



**FINANCIAL REPORTING COUNCIL**

**LEVY PROPOSALS 2005/06**

**MARCH 2005**

## **Introduction**

This paper explains the Financial Reporting Council's (FRC) proposals for its levy on companies for 2005/06. The proposals are to:

- extend the scope of the levy to non-UK companies whose equity shares have their primary listing on a UK market;
- proceed with the previously announced move from a flat rate levy to one based on market capitalisation; and
- to extend the levy from listed companies to those UK companies whose shares are publicly traded on markets other than the London Stock Exchange's (LSE) main market.

The paper seeks responses to six questions arising from the FRC's proposals. Comments on the proposals are invited by 16 May 2005.

## **Background**

The FRC is the United Kingdom's independent regulator for corporate reporting and governance. It was established in 1990. Following reviews of the existing regime which were undertaken in 2002, the Government significantly expanded the scope of its responsibilities and powers from 1 April 2004.

The FRC's aim is to promote confidence in corporate reporting and governance.

The FRC believes in wealth creation. It believes that its role in promoting confidence in corporate reporting and governance can make the creation of wealth more likely.

In pursuit of its aim the FRC's five key objectives are to promote:

- high quality corporate reporting
- high quality auditing
- high standards of corporate governance
- the integrity, competence and transparency of the accountancy profession
- its effectiveness as a unified independent regulator

The functions which it exercises in pursuit of its objectives can be summarised as follows:

- setting, monitoring and enforcing accounting and auditing standards
- statutory oversight and regulation of auditors
- operating an independent investigation and discipline scheme for public interest cases
- overseeing the regulatory activities of the professional accountancy bodies
- promoting high standards of corporate governance

Its functions are exercised by its operating bodies (the Accounting Standards Board (ASB), the Auditing Practices Board (APB), the Professional Oversight Board for Accountancy (POBA), the Financial Reporting Review Panel (FRRP) and the Accountancy Investigation and Discipline Board (AIDB)) and by its Council.

Some of its functions are supported by statutory powers, or by statutory obligations on other parties to meet its requirements. Some of its functions have no statutory backing but derive their authority from widespread support from its stakeholders.

Most of the FRC's activities affect all companies in the UK which are required to prepare accounts under the Companies Act, although some activities (primarily the work on corporate governance and the Operating & Financial Review) apply only to listed companies. As a consequence of the Companies (Audit, Investigations and Community Enterprise) Act 2004, with effect from April 2005 non-UK companies whose equity shares have their primary listing in the UK will come within the scope of the FRC's activities.

Further information on the FRC's approach to its work and its governance and accountability are set out in its Regulatory Strategy which is available on its website ([http://www.frc.org.uk/images/uploaded/documents/RegulatoryStrategy\(final\).pdf](http://www.frc.org.uk/images/uploaded/documents/RegulatoryStrategy(final).pdf)).

## **The FRC's previous funding arrangements**

For many years the FRC's core operating costs have been funded in equal proportions by the accountancy profession, the business community and the government. This is known as the tri-partite funding arrangement. Certain other costs (eg of audit inspection, and the investigation and discipline of accountants) are funded entirely by the accountancy profession.

The FRC is non-profit making organisation. Its intention in raising funds is merely to recover its costs and to ensure that it has an appropriate level of reserves.

The business community's share of the core operating costs is raised by means of a levy on UK companies listed on the LSE's main market, which is collected on the FRC's behalf by the Financial Services Authority (FSA) at the same time as the FSA invoices listed companies for their Listing Fees. This arrangement means that the incremental cost of collecting the FRC levy is very low. The FRC, not the FSA, is accountable for the amount of the levy and the amount of the FRC levy is shown separately on the invoices.

For a number of years the average cost per listed company was small (of the order of £500). Given that the amounts were small, all companies were simply charged at a single flat rate.

The costs increased significantly in 2004/05 as a result of the increases in the FRC's responsibilities with the result that to have continued with a flat rate levy would have been unfair to small listed companies. The FRC announced in June 2004 its view that it would be fairer in the long-term if the levy was to vary according to the market value of each company. The FSA has also made a similar decision with regard to its Listing Fees. Both organisations announced their intentions to introduce market capitalisation based levies with effect from 1 April 2005.

