmetry of the relationship between financial services companies and their customers, justify regulation. Nonetheless, an important debate is required concerning the ultimate role or objective for regulation, especially where regulators start to intervene in the decisions being taken by boards, the risks that should be borne by shareholders, or the freedom of consumers to make their own decisions. We worry when we hear talk of stopping excessive risk taking. We have yet to see an adequate definition of what acceptable risk is, and question where this leaves shareholders, boards and customers in the decision-making process. Should the regulator intervene to block an acquisition it deems an unacceptable risk? And if it does (or can, but does not) who is accountable for whatever outcome emerges? To protect consumers from excessive risk, should the regulator be allowed to decide how many multiples of salary an individual can borrow to finance their house purchase? Such an approach takes no real account of affordability or of how individuals and families may want to prioritise their expenditure.

HOW IS REGULATORY SUCCESS MEASURED?

We accept the need for regulators to maintain financial stability, but what level of bank failure are politicians, regulators and society prepared to accept? Zero-failure is not a valid goal in a market economy, but can politicians accept this? Does the implicit acceptance of 'too-big-to-fail' banks mean that a distorted market exists between big and small banks? Beyond financial stability, should the regulator's role be to promote competition and protect customers from unfairness, or should the regulator be an active advocate of extending consumer rights? This is a question that should be clearly answered by the new Financial Conduct Authority.

Without a clear understanding of the role of regulation and what success looks like, the risk is that we will see a constant ratcheting up of regulatory standards and intervention. Effective regulation will become a journey for regulators rather than a destination for the industry and its customers.

WHAT ARE THE WIDER CONSEQUENCES OF NEW REGULATION?

We accept that new regulation is unavoidable, but remain concerned that the wider consequences are not always considered. For us, the most significant area in this respect is around capital requirements. Regulators, politicians and society quite reasonably want to avoid future bank failures and one way to do this is to ensure that banks are adequately capitalised against future shocks. However, some commentators have considered that the capital requirements for Basel III may lead to:

- A risk of reduced availability of funding for corporate loans.
- Higher costs for these loans (banks will absorb some, but not all, of the cost of increased capital).
- Less competition in certain market sectors.
- Increased advantage to larger banks (due to the beneficial impact of better risk modelling and higher IT spend to support this).

Each of these results are arguably counter to the policy outcomes required to generate economic growth and promote competition. Likewise, concerns have been raised over the impact of Solvency II in the insurance sector on the asset classes insurers will hold, and on the price and availability of certain insurance products such as annuities.

We support moves to ensure financial services companies are adequately capitalised to withstand future shocks. However, just as we need a full analysis of the root causes of the financial crisis, we also need a full analysis of the impact of regulatory reform and evidence of alignment between regulatory reform and economic and social policy.

There is still much thinking to be done. Many aspects of new regulation are still in the drafting and consultation stage, so before more decisions are made, and further regulation is implemented, we would like to see an explicit consensus, based on a full understanding of the issues and their consequences. Through this, firms and consumers can have much more confidence in the value of regulation being implemented.

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WHAT IS THE UK GOVERNMENT'S POSITION ON REGULATION?

THE GOVERNMENT IS BY NATURE NON-INTERVENTIONIST – IN ITS “PRINCIPLES FOR ECONOMIC REGULATION – A CALL FOR EVIDENCE” (DEPARTMENT FOR BUSINESS, INNOVATION AND SKILLS – JANUARY 2011) IT'S CLEAR THAT IT SEES COMPETITIVE MARKETS AS A FACTOR THAT REDUCES THE NEED FOR FORMAL REGULATION. HOWEVER, IT DOES RECOGNISE THAT IN MANY INDUSTRIES COMPETITION IS CONSTRAINED.

Government's key priority is economic growth and it believes less, but more effective, regulation should be used as a means to protect and foster that growth.

It has put forward what it sees as key principles for economic regulation. Regulators should be accountable and efficient. Regulation should be predictable, coherent and adaptable to changing conditions. It should be focused on what really matters.

