ICAEW REPRESENTATION
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Enhancing Confidence in Audit: The Financial Reporting Council's Audit Enforcement Procedure

ICAEW welcomes the opportunity to comment on the FRC's proposed new Audit Enforcement Procedure published in March 2016. This response was submitted on 6 May 2016 by ICAEW.

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Section 2: Outline of the Proposed Procedure

1. **Do you consider the proposed Procedure adequately reflects the ARD requirements?**

2. This is a difficult question to answer because the Directive sets general requirements which Member States should put in place and general powers which competent authorities should be able to exercise but it is not specific about the procedures which should be created to exercise those powers. We have the following specific concerns:

   Definition of an "allegation" and the lowering of the threshold for investigation and sanction

3. The definition of *"allegation"* is going to lead to a significant increase in the number of issues which will require to be investigated either by the Case Examiner at the initial assessment stage or which may need to be the subject of a formal investigation. We do not believe that the need to *"detect, correct and prevent inadequate execution of the statutory audit"* as expressed in the Directive means that the threshold for review / investigation has to be set as low as the proposed test for allegation which appears to be as little as any breach of any auditing standard, however minor, and however little impact it has had on the overall reliability of the audit report.

4. An *"allegation"* would therefore be made out, and an auditor or audit firm would become subject to some form or review or investigation under the Procedure, for breach of technical standards such as; the failure to document the results of audit procedures in the audit file or not documenting the audit team fraud risk discussion during the planning stage. This would be the case even if it is clear from other evidence that such procedures or discussions did take place and where there did not appear to be any adverse impact on the reliability of the audit opinion.

5. While the introduction to the Consultation suggests that there will be an effective filter at the Case Examiner stage to prevent minor matters becoming the subject of formal investigations, the filter appears to be limited, as per the Guidance in Appendix B to only minor, technical breaches. It is unclear whether the examples provided above would fall into this category. If not, such matters would need to be reported by the Case Examiner to the Conduct Committee which, previously, has only been referred matters where there was a good reason to suspect that there had been misconduct. This may therefore require some reconsideration as to either whether the definition of allegation should be set so low or whether the test applied by Conduct Committee for a matter to be formally investigated should be higher.

   What if the Conduct Committee finds no good reason to investigate?

6. It is unclear either from the Procedure or the Guidance what happens to an allegation if the Conduct Committee determines that it should not be investigated either by the Executive Counsel or the relevant RSB. Either reference depends on the determination that there is a good reason to investigate.

7. The Case Examiner must refer any allegation of a breach of the Relevant Requirements to the Conduct Committee if it has not been resolved by constructive engagement. This may include every breach which is not a "minor, technical breach" (as per the Guidance at Appendix B). Under Rule 4, the Conduct Committee can only refer a matter to be investigated either by the FRC or by the relevant RSB if there is a good reason to investigate. Guidance is provided in Appendix C on how the Conduct Committee should determine this. However, Rule 4 does not provide for what should happen if the Conduct Committee should determine that there is no good reason to investigate despite this being a distinct possibility given the very low threshold for the establishment of an allegation.

8. Rule 4 is drafted almost on the presumption that any matter referred by the Case Examiner will meet the "good reason" test. Without amendment, this could, in turn, lead to many matters being investigated where formal investigation may be considered to be excessive and disproportionate on an objective analysis of the issue. We consider that this lacuna in the Procedure be re-examined.

"Good reason to investigate" test to be applied by the Conduct Committee

9. While the Directive requires Member States to put in place *"effective systems of investigations and penalties"*, there is nothing either in the Directive or the Regulation which prescribes the actual process which a Competent Authority should put in place. While it is clear that more matters may need to be considered within the whole process established, nothing in the Directive or the Regulation prevents the continuation of the current misconduct test as a threshold test to be applied to determine whether a formal investigation should take place. There does not appear to us to be any good reason why, for example, the Case Examiner's role could not be extended to dispense the first of the mandatory sanctions – notice to cease and abstain – if this is not already included within the proposed authority of the Case Examiner to send 'warning letters'. If so, the matters referred to the Conduct Committee could be limited to those of a more serious nature, where potentially more serious sanctions could be required to be used, and this would then justify the cost and time of a formal investigation by the FRC Enforcement division. Such a test could then be aligned with the current misconduct test. This re-alignment of the tiered thresholds within the overall process would also resolve the lacuna problem identified above. If the Conduct Committee did not consider that an allegation could amount to misconduct, then the matter would be remitted to the Case Examiner for administering a more minor sanction or the Conduct Committee could issue a notice to cease and abstain itself.