As an interim measure the FRC introduced for 2004/05 a two-tier levy with companies in the FT-SE 350 paying a higher amount (£4,250) than other listed companies (£1,600).

The FRC currently raises its levy on a non-statutory basis based on the widespread support in the business, investor and professional communities for its work. There is now provision in the Companies Acts for the Department of Trade & Industry (DTI) to make the FRC's levy a statutory charge. It is not the desire of either the FRC or the DTI to invoke those powers as the non-statutory arrangements have worked successfully and flexibly since 1990. However, should the non-statutory arrangements not prove to be sustainable then use of the statutory powers would need to be considered.

## **The FRC's budget for 2005/06**

The FRC is very conscious that 2005 is a year of major change for many companies, their shareholders and auditors. In these circumstances the FRC is not proposing any major new policy initiatives for 2005/06 but is focusing on finalising those which are already underway. It also plans to make further progress in implementing the additional responsibilities which it was given by the Government.

Its budget for core operating costs in 2005/06 (£10.3m) is flat in cash terms compared to its original budget for 2004/05, which it published in November 2003. At the start of 2004/05 it concluded that, as a result of a phased implementation of its new responsibilities, it could operate to a lower financial target of £9.3m.

The business community's share of the core operating costs for 2005/06 is £3.4m.

Further details of the FRC's priorities for 2005/06 and the costs which it expects to incur are set out in its Plan & Budget which can be found on its website ([http://www.frc.org.uk/images/uploaded/documents/Planandbudget\(final\).pdf](http://www.frc.org.uk/images/uploaded/documents/Planandbudget(final).pdf)).

## **Non-UK companies with a primary equity listing in the UK**

In previous years the FRC levy was payable only by UK companies. With effect from April 2005 non-UK companies whose equity shares have their primary listing in the UK will come within the scope of most of the FRC's activities. These companies include those whose shares are listed in the form of securitised derivatives and depositary receipts. This change in the FRC's scope affects approximately 130 companies.

In previous years these non-UK companies have been liable to pay the FSA's annual listing fee and we believe that it is appropriate that from 2005/06 they should also make a contribution to the FRC's costs. In recognition that not all of its activities affect non-UK companies, the FRC proposes to apply a discount to the levy payable by non-UK companies. It is not practicable to specify the precise proportion of the FRC's activities which apply to non-UK companies, as their circumstances vary, but the FRC believes that a discount of 25% is reasonable.

This proposal is not intended to raise more funds for the FRC (its spending plans for 2005/06 will not differ from those published in the Plan & Budget); the intention is to ensure a fairer distribution of the costs between companies within the FRC's scope.

## **Consultation question**

**Q1 Do you agree that non-UK companies should be brought within the scope of the FRC levy?**

## **The introduction of a market capitalisation based levy**

The FRC proposes to implement its previously announced decision to move to a market capitalisation based levy in 2005/06. The key features of the new levy are:

- a minimum levy payable by all firms
- further amounts payable by firms above a certain market capitalisation, with the rate per £m of market capitalisation declining in five levy size bands.

The minimum levy and the rates for larger companies will be calculated based on the number of UK listed companies and their market capitalisations as at 30 November 2004. This date is the one on which the LSE and the FSA base their fees; adopting this date avoids the need for additional data collection and inconsistency with their fee calculations.

There is no market capitalisation data readily available for those companies whose securities are traded in the form of securitised derivatives and depositary receipts. It is proposed that they will pay the minimum levy.