The Government's priority agenda items for reducing or improving regulation are taxation, employment and the environment.

This appears to signal a pragmatic approach. It doesn't suggest 'light touch' but is long on principles.

As the regulation debate evolves and matures, we are confident that decision-makers and regulators will understand that a regulatory environment based on principles is not an easy way out. The ACCA put it nicely in their 2009 report on the Future of Financial Regulation, whilst also pointing out a connection between the principles-based approach and simplicity:

“

It is essential that light-touch regulation, which has become so disparaged in the political debate, is not regarded as being synonymous with a principles-based approach. As the DFSA has pointed out, such an assumption is 'misleading'. ACCA believes that a principles-based system, sufficiently flexible to be relevant in a fast-paced business environment but with stronger emphasis on ethical codes and practices, should be the bedrock of the new approach.”

We concur, but would emphasise that a principles-based approach to regulation only works if those subject to it are prepared to take responsibility rather than look to the regulatory framework to do it for them. The regulated can't fall back on a rule book and say 'it's not covered'. It comes down to rights and wrongs – and perceptions of those will differ.

TAX POLICY AND THE BIG SOCIETY

THE CREDIT CRUNCH SHOOK THE FOUNDATIONS OF THE RELATIONSHIPS BETWEEN GOVERNMENTS, BUSINESSES AND INDIVIDUALS IN THE FIELD OF TAXATION POLICY. THE FINAL OUTCOME OF COMPLEX AND OFTEN CONFLICTING ASPECTS REMAINS UNKNOWN, BUT AFTERSHOCK THEMES CAN ALREADY BE DETECTED.

- Most governments in the developed world recognise the need to demonstrate to financial markets that they are capable of eliminating fiscal deficits within an acceptable timeframe. The result is broadly-based tax increases affecting both businesses and individuals.
These tax increases should continue to focus upon indirect taxation such as VAT and duties which generate fewer economic distortions and disincentives than increases in corporation tax and income tax. Of course, fiscal deficits are not entirely reduced by broadly based tax increases - instead they are eliminated by a balance between economic growth, fiscal policy and spending plans.
- The pendulum has swung. There is no longer general public acceptance of low profile but aggressively packaged artificial tax schemes. This has reinforced the determination of Governments (including the UK's Coalition Government) to negate the effect of such schemes.
We consider that a Big Society theme could emerge, whereby lower tax rates for both businesses and individuals become accepted by the general public – in the knowledge that scope for artificial tax avoidance has been curtailed.
- The UK Government has stated its commitment to simplifying taxation and reducing tax rates. This can only be achieved in the short term by removing tax reliefs and exemptions that do not endanger the UK as a favourable location for both listed international businesses and entrepreneurs.
The existing tax reliefs and exemptions supporting charities must be protected as they are clearly aligned with the Big Society theme.
- Providing an attractive location for increasingly mobile businesses, whilst continuing to collect sufficient taxation from the business sector, appears to be a priority for the UK Government's fiscal policies.
A tax competitive UK environment needs to override demands for accelerating coordination and alignment of tax policies on a European or global basis.

In summary, UK taxation needs to be carefully managed not to discourage the commercial aspirations and appetite of UK plc, its consumers and foreign investors. Economic recovery must be ensured so that the nation successfully eradicates its substantial fiscal deficit.

But, the Government also has an opportunity in the course of this parliament to modernise the excessively complex UK tax system, while reducing tax rates and aligning the tax system with its broader objectives.

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EMPLOYMENT: JUST THE JOB

EMPLOYERS DON'T NEED MORE REGULATION, WE NEED BETTER REGULATION.

Last July, support for regulatory reform came from a surprising quarter.

TUC general secretary Brendan Barber, speaking at the TUC/ British Chambers of Commerce debate 'Is Deregulation Dead?' claimed: "We simply cannot afford to sleepwalk back to the recent past. What we need now is not less regulation, but smarter regulation."

