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For the attention of Catherine Horton
By E-mail: consultation@frc.org.uk

4 May 2016

Dear Sirs

Consultation – Enhancing Confidence in Audit: The Financial Reporting Council's Audit Enforcement Procedure ("the new Procedure")

We appreciate the opportunity to provide input on the draft Audit Enforcement Procedure, published by the Financial Reporting Council (FRC) in March 2016.

We note the stated principles underlying the design of the new Procedure. Fairness to statutory auditors whilst protecting the public interest is fundamental and the aspiration to promote and facilitate earlier resolution of appropriate cases is sensible. However, the proposal to deal with the full spectrum of cases from minor breaches through to "misconduct" within a single procedure is ambitious and could be an impediment to achieving this balance. Success of the new Procedure will be highly dependent on how the scheme is operated in practice.

We have considered all five questions in the consultation paper and our specific views on these are included in the Annex to this letter. In this covering letter we provide some overall observations on what we believe to be the more important issues raised by this consultation document as highlighted below.

Finalisation of legislation

The new Procedure is intended to set out the mechanism for investigating breaches of a 'Relevant Requirement'. Included within the definition of a Relevant Requirement are requirements that will be set out in the Statutory Auditors and Third Country Auditors Regulations 2016 ('SATCAR 2016'). These have not yet been published in final form and hence the nature and extent of the requirements

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are not yet certain. It would be preferable for the new Procedure to be finalised only once the final content of SATCAR 2016 is known.

Speed of Implementation

While acknowledging that the new legislation comes into force in June 2016, we are concerned at the speed with which the new Procedure is being designed and implemented. We believe it is more important to take the time necessary to ensure the Procedure is well drafted and is capable of successful implementation.

Investigation test

So far as cases related to statutory audit are concerned, the new Procedure would replace the current threshold for an investigation under the Accountancy Scheme, of whether

(i) the matter raises or appears to raise important issues affecting the public interest in the UK; and
(ii) there are reasonable grounds to suspect that there may have been Misconduct;

with a consideration of whether there is a "good reason" to investigate an alleged failure to comply with a Relevant Requirement that is, a requirement under the 2016 Regulations, the Audit Regulations or Part 16 or 42 of the Companies Act 2006.

While we acknowledge that the FRC does not intend to deal with more trivial cases, we believe there is a risk that the new Procedure covers too broad a range (ie beyond the range of cases covered by the existing Accountancy Scheme and Sanctions regime). Much will depend on how the test is calibrated and operates in practice. "Misconduct" under the Accountancy Scheme applies to the more serious cases where the conduct of a member or member firm has fallen significantly below the standard reasonably to be expected or where the relevant conduct has brought or is likely to bring discredit to the Member, the Member Firm or to the accountancy profession. It is these more serious cases where there is a demonstrable public interest and which should properly be examined under the new Procedure. We believe the FRC should clarify its intentions by issuing a policy statement on its enforcement powers. This would help in the avoidance of doubt and would reinforce confidence on the part of both the public and the profession that it is the more serious cases which the powers are intended to address.

We recommend that it be made clearer that the characteristics of an alleged breach of a Relevant Requirement, which might suggest that a "good reason" to investigate exists (Appendix C: Conduct Committee Guidance, Para 5) are meant to constitute serious breaches. Some of the listed characteristics are quite subjective, in particular (a), (b) and (i) of Para 5 *("(a) it has the potential to damage public confidence in the audit profession; (b) it has the potential to damage investor confidence in the truth and fairness of the financial statements published by statutory auditors; and (i) it may suggest a failure in regulatory compliance processes or approach")*.

It would be helpful to make it clear that these relate to serious breaches of the kind that would be recognised under the ICAEW Disciplinary Bye-Laws 9.1 and 9.2. This will help to ensure that both the profession and the public alike can be confident that the Procedure will not prove to be more onerous than the Accountancy Scheme, which deals with the more serious matters. This appears to be

consistent with the FRC's Preliminary Impact Assessment which indicates that it is changing *"the operation of an existing process" [and that] "the changes in costs and benefits arising from the new Procedure are expected to be de minimis"*.

