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Dear Ms Horton

This response, which is to 5 consultation questions asked in *Enhancing Confidence in Audit: The Financial Reporting Council's Audit Enforcement Procedure* is joint between the Group A[1] firms and the members of the Association of Practising Accountants (the list appended below is of the firms which have ascribed to the response), namely the medium sized firms which are active in the mid-tier market.

Thank you for the opportunity to comment and we hope that you find our responses to the consultation questions helpful. We make some preliminary observations ahead of providing the responses.

- The new Procedure will apply only to enforcement action against an audit firm or individual auditor. It will not address either the conduct of accountants in business or of non-accountant directors. The primary legal responsibility to provide financial statements is placed on the directors of the company (a conclusion of the *Caparo* case that is still the law). It should not be the case that auditors should bear the potential for disciplinary action when the preparers avoid scrutiny.
- For self-evident reasons, we must endeavour to promote the attractiveness of the profession to young auditors and to retain the experienced ones: the regulatory environment must not be preclusive and the number of professional hazards and pressures to which Responsible Individuals are subject will surely affect the willingness of good entrants and experienced practitioners alike. This is an existential point that 'incremental regulation' needs to comprehend and respond to.
- We apprehend in our responses that the new Procedure will see many more sanctions being administered than has been the case until now. This must have consequences and those consequences will be felt most keenly by the mid and smaller-tier firms. The disproportion latent in this will be clear and it will not only be financial but reputational as well, particularly if any one such firm attracts a number of sanctions. This will be inimical to the audit market, run counter-intuitive to CMA objectives, and will inhibit Growth through restriction of supply and choice.
- It will also be counter-intuitive to the emphasis that the largest firms will lay on audit as part of the provision of much broader professional services. We have a crisis in the UK for many of the same reasons in the provision of medical services and we should try to avoid the same risk/reward related mistakes.

[1] **Group A** - Crowe Clark Whitehill, Haines Watts, Kingston Smith, Mazars, Moore Stephens, RSM, Saffery Champness, and Smith & Williamson; **APA** – Armstrong Watson, BHP, Blick Rothenberg, Brebners, Buzzacott, Dixon Wilson, Duncan & Toplis, James Cowper Kreston, Kreston Reeves, Mercer & Hole, Price Bailey, Roffe Swayne, and Shipleys.

- We have stressed in several of our responses that the new Procedure will wholly displace the current disciplinary scheme, replacing it with an entirely regulatory one. We do not see that such a profound shift has been matched by the inclusion of sufficient countervailing protections against arbitrary decision-making. What protections we see are both loosely specified and entirely discretionary, the consequence of which is that the balance between the need for effectiveness of the Procedure and the entitlement of firms to be able to defend themselves has been tipped in favour of certainty of 'conviction. We have received oral assurances about the way in which the Procedure will be administered but there is nothing in the proposed scheme itself that gives form to them and whereas we do not doubt the sincerity with which they were given, they need to be given written form if they are to be sustained going forward.
- We recognize that the FRC, as single competent authority, is working to a very tight implementation ARD deadline but we must be careful to ensure that we do not end up with a tranche of regulation which is far more enforcement-heavy than will obtain in other EU Member States.
- We recognise that the FRC subscribes to the regulatory principle of Proportionality and we recognize too our duty to make representations to it (the Chairman, Chief Executive, and senior Executives often invite us to comment in this respect) on instances where we see departures from that principle: we see dangers in what we have seen of the draft Procedure and are particularly concerned that progress towards a more educative and collaborative way of securing Audit Quality might founder on a rock of enforceability.

Answers to the consultation questions:-

Question 1: Do you consider the proposed Procedure adequately reflects the ARD requirements?

The overarching objective of ARD implementation is to have in place '*effective systems of investigations and penalties,...to detect, correct and prevent inadequate execution of the statutory audit*'. Regulation 4 of the Statutory Auditors and Third Country Auditors Regulations (SATCAR) adds some specification to the objective, obliging the Competent Authority (the FRC) to consider whether a statutory auditor *'has contravened a relevant requirement'*. *'Relevant Requirement'* is in turn given specific meaning in Part 1 of Appendix A of the new procedure – it is a breach of anything covered by SATCAR, or the Audit Regulations or Part 16 or 42 of the Companies Act 2006.