While for the TUC smarter regulation may have little to do with less regulation, for many, it has a lot to do with simpler regulation – and with simplicity, perhaps less can be more. We're hopeful that in the near future attempts to make regulation bite will coincide with attempts to simplify.

The summer 2010 creation of the Reducing Regulation Committee (RRC), chaired by Vince Cable, Secretary of State for Business, surely gives us hope that the future will herald simpler as well as fewer regulations.

AN EMPLOYMENT MINEFIELD

Unsurprisingly, Brendan Barber did point out that Britain ranked third lowest of the 26 OECD countries with regard to employment protection, with only American and Canadian workers having fewer rights.

Employment law is a minefield for many businesses, particularly small employers. Faced with an increasing mountain of regulation many employers are inclined to give up. Few management teams today are happy to comment authoritatively on whether their businesses comply with the detailed prescriptions of employment legislation. Many only face up to the detail when an employee sues for constructive dismissal on the basis of a sin the company never knew it had committed in the first place.

The new Equality Act 2010 generated a storm of comment when introduced in October. Newspaper comment was more colourful than communicative. Stories circulated about the banning of office banter, and the heavy hand of Europe weighing down on UK employers. But, even the Government accepts that the cost to UK plc of simply understanding the new legislation will amount to nearly £190m.



The Government must make it easier for small and medium-sized firms to take on staff – by stripping away burdensome employment regulation. ”

DR ADAM MARSHALL, DIRECTOR OF POLICY,
BRITISH CHAMBERS OF COMMERCE

With implications for pay policy, internal communications, harassment and employee rights, most employers will need to update their employment contracts and run courses for managers and staff in order to stand the best chance of complying. To date we see few of our clients hurrying to do either.

CLEARING THE MINEFIELD

We believe that in the next few years the tide will begin to turn against enthusiasm for employment regulation.

British Chambers of Commerce director of policy Dr Adam Marshall, says: "The Government must make it easier for small and medium-sized firms to take on staff – by stripping away burdensome employment regulation." His words are echoed by many. Certainly the need for economic growth in the UK private sector requires it.

ENFORCEMENT: HAS IT WORKED?

BLIND, TOOTHLESS TIGERS?

No governance regime can hope to work effectively with regulators without good eyes to see transgression, or real teeth to tackle the offenders.

After the Madoff fraud was exposed Paul Kanjorski, Chairman of a US Congressional Committee, claimed that the US regulatory system had failed and should be completely rebuilt. But, red flags had been waved. Over the years, independent commentators had raised suspicions about Madoff's business. The SEC itself reviewed Madoff's businesses eight times in 16 years and interviewed Madoff twice, but found nothing.

The enquiry into Sir Allen Stanford's businesses is also shedding light on the role of regulators and their enforcement regimes. Stanford's businesses had attracted attention from the regulators for years before they collapsed, accompanied by the usual crowd of red faces and forest of finger pointing.

The Financial Industry Regulatory Authority, the SEC's first line of defence when overseeing broker-dealers in the US, regularly conducted inspections of Stanford Group Company. From April 2007 they even issued fines of about \$70,000. One related to Stanford's failure to provide 'fair and balanced' treatment of the risks and potential benefits of some of the investments.

Financial analyst Alex Dalmady said it took him just 20 minutes to create the analysis spreadsheet that led him to claim the company was a fraud. But, it was the company collapse that stopped the business, not the regulators, despite their visits and fines.

In many spheres of economic activity the regulatory environment is driven by the threat of punishment for the guilty. Too often the punishment threat is far from threatening.

But, whilst wielding a bigger stick may deter transgressors, clarity and simplicity should be increased to help prevent unwitting transgression, and to make the regulatory environment more manageable for normal non-expert business folk.

SIMPLE AND EFFECTIVE

A regulatory environment that aims for simplicity is more likely to work than one that sacrifices simplicity for comprehensiveness.