We recommend that the 'good reason' threshold in Rule 4 should be applied again at the stage of considering any decision to proceed with enforcement action, as otherwise there is a risk that the parties could end up debating a relatively trivial breach that is far removed from the original reasons to investigate. This would include when consideration is given as to whether a respondent is liable for enforcement action by the Executive Counsel (Rules 14-15), by the Enforcement Committee (Rule 21) and by the Tribunal (Rule 51).

Focus of investigations

The impact on an individual of being personally made the subject of an investigation is significant and considerably greater than where the firm is the subject of investigation. This is particularly the case where the investigation takes a number of years to complete (see also section below on Duration of Investigations). While there will be cases where an individual's conduct will be deserving of sanction, unless there are very obvious reasons for doing otherwise, it would be preferable if the default position under the new Procedure is for the firm alone initially to be placed under investigation. The role of the engagement partner can then be considered as part of that investigation and if appropriate he or she could subsequently be placed under investigation at a later stage. We have a concern that if the new Procedure is seen always to be directed at individuals involved, this could impact on the attraction of the profession to those considering their career choices; and unnecessarily undermine both public and client confidence in the individuals personally under investigation.

The intention to include non-PIEs

The FRC should explain further the reasons for wanting to embrace non-PIEs within the new Procedure and should explain more precisely which non-PIEs it seeks to include.

Duration of investigations

While we support appropriate opportunities for early resolution of cases, we also note that the new Procedure comprises additional stages compared to the existing Accountancy Scheme. There is a risk that, where all the stages are utilised, the process could take longer than under the current arrangements.

In our response to the FRC Plan and Budget proposals for 2016/17 we indicated our support for the FRC's aim of completing investigations under the disciplinary schemes within no more than two years on average. Under the new Procedure, we would envisage the starting point would be when an allegation is referred to the Conduct Committee to decide if there is to be an investigation. While we would encourage the FRC to set this two year period as an indicator for professional discipline, we consider the regulator should try to conclude its formal investigation sooner, wherever possible, particularly where an individual is involved. However, we also consider it important not to curtail or shorten the constructive engagement stage of the process by the Case Examiner (or indeed any stage of the process) simply in order to move to the next stage or to meet the two year target. It will always be better to resolve matters at an earlier stage of the new Procedure even if a little more time is needed to achieve this.

Publications policy

The publications policy under the new Procedure differentiates between mandatory and non-mandatory publications. Particularly in respect of the latter, we believe that in general the guidance should give greater emphasis to the principle that the new Procedure is EHCR compliant ensuring fairness to Statutory Auditors whilst protecting the public. The damage to reputation which is inherent in a publicised investigation in itself already constitutes a powerful deterrent. For individuals, such as the audit engagement partner, the damage to reputation is significant, at a time before there has been any consideration of whether there is any real case to answer.

We believe that the current 'default' position – that the FRC will make an announcement unless there is a reason not to – should be reversed such that the presumption is that no announcement will be made until a Decision Notice is agreed or unless there is a specific public interest in doing so. This would mean that careful thought is given to making any announcement at an early stage of investigation beyond confirming that the FRC is looking into a matter and considering whether any formal investigation is required (which would cover both the new Procedure and the Accountancy Scheme). This approach would reduce the risk of an individual or a firm suffering adverse reputational damage where it could well be unjustified, and also increase the flexibility available to the FRC in case management. Even where the FRC is not naming individuals who are subject to an investigation, the fact that the name of the engagement partner is a matter of public record means that the FRC needs to be particularly careful when making any announcements about any investigation into a Member Firm.

Future of the Accountancy Scheme

The Introduction to the new Procedure notes that the FRC and professional bodies are considering the extent to which the FRC should continue to deal with public interest cases which do not involve the statutory audit and whether the existing Accountancy Scheme should continue to operate. In addition, it is unclear from the consultation document how the existing Accountancy scheme and the new Procedure will interact. In particular, it is possible that in relation to the same case, the statutory auditors would be held to the lower threshold under the new Procedure, while Members in the audited company would be judged under the higher threshold of "misconduct" under the Accountancy Scheme.