The amounts payable by companies of any given size will be determined by the decisions on:

- the amount of the minimum levy
- the size limit for companies to which only the minimum levy applies
- the speed at which the rates payable by larger companies decline

In order to allow companies to estimate the likely amount of the levy the FRC has calculated provisional rates as follows:

Band	Market capitalisation (£m)	Levy rate per £m of market capitalisation (£)*
1	Up to 100	Min levy £700
2	100 - 250	5.50
3	250 - 1,000	4.25
4	1,000 - 5,000	3.50
5	5,000 - 25,000	0.075
6	> 25,000	0.02

**\* non-UK companies will receive a discount of 25%**

The following example illustrates the way in which the levy will be calculated for a UK company with a value of £350m:

Market capitalisation band (£m)	Levy calculation	Levy payable (£)
Up to 100	Min levy	700
100 - 250	150 x 5.50	825
250 - 1,000	100 x 4.25	425
		<b>Total 1,950</b>

The proposed market capitalisation bands are identical to those proposed by the FSA for its UKLA fees for 2005/06, which will reduce the costs of collecting the FRC levy. The proposed minimum levy and the rates in the other bands differ from those proposed by the FSA because the number of companies which are liable to pay the FRC levy differs from those who pay the UKLA fees and the FRC's costs are also different.

If the two-tier levy used in 2004/05 was to be used in 2005/06 then the levies needed to raise £3.4m would have been approximately £5,000 for the FT-SE 350 and £1,650 for other listed companies.

The effect of the market capitalisation levy is that around 1,100 of the 1,350 companies who pay the FRC levy will pay a lower fee than they would do under the two-tier levy. The maximum fee payable by the largest company is estimated to be around £22,000. Non-UK companies would contribute approximately 5% of the business community levy.

These provisional rates are based on the inclusion of non-UK companies (discussed above) but take no account of the proposal (discussed below) to extend the FRC levy to companies which are publicly traded on markets other than the LSE's main market.

### **Consultation questions**

- Q2 Is the proposed amount of the minimum fee reasonable?**
- Q3 Has the proposed level up to which only the minimum fee is payable been set at a reasonable level?**
- Q4 Does the reducing marginal cost per £m of market capitalisation produce a reasonable levy for larger companies?**

### **The extension of the levy to other publicly traded companies**

When the FRC was first established the LSE's main market was the only forum for public trading in companies' shares. The position is now different with AIM and OFEX now trading shares in significant numbers and values of companies. The competitive landscape for exchanges continues to evolve and it is possible that other markets may emerge in future.

AIM and OFEX were both created in 1995. They were created to offer all the benefits of being traded on a public market but within a regulatory environment designed specifically for smaller companies. Although the regulatory regimes for AIM and OFEX are lighter-touch than that for the main market, companies traded on AIM and OFEX are subject to disciplines associated with being publicly traded and are subject to public scrutiny of their performance.

Specifically in relation to the FRC's responsibilities, AIM and OFEX companies and their auditors are subject to the accounting and auditing standards which the FRC sets, monitors and enforces. The only significant aspect of the FRC's work which does not apply to AIM and OFEX companies is its work on the Operating & Financial Review and the Combined Code on Corporate Governance (which accounts for less than 5% of the FRC's costs).

There are differences between the tax and securities markets regulatory regimes under which AIM and OFEX operate but the FRC believes that the two markets are substantially similar as regards its activities.

There are now over 1,000 companies traded on AIM and OFEX which have a combined market capitalisation of around £30bn. AIM has experienced particularly significant growth in the last two years. During this period the number of companies on the main market has declined.

The point has now been reached where the amount of the FRC's costs which can be fairly attributed to AIM and OFEX is not de-minimis, but the business community's share of those costs is being met by a declining number of listed companies. There is, therefore, a degree of cross-subsidisation between, on the one hand, the main market and, on the other, AIM and OFEX which the FRC believes is no longer defensible.

Looking to the future the position would become worse were the recent trends of numbers of companies on the two markets to continue.

For these reasons the FRC believes that the time is right to extend its levy to UK companies traded on AIM and OFEX. The extension of the levy to AIM and OFEX is not intended to generate additional income for the FRC: the FRC will continue to operate within its published budgetary limits. The purpose is to ensure a fairer distribution of those costs across the business community.

The FRC also recognises that one of the features of the AIM and OFEX markets is that they involve lower regulatory costs than the main market. The FRC has taken this into account in making its proposals for the way in which its levy would be extended to AIM and OFEX companies.