Arguably, this approach is already being translated into policy and practice. The Government's Big Society programme aims to empower local people and communities and take power away from central governing politicians. If successful, this should foster a climate in which red-tape is cut back. The RRC with its bonfire of unwanted regulation is a step in the same direction. Ineffective regulators can expect to be swept away.

But in addition to simplicity, the regulators need to have teeth. We anticipate regulatory enforcement and the effectiveness of sanctions will increase over the next few years. Both will help communicate to the regulated what really matters and why it will be worth keeping in line.

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COMPLEXITY AND A HOTCHPOTCH OF FINANCIAL REPORTING REGULATION

FINANCIAL REPORTING IN THE UK HAS LONG BEEN REGULATED THROUGH THE COMPANIES ACTS AND THEIR INTERACTION WITH ACCOUNTING STANDARDS – AND FOCUSED ALMOST EXCLUSIVELY ON ANNUAL FINANCIAL STATEMENTS. BUT THE WORLD HAS CHANGED.

There was a time when the printed annual report was the main source of information about companies for both existing and potential investors. Now, company communications have become more sophisticated and frequent, not least through heightened public relations activity.

COMPLEX AND CONFUSING

But, financial reporting for public companies has also become much more complex. Annual reports commonly stretch to 200 pages and the regulations imposed by International Financial Reporting Standards (IFRS) can seem difficult to interpret, even for experienced business people. Valuation with reference to fair value can produce volatile results and large ranges in value. Many assets, such as brands or customer lists, do not have ready markets from which value can be reliably determined.

Analysts following the largest companies may find today's detailed annual report data useful, but it is unlikely that reports from smaller public companies gain an avid readership. However, they still have to produce the same level of detail. Failure to comply opens them to censure from the Financial Reporting Review Panel, which enforces the quality of reporting.

The over-complexity of accounting has also led to companies establishing their own measures, not necessarily adapted from the recognised formal frameworks.

Narrative reporting by companies is also being increasingly criticised. The absence of real discussion of risks and opportunities, or of board judgements, is a matter of some acute concern.

DIFFERING STANDARDS

Reporting requirements are a hotchpotch. IFRS is different to UK GAAP standards, which in turn are being replaced by the Financial Reporting Standard for Medium-Sized Enterprises. This standard, intended to replace UK GAAP for all but the smallest companies, is neither UK GAAP nor is it IFRS.

Financial reporting regulators have got themselves into a mess.

- The UK has a public company reporting framework that is theoretically sound, but which has become cluttered and over complex.
- A new private company framework that for most companies is different from the framework on which the rest of the world is converging.
- A framework for the very smallest companies that remains broadly UK GAAP.

The gold standard must be one set of global standards which are capable of being understood, whilst giving comparability between entities.

REVIEW REPORTING...OR RISK IRRELEVANCE

We believe the accounting regulators – the accounting standards bodies nationally and internationally – will go back to the users of accounts and ask them what they really want. Stakeholders might call for a degree of simplicity in financial reporting of the raw numbers, bolstered by adequate narrative reporting of where the company actually is, what its risks are, and how its future looks.

What is certain is that unless investors speak out, financial reporting will become more complex. It will become more divorced from everyday financial decision-making of any business, and less relevant for the entire business community.

CORPORATE GOVERNANCE – MORE COMPLIANCE AND EXPLANATION

CORPORATE GOVERNANCE WILL CONTINUE TO EVOLVE.

We believe the focus on improving governance will continue, and that it will begin to affect the expectations of private as well as public companies.

A new Corporate Governance Code was issued in June 2010 for listed companies. It retained the 'comply or explain' principle but increased the onus on non-executive directors. They are now required to give 'sufficient' time to their responsibilities. There is also an obvious and overt direction for them to challenge corporate strategy. Boards must now also be formally externally assessed on a regular basis.

New guidance has been published for smaller public companies by the Quoted Company Alliance and for private companies by the Institute of Directors.

Publication of the Stewardship Code for institutional investors looks set to strengthen communication between companies and investors. This is part of a continuing trend attempting to involve investors more in their investees' affairs. An example of this trend was provided in January this year when the FRC proposed that investors discuss auditor appointments with principal shareholders.