In particular, we would suggest that the conduct of Members in the audited company should be examined within the same scheme as the Audit Firm; cases involving some form of audit failure often involve poor conduct by Members at the audited company. Bifurcating the processes under which the conduct of the relevant Members (the Audit Firm and those within the audited company, respectively) is examined detracts from the reality that successful audit requires Members within both organisations to be performing their roles appropriately.

We would support early clarification and resolution of this issue, since the existence and operation of two similar but different disciplinary regimes will add to regulatory complexity and could lead to unfairness in the way different respondents in a case are treated.

There is a potential solution to this issue where a matter is delegated to a Recognised Supervisory Board (RSB) to investigate (including PIE matters). In these circumstances, the RSB could also simultaneously investigate the conduct of the Members at the audited Company. This would have the merit of ensuring that such Members' conduct is properly considered alongside and in the context of

the audit work which was conducted by the Member Firm. The RSBs are able under their own rules to consider a wider spectrum of conduct than the FRC is under the Accountancy Scheme and therefore it makes sense for them to undertake this exercise. This would then naturally lead on to the RSB taking any appropriate action against Members at the audited Company.

Governance of Conduct activities

We believe that the FRC's Conduct activities should be seen to be subject to good governance. The FRC should be accountable to Government (the Department for Business, Innovation & Skills) and there should be a post-implementation review of these new enforcement arrangements after two or three years of operation.

In our letter of September 2012 on changes to the existing Disciplinary Scheme we noted, in the context of the then new FRC Reforms, that as a body acting in the public interest, the FRC should be seen to be setting an example of good governance in its own arrangements. This would include ensuring appropriate safeguards to manage differing and overlapping public interest objectives, and reviewing periodically the effectiveness of its operations. We further noted from the Impact Assessment of the FRC Reforms that, as part of the planned post-implementation review, there would be a full evaluation of the effectiveness of the proposals after three years. We suggest that there should be an evaluation of the governance arrangements of the Conduct Committee as part of any such review, to assess how the committee is managing its different activities and responsibilities to stakeholders.

We would be pleased to discuss our views further with you. If you have any questions in the meantime regarding this letter, please contact Gilly Lord (0207 804 8123), Philip Mills (0207 213 2561) or Graham Gilmour (0207 804 2297).

Yours faithfully

PricewaterhouseCoopers LLP

ANNEX 1

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

Whilst we acknowledge that new Procedure reflects many elements of Article 30 of the Audit Directive 2014/56/EU, we do have concerns as to a number of uncertainties and grey areas which we explain in our letter and in our comments below.

The FRC has proposed to enhance the sanctions identified in the Directive with three further measures. One of these is exclusion from the profession. In circumstances where the FRC will have the power to remove the RI status of the individual auditor, it seems excessive for the FRC to be in a position to impose exclusion above and beyond this. It should be for the RSB to reach its own view on the basis of the FRC's findings/sanctions as to whether it needs to take further steps including, in appropriate cases, exclusion from the profession.

One point we would draw out is whether the FRC has gone too far in excluding from membership of a tribunal anyone who has been an auditor in the previous three years. In our view recent experience of auditing is critical to ensuring informed decision-making at the tribunal stage. Whilst the Directive indicates that the public oversight function must be governed by "non-practitioners", we do not believe that should mean that the new Procedure should involve only "non-practitioners" (ie those who are neither in practice nor have been so in the preceding three years) at every step. In particular, the accountant tribunal member should be able to be someone who either is or has been a practitioner within the past three years.

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

We do have some concerns in this area, regarding the fairness to those subject to the new Procedure. Much will of course depend on how the new Procedure is operated in practice. We comment below on some specific areas.

Rules 14-16: We are not convinced by splitting the two stages of Executive Counsel's consideration of the matter and the subsequent Enforcement Committee's consideration. Executive Counsel is able to act without being held to account by any committee (unlike the position under the Accountancy Scheme) and it is likely to result in fairer and better decisions if the Executive Counsel has had his views tested by the Enforcement Committee (or Investigation Committee as the case may be).