10. Setting the test for consideration by the Conduct Committee at the level of "possible misconduct" would also remove the risk of the Conduct Committee becoming overwhelmed by the sheer number of matters which will need to be reviewed by it and, most importantly, keep the focus of its attention firmly on the more serious matters which is the main thrust of the Regulation. It would remove from consideration cases where the issue amounted to one single, negligent act which did not fall within the definition of "minor, technical breach" for resolution by the Case Examiner and which, in itself, is not evidence of any pervasive or systemic issue and which may not have had any overall impact on the reliability of the audit report itself.

11. Further advantages of maintaining a "possible misconduct" test at the Conduct Committee level is that this is a test which the Conduct Committee members have become used to applying and a continuation will provide some consistency with how similar matters were dealt with pre and post the introduction of the Procedure. The maintenance of such a test will also keep consistency with the tests for investigation contained in the bye-laws and regulations of the RSBs.

Potential impact of the threshold changes on the future of the audit profession

12. While not covered within the Consultation, it is clear from other discussions regarding the intended delegation of powers from the FRC to the RSBs that there will be an expectation that the RSBs own processes for assessing and investigating audit issues may need to be altered to be consistent with the Procedure.

13. If there is going to be an expectation that the RSBs' audit registration committees will have to have reported to them, and will need to consider taking action against auditors and firms for every "allegation" even in the non-PIE context, this may have a significant impact on the costs of current processes and the time to bring matters before Committees (given the increased reporting requirements) and the number of firms having sanctions imposed on them.

14. Bearing this in mind, either the FRC should consider carefully the threshold it is proposing to adopt for "allegation" and for "good reason to investigate" or, it maintains the current thresholds in the Procedure, it should make it clear that different thresholds can continue to be used by the RSBs in their work to review and monitor the work carried out by audit firms working on non-PIE audit work.

Delegation of investigation of PIE audit complaints

15. We note that the Procedure specifically provides for the Conduct Committee to delegate to RSBs the investigation of PIE audit complaints following the guidance in Appendix C. We welcome this provision as it seems to us only sensible and practical for the FRC's Conduct Committee to have available to it an alternative option for the investigation of PIE complaints relating to less serious allegations or the audit of smaller PIEs. If such an option was not available, the FRC's enforcement team's focus on the most important matters would be diluted by the requirement to accommodate the investigation of less serious matters or issues affecting the audit of smaller PIE entities. However, we have a number of concerns about how such a process is proposed to work effectively in practice.

16. We have noted in the reference in page 2 of the Consultation to the FRC being *"required to sanction breaches of the requirements set out in the Audit Regulation and Audit Directive in relation to PIEs and other classes of Statutory Audit which the FRC has decided to retain"*. We understand that this is a reference to the FRC's belief that, even if a PIE audit complaint is delegated to an RSB for investigation, it must be transferred back to the Executive Counsel for a determination as to culpability and sanction. As we have rehearsed in prior correspondence and meetings, we disagree strongly with the FRC's interpretation of the wording in Article 24 of the Regulation that Article 24.1(c). We do not believe, nor do our legal advisors believe, that that sub-paragraph means that the Competent Authority has to sanction itself all cases even where a decision has been made by the Conduct Committee under Rule 4 to delegate the investigation of the complaint. We believe that the non-delegable task is limited to the setting of sanctions guidance to be applied to PIE audit complaints and that the determination of sanctions in

accordance with the FRC guidance by the RSBs' tribunals would be compliant with the Directive requirement.