TAKING ON THE RISKS

The main spotlight is moving on to risk and its management by boards. Most likely, there will be a refreshment of the Turnbull Guidance on risk and internal controls. This will address issues such as:

- Who owns which risks?
- Where does operational management stop and the board responsibility begin?
- What assurance does the board need?
- How does the board report on risk?

Naturally, the answers to these questions will vary from company to company.

Boards will need to be sure that they have considered what is right for their business and be able to validate their deliberations and decisions. This will enable them to respond adequately to new regulation.

BUT ON THE HORIZON...

The EU is expected to issue a Green Paper in April 2011 on corporate governance. No one is sure what it will contain as yet – but we should expect less enthusiasm for the 'comply or explain' concept and there may be some desire for statutory enforcement. These would be backward steps in our view.



AUDIT UNDER THE MICROSCOPE

IT IS RARE THAT AUDIT SUSTAINS GENUINE PUBLIC INTEREST FOR LONG, BUT THERE IS CURRENTLY AN UNPRECEDENTED INTEREST IN AUDITING FROM REGULATORS, GOVERNMENT AND THE PRESS.

It is focused on two areas:

- The purpose and future of audit.
- The degree of competition in the audit industry.

Major enquiries into these areas are being undertaken in the UK's House of Lords and also in the EU.

THE PURPOSE AND FUTURE OF AUDIT

The world of auditing has not been immune from the fallout following the credit crunch.

The Financial Services Authority (FSA) believes that something must be wrong when banks received clean audit reports and failed only months later. The FSA and the Financial Reporting Council (FRC) consider that auditors showed a lack of 'professional scepticism' in their work. And banking is not the only business sector being queried.

An outdated model

We believe that the real problem is that the established and long unchanged audit model is outdated. Audit is a statutory requirement for most businesses but it is also very much a 'one size fits all' tool. It applies to small businesses in the same way as it does to global financial businesses with their enormous complexities.

Whilst the audit is a statutorily required service, with the sole intention of reporting to shareholders, other users have naturally taken reassurance from it (whether entitled to or not). We suspect the FSA assumed auditors of banks were working beyond their statutory duties, to assess the prospective financial health and the effectiveness of their client's business model.

Other user groups – such as HMRC, lenders, suppliers and the wider community – may also have looked to audit to give them reassurance. It is entirely legitimate for users of financial information to seek assurance about their particular needs. However audit doesn't necessarily provide that assurance.

Shape assurance to modern requirements

We believe it is now time to ask all users what they actually want in terms of financial assurance, and to shape the assurance given by audit firms to those needs.

Some of the answer may be statutory audit, but some of it may also be the provision of specific assurance relating to users' needs and contractually agreed with a company.

At the same time, we believe too many companies are subject to a statutory audit.

Why should an owner-manager have an audit unless he or she wants one?

Their bank may want reassurance about security values – but that's a different, lesser exercise. They may want specific work done – but again, why a statutory audit?

This more focused approach to assurance will lead to more being required for the largest companies and less for the smaller – but the end result will be more relevant to users and their needs.



We believe that the real problem is that the established and long unchanged audit model is outdated.

COMPETITION WITHIN AUDIT

Merger mania in the 1980s caused the largest companies to get bigger in scale and smaller in number. In the accounting industry, firms felt the need to demonstrate their own scale and global reach to attract the largest clients.

The merger that created PwC, and the collapse of Andersen, left four firms whose size set them apart from the competition. In the UK, these four now audit all but one of the FTSE100 companies.

As long as they do what they do well (and we believe they do in terms of audit quality) what could be wrong with that? Well, we believe that it affects price and restricts choice.

Pricing

Many have suggested that in the audit market price competition is fierce. It may be when there is a tender, but FTSE companies change auditors on average every 50 years. It is therefore disingenuous to apply the rare change of an auditor to audit pricing more generally. Studies, such as the Oxera Report in 2006, have made clear the inflationary effect of lack of competition on audit pricing.