Appendix B: Guidance for Case Examiner para 1 states that the Case Examiner is required under Rule 3 to determine whether the information amounts to an "allegation". It is unclear from the guidance whether the Case Examiner (whom we presume will be an employee of the FRC) will be an accountant (with or without experience of audit), a lawyer or some other professional. We would strongly recommend that the Case Examiner should have audit experience. Different Case Examiners will no doubt deal with different cases. This, together with the fact that the characteristics of an alleged

breach (as listed at Appendix C, para 5) are very broad means that there is the likelihood that different Case Examiners will arrive at different conclusions. It will be important in the interests of fairness to Respondents that an appropriate mechanisms for monitoring and supervision are in place to ensure consistent application of the new Procedure.

Furthermore we believe the Case Examiner too should bear in mind the factors that are included in Appendix C at paragraph 5 (those characteristics which suggest a "good reason" to investigate), since this will enable him to sift out matters which, although they may technically constitute "allegations" are either without foundation, are obviously spurious or only minor. If this does not happen, then there is a risk that the Case Examiner will be required to refer far too many matters which do not merit consideration under the new Procedure.

Appendix G: Sanctions Policy, para 22 states *"When determining the sanction to be imposed, a Decision Maker should disregard the fact that sanctions have been, or may be, imposed by another regulator or other authority in respect of the breach of the relevant requirements…"* We consider that this could give rise to "double jeopardy" – that the auditor could be punished twice for the same offence. One way of dealing with this might be to amend the reference to read *"…a Decision Maker should have regard to the fact that sanctions have been, or may be, imposed by another regulator…"*

Sanctions Policy, para 31 envisages that a Decision Maker may make a public declaration to the effect that *"an audit report does not satisfy the audit reporting requirement"*. Great care will be needed when considering making such a declaration in respect of a company whose shares are still being traded, including as to whether it is intended to convey that the audit opinion is therefore considered necessarily to be wrong and/or that the financial statements of the company are therefore not considered to be true and fair. This will be particularly important where there is or may be litigation in relation to the audit.

Sanctions Policy, para 38 suggests that *"the total turnover of the Statutory Audit Firm and the effect of a financial penalty on its business"* should be considered when assessing an appropriate level of fine. The Sanctions Guidance should include the same wording as para 33 of the Sanctions Guidance applicable to the Accountancy Scheme, recognising that it will be appropriate to consider the revenue of the "relevant business unit", rather than necessarily the entire audit firm.

Sanctions Policy, paras 58 and 59 deal with Aggravating and Mitigating Factors and include the notion of self-reporting or failing to self-report a breach of relevant requirement. It would be of concern if by this the FRC is envisaging self-reporting which goes beyond what is already required under the rules of the relevant RSB. ICAEW Disciplinary Bye-Laws 9.1 and 9.2 of the ICAEW require the reporting (and Bye-Law 15, self-reporting) of certain matters, all of which are clearly serious breaches (eg criminal offences involving dishonesty etc and "serious breaches" of various Regulations). The Guidance should make clear that neither it nor any of the Rules are intended to enhance the existing self-reporting requirements, since there is otherwise a risk of firms self-reporting many minor issues which are adequately dealt with through existing processes which are reviewed as part of the AQR's annual inspections. The FRC has indicated that it does not want to encourage a "tsunami" of minor breaches being reported; these provisions could however have just this effect.

Sanctions Policy, para 59 identifies a mitigating factor that the Statutory Auditor or Statutory Audit Firm was deliberately misled by a third party. In circumstances where that third party was a Member in the audited company, the new Procedure as currently envisaged will not have considered the

conduct of that other Member and consequently the Tribunal or other Decision Maker may not have the benefit of the requisite information in order to account for this mitigating factor.

Appendix H: Publications Policy paras 12-14 allow considerable discretion to the Conduct Committee or Investigations Committee in decisions regarding non-mandatory publications. As noted in our covering letter, an announcement of the commencement of an investigation can in itself adversely impact the reputation of an auditor (as can an announcement regarding an investigation where a sanction has *not* been imposed). An auditor will often be "innocent" at this point, but the negative publicity and reputational damage do not respect this uncertainty. For example, in one case we are familiar with an investigation was launched and subsequently dropped, but the adverse publicity surrounding the investigation meant that the company decided to dispense with the incumbent auditors and appoint a different audit firm. We therefore consider it important that the Publications Policy is operated in a scrupulously fair and proportionate way.