The FRC believes that the market capitalisation basis for calculating the levy for listed companies should, in principle, also apply to AIM and OFEX companies. The proposed market capitalisation bands would mean that the vast majority of AIM and OFEX companies would pay only the minimum levy. This would mean that, as a starting point, two companies of equivalent size on the main and AIM and OFEX markets would make similar contributions to the FRC's costs.

However, the FRC also acknowledges that there are valid grounds for assigning a lower weighting to AIM and OFEX companies. Firstly, as explained earlier in this paper, some of the FRC's activities do not apply to AIM and OFEX companies. Secondly, AIM and OFEX companies collectively have a lower public profile than do companies on the main market and that as a result they would command a lower risk weighting in the FRC's activities (for example in the selection of company financial statements to be reviewed by the Financial Reporting Review Panel (FRRP)).

For these reasons the FRC proposes that AIM and OFEX companies would receive a discount of 25% on their levy compared to companies on the main market. This discount would be kept under review in future in the light of the relative development of the two markets and the balance of the FRC's activities.

If AIM and OFEX companies were to be included within the levy then the FRC would be able to set the minimum levy and rates for larger companies which would be lower than would otherwise be the case. The final rates will be calculated based on the number of eligible listed, AIM and OFEX companies and their market capitalisations as at 30 November 2004.

In order to allow companies to estimate the likely amount of the levy if it were to be extended to AIM and OFEX companies the FRC has calculated provisional rates as follows:

Band	Market capitalisation (£m)	Levy rate per £m of market capitalisation (£)*
1	Up to 100	Min levy 550
2	100 - 250	5.00
3	250 - 1,000	4.00
4	1,000 - 5,000	3.25
5	5,000 - 25,000	0.075
6	> 25,000	0.02

**\* AIM, OFEX and non-UK listed companies will receive a 25% discount**

On the basis of these provisional rates AIM and OFEX companies would in aggregate contribute approximately 10% of the business community levy. Most AIM and OFEX companies will pay only £412.

The effect of including AIM and OFEX companies in the levy is that the number of companies on the main market who will pay a lower fee than they would do under the two-tier levy is increased from 1,100 to 1,200. The maximum fee payable by the largest company is estimated to fall from around £22,000 to around £21,000.

One of the considerations associated with including AIM and OFEX companies in the levy is the need to identify an invoicing and collection mechanism which will keep the incremental cost of collecting the levy as low as possible. As explained on page 2, the FRC has a collaborative arrangement with the FSA for collection of the levy from listed companies which keeps the incremental costs very low. The FRC believes that it is possible to devise comparably low cost arrangements in respect of AIM and OFEX companies but further work needs to be done on this matter.

The FRC believes that these proposals are fair and reasonable and that the levy payable by AIM and OFEX companies is sufficiently small that it will have no impact on companies' views as to the benefits of being traded on AIM and OFEX.

### **Consultation questions**

- Q5 Is the principle that the FRC levy should be extended to companies traded on AIM and OFEX appropriate? Are there differences between AIM and OFEX which are relevant to the applicability of the FRC levy?**
- Q6 Is the proposed discount level for AIM and OFEX companies reasonable? Are there differences between AIM and OFEX which are relevant to the level of the discount?**

## Contact details

Comments on the Levy Proposals should be sent to:

The Planning Manager  
Financial Reporting Council  
5th Floor, Aldwych House  
71-91 Aldwych  
London  
WC2B 4HN

e-mail: [levy@frc.org.uk](mailto:levy@frc.org.uk)

For general information about the work of the FRC, please see our website at: [www.frc.org.uk](http://www.frc.org.uk)

For any further enquiries, please contact: [enquiries@frc.org.uk](mailto:enquiries@frc.org.uk)

or write to us at:

Enquiries  
Financial Reporting Council  
5th Floor, Aldwych House  
71-91 Aldwych  
London  
WC2B 4HN

Telephone: 020 7492 2300

Fax: 020 7492 2301