Quality

There is no ground for any argument over quality. The published results of the FRC's Audit Inspection Unit show that the six largest firms have equivalent quality. However we do believe that the concept of audit quality needs to be examined in a broader and not purely in a technical sense, to ensure corporates and investors do receive real value.

Choice

The real issue is one of choice. With governance encouraging the appointment of separate advisers to deal with issues such as taxation or corporate finance, there is often only one or two of the largest firms that are available as audit suppliers. Market mechanisms have not dealt with this unsatisfactory situation effectively – as a consequence of both corporate inertia and familiarity with the very largest firms.

And if one of these large firms were to fail, the consequences for capital markets could be grave in terms of the ability of the audit market to supply service – not to mention the consequent potential loss of faith in public reporting.

Action

The EU Green Paper on audit, published in late 2010, has mooted a number of ways of stimulating competition, including regulatory intervention.

This is a market that needs competition and we support the EU in exploring all the possibilities. Investors want more competition and the market risk demands it. Doing nothing is not an option.



THE WIDER ENVIRONMENT: BRAVE NEW WORLD

THE WORLD IS UNDOUBTEDLY A MORE COMPLICATED PLACE THAN THE LAST TIME THE GLOBAL ECONOMY WAS IN CRISIS, AND IT'S NOT SET TO REVERSE. GLOBALISATION, TECHNOLOGY AND CHANGING ATTITUDES WILL INCREASINGLY AFFECT OUR VIEWS OF REGULATION.

Globalisation of business has brought increased complication for regulatory regimes.

Even if international trade suffers from recessionary aftershocks, the world will be left a more interconnected place than it was before, with businesses sitting across international borders and economic fault lines. Even small firms find themselves at the centre of international supply chains of a complexity impossible to imagine just one recession ago.

Our first Transitions report considered the new world order – which has significant implications for the regulatory environment. Banks now have the option to choose which country's regulatory environment suits them best. Big companies are more prepared to relocate globally depending on prevailing local rates of tax.

GLOBAL INFLUENCES

In a world in which China and India have more influence, the approach of their regulators needs to be acknowledged. Policymakers are increasingly sensitive to regulatory arbitrage as multi-national companies look to play one regulatory framework off against another. New economies have another set of tools in the bag.

Regulatory arbitrage has existed closer to home. Within the EU, businesses have suspected that different national applications of EU regulations have led to countries taking unfair advantage. Announcements from Vince Cable's office in December 2010 suggest serious attempts on behalf of the British authorities to minimise this in future.

Key to the new measures will be the principle of copying out European directive text directly into UK law. The copy out principle should ensure that British interpretations of European law will not unfairly restrict British companies.

We predict that regulatory environments around the world will become increasingly aligned. But it will take time.

THE ADVANCE OF TECHNOLOGY

International complexities have been exacerbated by technological advances. Technology has not just transformed communication, it has transformed relations between people.

Technology has brought people closer together, yet at the same time perhaps has also driven them further apart.

In many lines of business, particularly in the City, decisions are no longer taken by individuals at all, but by computers - assessing the odds, reacting to pre-programmed trigger points and then exercising their algorithms. In such circumstances the regulatory environment is hard-pressed to keep up.

Yet we should not underestimate the importance of face-to-face communication in governance, and the role communication plays in challenge, debate, check and balance.

The regulators are going to have to work hard to catch up with the Facebook generation – the internet is a hard place to regulate but we expect them to make the attempt. As yet we don't know how this will be achieved, but it will require national regulators to work together beyond their usual boundaries.

On the upside, the communication of regulation has been vastly broadened and enabled by technology, and we anticipate further improvements in this area.

BLURRING OF THE COMMERCIAL WORLD

Further regulatory complexity has come from the breakdown and blurring of distinctions between sectors and segments of the commercial world. Banks now design and sell 'products', for example. Car manufacturers sell finance packages. Supermarkets promote their professional services at the checkout.