17. It would appear to us to be far more practical, and efficient, to leave a PIE audit investigation, once delegated, to the RSB to investigate, determine liability and sanction. In the case of ICAEW, there would be little practical difference between a sanctioning process conducted by the ICAEW Disciplinary Tribunal and Appeal Panels, which now operate with lay majorities, and the FRC's own Disciplinary and Appeal Tribunals which have similar constitutions. The only difference would be that our Tribunals for delegated audit cases would be required to use the FRC sanctions guidance. The alternative process, driven by the FRC's conflicting interpretation, creates a far less robust and efficient process whereby a complaint is passed from one body to another and back again and the Executive Counsel is forced to make a determination on culpability and sanction on the basis of an investigation report prepared by a different body.

18. Even if the FRC's interpretation of Article 24.1(c) is correct, it would appear that the non-delegable task is limited only to *"sanctions and measures"*. There is no mention in the Regulation of the Competent Authority having to determine culpability in such cases. Even on the FRC's interpretation, compliance would be achieved with Article 24.1, if a matter were returned to the Executive Counsel for the determination of sanction after a determination on a prima facie case had been made by ICAEW's Investigation Committee, considering an investigation report prepared by ICAEW's investigation team. A Decision Notice could then be issued and rejected by the member or firm if it disputed the decision on culpability or sanction. Of course, if culpability was to be determined this way, it would be much more logical and practical for that Committee to determine sanction too using the FRC Sanctions Guidance. Any concerns which the FRC had about the proper application of that guidance or on the level of penalties imposed, could be a subject of review during the annual inspection with additional guidance issued to tribunals if it is considered that their application of the guidance had been incorrect in one or more cases.

19. We have also addressed below a further concern regarding the recovery of costs incurred by RSBs in carrying out investigations of delegated audit complaints. While our principal concern is the lack of any proposed costs contribution in the proposed Decision Notices, an ancillary concern is the lack of any proposed mechanism whereby, if a costs contribution is requested, this figure includes the costs incurred by the RSBs in carrying out these investigations or a mechanism for remitting these costs to the RSBs. The costs of a delegated investigation may not only be limited to internal time costs but could, of course, extend to the costs of expert witnesses or advice from Counsel. This issue would, of course, not arise if delegated complaints were left to be determined by the RSBs' own tribunals at least as to culpability, if not also for sanction, as the RSB's tribunal would be able to make a costs order to cover the RSB's own costs of the investigation. We consider this to be another strong, practical reason why a more practical, and pragmatic, interpretation should be given to Article 24.1(a).

Do you agree that the Procedure achieves a balance between protecting the public and fairness to those subject to the Procedure?

20. We have the following concerns on whether the Procedure achieves the correct balance:

Autonomy of the Executive Counsel

21. Rules 14 and 15 provide that a decision on the culpability of respondent will be made by the Executive Counsel alone based on an investigation carried out by the Executive Counsel and his team. There does not appear to us to be the necessary separation of functions between the Executive Counsel acting as investigator, and the Executive Counsel acting as adjudicator. We are concerned at how it is proposed that the Executive Counsel would be able to make a fair and objective assessment that there is no case to answer if his team has reached an adverse conclusion.

22. While the respondent can always challenge a Decision Notice before the Enforcement Committee and, thereafter, the Disciplinary Tribunal, we believe that the contents of any Decision Notice should be corroborated by a committee of people who have been unconnected with the original investigation. Otherwise, the Executive Counsel can issue, without any review, Decision Notices against individual respondents proposing to remove their ability to sign audit reports – which can threaten their ability to work - and / or proposing significant financial penalties. Even with the ability to challenge, these Notices could have a devastating impact on the recipient. It is also possible that some respondents may not have the financial means or support to mount a challenge to an adverse determination in that initial Decision Notice either by employing lawyers to make written representations to the Enforcement Committee or in mounting a full defence before a Disciplinary Tribunal.

23. We would also point out that the Executive Counsel's power to issue a Decision Notice with complete autonomy stands in contrast to the current requirement of the Executive Counsel to seek approval on the terms of settlement of any matter prior to tribunal. The Executive Counsel can only enter into a settlement if the terms of that settlement have prior approval from a member of the Disciplinary Committee.

24. We believe that there is already a potential answer to this concern by the simple reassignment of tasks to the Committees which are involved in the Procedure at the administrative stages (see below).

Additional sanctions

25. We do not consider that the FRC should continue to maintain the right under the Procedure to expel a member from membership of his or her professional body. We do not believe that this is necessary and that this strikes a balance between protecting the public and fairness to respondents in the process.