Publications Policy, para 5 should make it clear that it is only a Final Decision notice (as opposed to the suggested Decision Notice only) that is required to be published. Where Decision Notices are not agreed by the Respondent then no publication of any Decision Notice should be made, as this would be prejudicial to the Respondent both in terms of reputation and in the procedures that follow.

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

Yes, we consider there is asymmetry in the way accountants in business are treated compared to auditors. The quality of published financial statements rests significantly on the quality and conduct of finance staff, especially those who are officers of the company, but the proposed Procedure applies only to the statutory auditor. In our view the new Procedure should apply to all accounting professionals involved in the audit process so that there is a level playing field and no perception that the auditors alone are being pursued due to the lower threshold for the investigation test.

Currently there is no acknowledgment of or explanation as to how spurious or vexatious allegations made against auditors will be dealt with. The Case Examiner should explicitly have the ability to sift out (and thus "resolve") those matters which whilst on the face of them may have the elements to constitute an "allegation" are nonetheless made spuriously, vexatiously or otherwise in bad faith. There should be no suggestion that Constructive Engagement should necessarily involve the acceptance of an allegation which has no foundation.

We believe it would be helpful to establish some indicators in order for the FRC to track its progress and performance in the area of professional discipline. In its Plan and Budget for 2016/17 the FRC sets as a target *"to close or conclude disciplinary investigations for public interest cases involving accountants and actuaries after no more than two years on average"*. Long-running investigations have a negative impact on all concerned and we therefore suggest that this be adopted as a formal indicator on which the FRC is held accountable. Another measure that could be introduced is a time limit on investigations, something of which other regulators make use.

We further suggest that the Audit Enforcement Procedure be subject to a post-implementation review after a period of two to three years, to determine whether it has operated in an efficient and effective manner.

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

Part 3: Investigation
Rule 8 (a) It is not clear in what circumstances the Executive Counsel would consider it necessary to attend on-site at the auditor's offices. The circumstances and manner in which it is proposed that this power would be used should be clearly set out.

Rule 10: The time limit for the response to an Investigation Report of 28 days seems remarkably short. If the report is similar to draft/complaints provided under the Accountancy Scheme (for which there is an 8 week standard response period, which is in itself often too short in complex cases) then halving that period to 28 days seems unrealistic and indeed potentially unreasonable, especially where the FRC have taken a prolonged period to produce their Investigation Report.

Part 4: Enforcement Committee
Rule 18 (b) provides that *"the Respondent be provided with copies of any document that has not been previously provided which may be considered relevant"*. This comes at a relatively late stage of the process and we believe such documentation should be made available to the Respondent prior to any Decision Notice made by the Executive Counsel under Rule 15. Clear guidance should be given as to "unused material".

Rule 19: The Enforcement Committee meets in private and does not hear oral evidence and considers documents and representations placed before it by the Executive Counsel and the Respondent. Does the Executive Counsel attend this meeting himself, bearing in mind the Respondent is not permitted to be present? This would not seem appropriate.

Part 5: The Tribunal
Rule 39: It should be made clear that the Respondent is not one of the people who can be excluded by a Tribunal from any Hearing.

Rule 40: This rule requires some further explanation.

Rule 44: Further explanation is needed as to the effect of this rule. It would not seem appropriate that Tribunal members should not all be present throughout a Hearing. The same point applies to Appendix E, para 13 which deals with both Tribunals and Appeal Tribunals.

Part 8: Reconsideration.
The rules in this part of the new Procedure are unclear and no guidance or commentary appears to be offered by way of further explanation. As presently drafted they suggest that the FRC can, without the agreement of the Respondent, reconsider certain decisions, including whether something amounts to an "allegation" and including a decision by a Tribunal to cancel a hearing; and that the FRC can do so in some circumstances for a period of up to 5 years after such a decision was made. There should be clear explanation and guidance as to why any such power is justified, failing which we do not consider it would be appropriate for there to be any such reconsideration as it appears to include the risk of double jeopardy which is inconsistent with the first of the three principles cited by the FRC as underpinning the new Procedure.