Governance is always easier when organisations and individuals keep to their allotted places in the scheme of things and respect the boundaries that regulators have imagined for them. For regulators the world is now less clear and less tidy. The pace of change and disintegration of the old order increasingly leaves regulators struggling to keep up.

ATTITUDES ARE CHANGING

Importantly too, the relation of individuals to authority and to their organisations is changing.

As long as economic uncertainty lasts, issues will increasingly become politicized. But, other than for minorities at the fringes of economic life, we don't believe that this is any indication of a shift between left and right. Rather it reflects a changing paradigm.

People will become more concerned and will choose to take more responsibility for their future, whilst occupying the centre ground. The Government's Big Society vision is in line with the spirit of the times.

Longer-term trends among individuals may equally concern the regulatory environment.

- Staff are becoming less respectful of their superiors. They have less patience with hierarchies.
- Younger staff do not engage with the printed word as much as their older colleagues.
- Organisational cultures and structures are reflecting these changes – and appear to be popular and successful. Creative yet often chaotic cultures operating within fluid, flat, flexible corporate structures are not ideal candidates for regulation regimes.
- In the interests of efficiency, controls and roles that do not add value to the process or the quality of the decision ('redundancies', as the theorists call them) are being stripped out.
- There is an increased expectation of transparency within and between organisations, from individuals.

These changing sociological qualities and characteristics present wide-ranging and considerable challenges to those responsible for designing and policing the regulatory framework.

These trends suggest long term solutions will only succeed if based on principles rather than rules, on simplicity rather than complexity, on personal responsibility rather than compliance.



OUR PREDICTIONS AND CONCLUSIONS

WE BELIEVE FUTURE REGULATION WILL BE SIMPLER, CLEARER AND BASED ON A PRINCIPLES LED APPROACH.

- Across every sphere of regulation, simplicity should be the chief objective and a principles based approach will be key to achieving this in most spheres of regulation. We believe failure to follow this path will impede businesses' focus on, and opportunities for, growth.
- The financial services industry has a more pressing need for regulation reform than other sectors. A wide range of tools are available to regulators and should be used swiftly and proportionately when financial services firms transgress clearly defined rules and principles. Regulation in this sector will need to be tight for some years.
- We believe financial services regulatory reform is in danger of starting from the wrong place. We need to focus on the root causes of the recent financial crisis, whether solutions fix the inherent problems and decide what is actually needed from regulation.
- Calls for structural reform will continue, but currently threatened structural regulation of banking activity will diminish.
- There will be step-by-step moves towards a much simplified tax system. Attention will focus on lower direct tax rates rather than exemptions and allowances. This will encourage investment by corporates in those areas that make economic sense for their business, rather than those which offer the best fiscal incentive – making the UK a more competitive place to do business.
- Employment regulation will diminish, as the drive for growth encourages lower barriers to employment.



- Financial reporting and auditing are on the verge of some fundamental rethinking. Audit has become outmoded and often delivers below user expectations. It must change or become discredited. Financial reporting has become overly complex and often fails to deliver a clear message about a company's fortunes. Failure to address both of these concerns will affect confidence in the information provided to capital markets, and will erode value over the longer term.
- Regulators will be expected to enforce regulation, or lose their mandate to regulate. If regulators are not clearly accountable for the desired outcomes of regulation, it is likely that it will tend not to focus on what really matters. This could potentially lead to increased compliance costs and would act as a brake on growth.
- Corporate governance will grow in importance. The emphasis will move to the management and disclosure of major risks. There will be an increasing work load for audit committees, who will not necessarily be ready (or remunerated) for extra responsibilities. There will be a requirement to spend more on financially astute non-executives. We are also concerned that 'risk' might become something of an industry – leading to more boilerplate, rather than more thought being given to the substance of the business.
- Personal responsibility and other intangible, extra-regulatory forces will play an increasing role in shaping the regulatory environment.
- There will be increasing convergence in regulatory environments between countries, leaving less room for regulatory arbitrage, but this will take time.

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