The consequence of the new Procedure applying these defined terms creates a fundamental shift away, particularly from the Accountancy Scheme. The result will be a new construct that is essentially regulatory, not disciplinary, in nature. This in turn has another consequence, in that it aligns *any* departure from *any* regulation with which statutory auditors must comply with the right to sanction that departure, makes the frequency of recourse to formal sanctions on the part of the competent authority much more likely, and reduces the capacity of those subject to the Procedure to affect or disarm any given intention to sanction.

We have had the benefit of being able to put this point to senior FRC executives and been given helpful assurances that it is not its intention to invoke the new Procedure for every such departure. We, for our part, are happy to accept those freely given assurances, which are themselves consistent with our reading of the ARD and the draft UK implementing legislation, but it seems equally obvious that it will be much easier for the FRC to apply sanctions than has been the case in the past, simply through the adoption of executive policy. This is the major distinguishing feature of a regulatory system as opposed to a disciplinary one.

At the moment, the FRC has both kinds of system and it appears to us that it was not necessary to introduce the wholesale changes of the new Procedure when amendment of the existing ones would have been capable of implementing the requirements of the ARD.

Question 2: Do you agree that the Procedure achieves a balance between protecting the public and fairness to those subject to the Procedure?

This is very difficult for us to be able to assess as the question of balance is fundamentally about how implementation is carried through. There is a distinction between fairness of process and fairness of the ends and objectives of implementation, a distinction which the drafters of the Procedure will readily appreciate.

We made, in our answer to Q1 above, reference to the fact that the new Procedure is essentially, even though the later stages of process replicate the Tribunal phase of the Accountancy Scheme, a regulatory system. The principal consequence is that the focus for those administering it, from the Case Examiners to the Conduct Committee, will be less on whether a breach of a Relevant Requirement has taken place - that will, from a prosecutorial point of view, be much easier to prove - as on what the consequences ought to be. These are quite different qualitative judgements in which those subject to the Procedure will have little or no say and the danger of them being subject to sanction must therefore be greater.

This is not the case at present as the Accountancy Scheme obliges its Executive Counsel to assess in a qualitative sense the degree of departure from a given requirement and affords the statutory auditor the right to make representations in relation to that assessment. The consequence of this is that the interests of and fairness of the Procedure towards the statutory auditor have fundamentally shifted, making certainty of 'conviction' a higher priority than any other, not least of all the public interest.

Visibility and frequency of use of sanctioning powers only support the efficacy of the Procedure, not whether it can truly be said to underpinning the public interest. For that reason, checks and balances need to run throughout the Procedure. We can see that some are proposed – a filtering mechanism at Case Examiner stage, for example - but we think far greater emphasis ought to have been given, and still can be, to the interface of the new Procedure with the way that audit monitoring is delivered. This is particularly important in the wake of the McKinsey Review and the apparent willingness on the part of the FRC to engage with the profession in a spirit of collaboration, intended to secure enhanced Audit Quality through the free exchange of firms' practising experiences with the FRC's external appreciation of how technical and ethical standards ought to be applied to achieve the best result in the public interest.

There were signs that the chemistry between the firms and AQRT was building in exactly that direction of educational travel, which is akin to how other professions address competence issues: the airline industry, for example, is as heavily process-based as audit and virtually the entire focus of the training that the Civil Aviation Authority mandates is through monitoring of cockpit competence.

We believed when we responded to the McKinsey Review consultation, and we continue to believe, that the AQRT function is the critical one in the encouragement of overall Audit Quality and that that phase of the competent authority's interface with the practising profession should be further refined and developed. Whereas we accept, of course, that it would be inappropriate for an egregious breach of standards to go unsanctioned, we draw a sharp distinction between breaches of integrity (wilful breaches) and breaches caused by technical misjudgements (errors of practice). We think it would be accepted on the part of the competent authority that the profession tends to throw up very few examples of breach of integrity; most instances will be failures that can be 'trained out'. This is the great value of audit monitoring, allowing audit monitors and those who moderate their reports to take a view on the character of the breaches they encounter.

Audit monitors are now sufficiently experienced as to be able to form their own assessments of what ought to attend the breaches they come across and it would be inappropriate, in our view, for that qualitative function to be lost in the implementation of the new Procedure.