Part 9: Amendment of the Allegation.
Rule 77 states that the Enforcement Committee, Chair or Tribunal can amend the particulars of an allegation. It should be for the Executive Counsel to determine the particulars of an allegation and for the Enforcement Committee, Chair or Tribunal to assess whether or not that case has been made. Again, this would be inconsistent with the first of the three principles cited by the FRC as underpinning the new Procedure.

Rule 95: the wording of this rule is somewhat unclear and would benefit from some redrafting.

Appendix C: Conduct Committee Guidance
We have set out our comments on Para 5 regarding the clarification that the nature of the characteristics of an alleged breach of a Relevant Requirement which might suggest a good reason to investigate exists, should constitute serious matters.

Para 6 (a) It would be helpful if, in keeping with our comments above on Rule 5, this could be made clearer to ensure that it is only "serious" potential damage to investor confidence that is included, since this is otherwise too subjective.

Appendix D: Case Management Committee Terms of Reference.
We note that the composition of the Case Management Committee appears designed to exclude individuals with recent, relevant audit knowledge and experience. We believe up-to-date knowledge and experience is important, and suggest a more appropriate balance be struck between avoiding conflicts of interest and ensuring access to relevant experience. Whilst we acknowledge that there are constraints on the ability of practising auditors to govern the public oversight functions, the FRC should nevertheless involve practitioners wherever possible including as Tribunal members.

Appendix F: Hearings Guidance
Para 37 states that Cases will only be heard by the Appeal Tribunal where the "Chair of the Tribunal" has given permission under Rule 62. We presume this must be the Chair of the Appeal Tribunal rather than the Chair of the Tribunal as the Guidance currently suggests.

Appendix G: Sanctions Policy, para 71.
We note that the percentage reductions for early resolution differ from those in the existing Accountancy Scheme. For stage 3 up to the commencement of any tribunal hearing the reduction in the existing scheme is up to 20%, while in the proposed Procedure the reduction for a similar stage is 5-15%. We suggest they are made consistent. Also, in the event that any charges are permitted to be amended, the percentage reductions should be reset at that point, ie to 25-35%.

Appendix G: Sanctions Policy, para 77.
The text refers to *'the truth and fairness of the financial statements published by Statutory Auditors or Statutory Audit Firms'*. Financial statements are published by companies on which the Statutory Auditors provide an audit opinion.

In some disciplinary matters a Respondent might be able to agree the substance of an allegation but not be able to agree the extent of the sanction with the FRC. It would be helpful if the new Procedure could provide for this situation in order that there is a clear mechanism that would enable a tribunal to determine the sanction without the need for the Enforcement Committee stage to be gone through.

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

As noted in our response to the 2016/17 Plan and Budget, we observe that considerable uncertainty can attach to estimates of audit disciplinary costs. Actual costs could well be quite different from the estimated costs depending, for example, on the number of tribunals that take place. In the event that actual costs are higher than those estimated, there is a risk that the total amount of funding provided by the accountancy profession could exceed a threshold where an observer might consider that the FRC is no longer "free from undue influence". In those circumstances, some recalibration or rebalancing of sources of funding may be necessary.

We do not agree that any income from fines levied should under no circumstances be used for the benefit of the profession. Some more thought should be given to how such funds could in fact be used to help the profession in terms of improving audit quality.

Moreover, it appears that the income from fines could be used to finance future case costs. In the event that the FRC pursues a case where there are insufficient grounds for investigation, the FRC should be held accountable and suffer costs or some financial 'penalty'. If such cases are simply funded from prior revenues, there is no onus on the FRC to ensure that it pursues cases only where there is a demonstrable good reason to investigate and a reasonable prospect of success.

As noted in our covering letter, we believe that the FRC's Conduct activities including the funding arrangements should be seen to be subject to good governance. FRC should be accountable to Government (the Department for Business, Innovation & Skills) and there should be a post-implementation review of these new enforcement arrangements after two or three years of operation.