26. The Directive is prescriptive about the sanctions which it considers the Competent Authority should have in Article 30a. These all focus on the audit work which has found to be at fault. While the Directive states that Member States could add additional sanctions, we consider that these should be limited to additional sanctions relating to the protection of the public from poor audit work by a particular audit firm or auditor. For that reason, we have no objection to the inclusion of the additional sanctions (f) and (h) suggested at page 2 of the Consultation. However, we believe that decisions on whether an individual should be expelled from membership of an

RSB should only be made by the RSBs in accordance with the tests prescribed in their own bye-laws or regulations.

27. In proposing that this sanction be removed from the list of sanctions to be applied by the FRC, we are not proposing that it should not fall to be considered in relation to the act which has caused the FRC to consider the imposition of a sanction. It is proposed instead that the RSBs be left to consider whether the findings made by the FRC and the sanctions imposed should lead to the RSBs taking the individual member before their Disciplinary Tribunals in appropriate cases to determine whether they should remain within membership. Indeed, this is a process which RSBs are used to following in cases where members are brought before Disciplinary Tribunals as a result of either a criminal conviction or an adverse finding made against them by another regulatory body.

28. Aside from the conceptual concern that only the body granting membership should be entitled to take away that membership, we believe that it is important to maintain consistency between the decisions taken on the most draconian of steps of excluding an individual from his or her professional institute and that this can only be achieved by decisions being made by the RSBs' own tribunals. Indeed, we have had concerns – which we have expressed – in relation to decisions taken by FRC disciplinary tribunals to exclude ICAEW members in circumstances where such exclusions are inconsistent with the views taken by our disciplinary tribunals in similar cases. In particular, our tribunals have been firm in the belief that exclusion from membership should be restricted only to cases where there is evidence of a lack of honesty or integrity of a member rather than acts of incompetence or recklessness.

29. While the justification for including the right to expel within the sanctions to be available to the Decision-Makers under the Procedure is based on the continuation of sanctions already available under the Accountancy Scheme, we do not believe that the right to expel should have been included in the Scheme, that it is not a power which should be exercised by the FRC for the reasons articulated above and that the introduction of the Procedure provides the ideal opportunity to regularise this position and allow greater consistency in the application of this sanction.

Do you consider there is anything missing from the proposed Procedure that would improve its effectiveness?

30. We are confused by the proliferation of Committees during the administrative stages of the Procedure and their roles, and the contrasting lack of any Committee review or corroboration of the judgment reached by the Executive Counsel at the initial Decision Notice stage. We believe that the process could be made far more efficient, speedy and cost effective by having just one Decision Notice stage.

31. While we understand, and accept, the role of the Conduct Committee, we do not understand the need for there to be an Investigation Committee to monitor the progress of investigations. The progress of investigations is a matter which should be well within the remit of the Head of Enforcement.

32. In contrast, we can see a valuable role for a second committee to review draft Decision Notices prepared by the Executive Counsel at the end of the investigation phase and for that Committee (either the Investigation or the Enforcement Committee) to review the draft Notices, the investigation report and the representations made by the respondent, to decide whether sufficient investigation

work has been carried out to reach a reliable conclusion or whether more work should be carried out (stipulating what work). If it concludes that sufficient investigation work has been carried out, then the Committee would consider whether it agrees with the judgment made by the Executive Counsel on culpability, whether it concurs with the wording of the "outline of adverse findings" and, finally, whether it concurs with the level of sanction proposed and any costs order (see below).

33. If such a Committee were to carry out a review at this first stage, prior to the issue of the initial Decision Notice, we believe that this would dispense with the need, or rationale, for any second stage or involvement of a third committee. If the respondent failed to accept the offer of a compromise in a decision notice issued by the Executive Counsel which the respondent knew had been vetted by an independent committee, it would be much more likely to be accepted. If it is not accepted, the complaint would then be preferred directly after that first stage to a tribunal.

34. The reduction of the administrative stage to one Decision Notice, properly considered would undoubtedly speed up the process and reduce a respondent's costs of having to respond and make representations in paper at two different stages.