We understand that one of the disciplinary schemes that the FRC used when devising the new Procedure was the Solicitors' Regulatory Authority. We make this point as the SRA's scheme is heavily focused on 'outcomes-based regulation', in which there is a strong educative emphasis that seeks to minimise recourse to formal sanctions. We should be pleased to learn if the FRC is committing to outcomes-based regulation in the same way as the SRA is.

Question 3: Do you consider there is anything missing from the proposed Procedure that would improve its effectiveness?

We refer to our answer to Q2 above, and add that Appendix B (*'Guidance for Case Examiner'*) could provide for the Case Examiner to have regard to the conclusions of AQR reporting: at p7, the consultation paper says that, *"[t]he Case Examiner will operate a procedural 'filter', by receiving information about PIE and non-PIE audits*

and deciding if the information amounts to an allegation i.e. information about a Statutory Auditor or a Statutory Audit Firm which raises a question as to whether they have breached a Relevant Requirement.".

He or she may decide that the case is capable of being adequately addressed through 'Constructive Engagement' (and by inference by means falling short of a formal sanction) and Part 1 (Interpretation/Glossary) of the Procedure defines Constructive Engagement as *"...any of the range of forms of engagement set out in the Case Examiner Guidance issued by the Conduct Committee.".*

We think it should be explicitly stated in Appendix B that Constructive Engagement can take place during the AQR process[2].

Rule 12 describes as suitable for Constructive Engagement *"...a minor, technical breach of the Relevant Requirements. Such cases will usually be at the very lowest end of the spectrum of allegations"* and Rule 13 says that, *"Constructive Engagement may be appropriate where there is no real harm to investor, market or public confidence in statutory audit process and where there is no evidence of financial detriment to anyone"*. We assume that these two tests for suitability of Constructive Engagement are conjunctive but would appreciate confirmation.

Whereas there is no obligation under the new Procedure to self-report instances where audit firms are aware of breach of a Relevant Requirement (though there is a right for firms to do so), it seems to us that it will be critical for the success of Constructive Engagement for firms to know when it would be appropriate to self-report. We believe that a Protocol should be written in agreement between the firms (and a Technical Advisory Group could usefully assist in its drafting), so that there is some clarity around judgement-making. There should also be an explicit concession that self-reporting is a factor to be taken into consideration in terms of deciding what, if any, further process is necessary in light of the disclosure.

Question 4: Do you have any other comments about the proposed Procedure?

We have a number of miscellaneous points:-

- we should like to be apprised of what matters in the regulatory/disciplinary sphere will be delegated to the RSBs, and whether they will be expected to replicate the new Procedure – members of the RSBs are bound by contract to the RSB's disciplinary arrangements but those are not predicated on the same threshold of liability to disciplinary action as the new Procedure envisages.
- we understand that the new Procedure will apply to all PIE audits and also to audits of non-PIE listed companies with a market capitalisation of more than €200m but should be obliged for confirmation.
- when the Case Examiner, Conduct Committee, or Investigation Committee is making a conclusion regarding a Statutory Auditor's judgements, can it be confirmed that the focus will be on whether professional scepticism has been shown and whether it has been adequately documented, and not on the substitution of the Examiner's or Committees' opinion of those judgements?
- we understand that it will no longer be necessary for the fact of cases taken forward for investigation (ie beyond Constructive Engagement) to be published at that stage. Can it be read into the consultation paper that it may also no longer be necessary to publish the names of individual partners or Responsible Individuals at that stage either? It seems to us that such has been an unnecessary burden on individual professional reputation hitherto.
- on matters affecting the reputation of firms, it seems unnecessary, from the point of view of implementation of SATCAR and ARD, to publish the fact of closing down a given case with no further action being taken, if that case has not been published earlier.

Question 5: Do you have any comments on the proposed funding arrangements?

The consultation paper does not confirm what, if any, specific additional costs of operating the new Procedure will be levied on audit firms and whether sums accrued through financial sanctions will go towards those costs, and we would appreciate an indication.

[2] Indeed, the consultation paper raises that possibility: at p7 under Stage 1, it envisages that Constructive Engagement could already have taken place by the time the Case Examiner receives the information he will be dealing with.

We will be happy to engage further with the FRC on any of the matters raised above.

Yours sincerely

Tom McMorrow