Do you have any other comments about the proposed Procedure?

35. We are concerned at the fact that the Decision Notices proposed to be issued by both the Executive Counsel and the Enforcement Committee are to set out the adverse findings and the sanctions but that they will not be seeking to recover any costs of the investigation (up to that point) from the respondent. We can only presume that this is a drafting error as we cannot think of any plausible reason why a respondent accepting a decision notice should not then automatically and deservedly be responsible for the costs which have been incurred in the investigation carried out until that point.

36. Costs incurred during just the investigation phase of significant cases have amounted to several million pounds so it is essential that this Procedure seeks to make full recovery.

37. However, in pointing out this omission, we recognise that the determination of an appropriate costs order by the Executive Counsel for inclusion within the initial Decision Notice if the final procedure for the initial stage remains unchanged will present the Executive Counsel with a potential conflict of interest. This is because the Executive Counsel will need to decide how much of his own team's costs should be charged and recovered. This might be a difficult exercise if mistakes have been made during the investigation. We see the need to assess and include costs within the Decision Notices as another powerful reason why the Executive Counsel's own determinations should be reviewed, challenged and blessed by an independent committee before the initial Decision Notice is issued. The Committee can then take a view – as does the ICAEW's Investigation Committee – on the costs which have been incurred and which are proposed to be requested from the Respondent.

38. As we have also pointed out above, we are also concerned at the lack of mechanism in the process to allow the FRC to claim any costs incurred by the RSB in dealing with delegated investigations if the Procedure continues to require every matter to be returned by the RSB to the FRC for determination on culpability and sanction.

39. We would also refer to the points we have made in correspondence on the draft Procedure immediately prior to the launch of the consultation.

Section 3: Funding

Do you have any proposed comments on the proposed funding arrangements?

40. We do not believe that the current process whereby the FRC remits the fines imposed on respondents to RSBs should be changed.

41. Shortfalls will always arise out of a process where the RSBs pay all investigation costs for all cases but where some cases may not ultimately lead to complaints being brought and other complaints may be rejected by tribunals with no costs orders being made against respondents. The theoretical offset in the funding of cases where no costs recovery is made is the receipt by the RSBs of the fines where complaints are proved. However, even this theoretical offset has failed in the case of ICAEW at least with there being a considerable deficit over the last 10 years between the money paid to fund investigations and the costs recoveries and fines which have been collected by the FRC from respondents. The suggestion in the Consultation that no more fines would be remitted by the FRC to the RSBs would just exacerbate the gap between funding and recoveries even further.

42. It appears from the Consultation that the FRC considers instead that the fines should be retained by it in order to form a 'case costs fund' to pay for future investigations and prosecutions. This suggestion has been raised by the FRC in the past in discussions with ourselves and other RSBs and has always been met with the question why such a fund is necessary to establish given that the RSBs have been responsible for the payment of case costs under the Companies Act and the Scheme and no request for payment of costs has ever been refused by ICAEW or, to our knowledge, by any other RSB. We are not therefore sure we understand either why such a fund is required.

43. If the 'case costs fund' is proposed to be established to provide the funding in advance, rather than the current system of costs incurred being requested quarterly in arrears, and that the objective is to improve cash-flow, then this is a suggestion which ICAEW would be prepared to consider as long as appropriate safeguards were put in place. The first safeguard would be the separation of funds contributed from fines imposed on, and paid by, ICAEW member firms from fines contributed by other RSBs' members and member firms. The ICAEW fines would then only be used by the FRC to fund future investigations of ICAEW member firms and members rather than to help pay for the cost of investigations into members and member firms belonging to other RSBs. The second safeguard would then be that the case costs funds received and retained by the FRC would reduce, pound for pound, the next quarterly funding request from the FRC.

44. Since the publication of the Consultation, we understand that HM Treasury has indicated that it should receive all fines imposed by the FRC. We also understand that this has led to a series of meetings between FRC, BIS and HMT on a way forward. Neither the FRC, nor any of the RSBs, receive any government funding and the HMT proposal will undermine the future viability of the RSB system unless full costs recovery by the RSBs was guaranteed. This is not possible because of the costs which are spent by the FRC in investigating matters which do not subsequently lead to complaints.