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Dear Ms Horton

FRC's consultation Enhancing Confidence in Audit: The Financial Reporting Council's Audit Enforcement Procedure

Deloitte LLP welcomes the opportunity to respond to the FRC's consultation *Enhancing Confidence in Audit: The Financial Reporting Council's Audit Enforcement Procedure* (the "Consultation").

We recognise the integral role of the Financial Reporting Council (the "FRC") in setting the framework within which auditors operate in the UK. We welcome the proposal for a new Audit Enforcement Procedure (the "Procedure") in relation to investigations and disciplinary cases of those matters which concern Public Interest Entities ("PIEs"), and we support its focus on the timely and effective resolution of disciplinary matters.

In the main we agree with the Procedure, subject to the important points detailed further below. We believe that, if our points are addressed, the Procedure will improve audit quality, achieve natural justice and enhance the cost effectiveness of the Procedure, and ultimately contribute to the FRC's overall aim of enhancing justifiable confidence in audit. We particularly welcome the focus on constructive engagement between the Respondent and FRC.

Our response to the specific questions in Sections 2 and 3 of the Consultation are set out in Appendix A below. In addition, we have provided commentary on certain proposed rules in the Procedure in Appendix B.

If you would like to discuss our comments in more detail, please contact me (djbarnes@deloitte.co.uk or 020 7303 2888) or Bonnie Cooney (bcooney@deloitte.co.uk or 020 7007 2305).

Yours sincerely

David Barnes
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Appendix A - Responses to Consultation questions

Q1: Do you consider the proposed Procedure adequately reflects the ARD requirements?

For the most part, yes. For example, the Procedure ensures that the FRC, as the Competent Authority, has the power to exercise its functions under the EU Audit Directive (the "Directive") and EU Audit Regulation (the "Regulation"), including:

- the availability of sanctions which reflect Article 30 of the revised Directive;
- the delegation by the FRC of tasks as permitted by Article 24 of the Regulation; and
- the retention of the right of appeal as required by the Directive.

We consider that if the suggestions set out below about the fairness and effectiveness of the Procedure are adopted, then the proposed Procedure will provide a balanced approach to the ARD requirements.

Q2: Do you agree that the Procedure achieves a balance between protecting the public and fairness to those subject to the Procedure?

In general, yes. However, we do have a few comments in relation to this balance:

A fair and effective procedure

It is crucial that the Procedure is used to rectify and improve significant audit quality issues, as opposed to punishing and publishing every single breach of the Relevant Requirements. We support an enforcement process and appropriate sanctions where it is proven that a Statutory Audit Partner has committed a serious breach which could put into question his or her competence, demonstrates a lack of integrity or which undermines public confidence in the audit firm. But this needs to be balanced and proportionate and not detract from the attractiveness of a career in audit which would not be in the public interest nor in the interests of the profession as a whole.

We consider on balance the Procedure goes some way to resolve concerns regarding the fairness and effectiveness of the Procedure, however we propose some additional suggestions in Appendix B.

Threshold for breach of Relevant Requirements

The Procedure is applicable where there is a breach of the Relevant Requirements. As the Procedure is silent as to what amounts to a breach and appears to apply to any breach, this could be interpreted extremely wide and apply to any deviation from standards, for example, administrative errors.

We recommend that the Procedure include a threshold for a breach of the Relevant Requirements, for example, a 'materiality' threshold which is more appropriate for an enforcement process, materiality being a breach which undermines public confidence in the reliability of the audit firm. Whilst we note the Procedure refers to 'a good reason to investigate' this is a very wide discretion which appears to only apply to the decision whether to investigate. The test should instead be whether an investigation is necessary given the severity and materiality of the alleged breach, the evidence (or lack thereof) available to date and the public interest. We suggest that there is no public purpose in the Case Examiner directing an investigation over a minor or immaterial error, particularly in cases where the Audit Quality Review team (the "AQRT") is already satisfied with the firm's response, as addressed further below. We further suggest that such a test should be applied in all aspects of the Procedure.

Constructive Engagement

We welcome the use of constructive engagement, and consider it a hugely important step in the Procedure to ensure only the most serious matters proceed to an enforcement process. We understand this principle to mean that the

FRC will be open to constructive dialogue around cases, which would in turn help both the profession and the FRC come to proportionate, cost effective and constructive outcomes.

This provision should give the Respondent an opportunity to discuss with the Case Examiner how breaches are being addressed, for example, by agreeing training requirements, reallocating work, changing policies and guidance or amending audit work programmes. If the Case Examiner is satisfied with the approach, it should be open to them to impose no formal sanction. To this end, and noting that Appendix B of the Procedure makes only passing reference to constructive engagement, it would be helpful for the Procedure to be more specific regarding what constructive engagement might entail and in which cases it may be appropriate (and inappropriate). We further note, it appears to be entirely at the discretion of the Case Examiner whether to proceed with constructive engagement; we submit there should be opportunity for constructive engagement, where, for example, the matter is to be referred to the Conduct Committee.

The Case Examiner should also have regard to dialogue that has taken place with AQRT. In circumstances where a firm is in discussion with the AQRT and has taken or is taking action to their satisfaction in respect of a breach, the AQRT should remain empowered to resolve the matter to its satisfaction.

In our view, constructive engagement should be used for breaches other than merely "the very lowest end of the spectrum." Given that discussions with the AQRT may well have taken place for a minor breach, it does not seem cost-effective or in the interests of expedient resolution for such breaches to also be investigated by the Case Examiner. It is appropriate, therefore, that constructive engagement be used for those breaches that range between a minor breach and a very serious breach, with the application of the appropriate thresholds discussed above and in Appendix B. Whilst we note the availability of certain sanctions under Rule 92 of the Procedure, given the benefit of constructive engagement to facilitate dialogue, save costs and rectify a wide range of issues before any enforcement is required, we are of the view that the constructive engagement should be the presumed course of action. This means that clarity regarding what amounts to a breach of the Relevant Requirements, discussed above, is all the more vital.

Personal liability and responsibility of individuals

The Procedure specifically applies to statutory auditors and audit firms. Statutory auditors will include natural persons. We have a real concern that, whilst the Procedure in theory does not attribute 'misconduct' to those individuals that have been found liable for a breach of a Relevant Requirement, in reality it will still have the same effect on the professional reputation and careers of those individuals. Understandably, those charged with governance at PIEs (who may not appreciate the absence of any materiality threshold in the Procedure) may have significant concerns if their statutory auditor is subject to enforcement proceedings, or sanctioned, regarding a breach of a Relevant Requirement.

Save in circumstances where a very serious breach which suggests a lack of general competence or lack of integrity is demonstrated by the individual, the Procedure should be amended to apply sanctions (and publicity) only to the firm. This approach would also speed up the disciplinary process since without a risk of personal and reputational damage to individuals, audit firms will be more readily prepared to resolve matters by compromise.

Q3: Do you consider there is anything missing from the proposed Procedure that would improve its effectiveness?

Please see our points detailed in our response to Q2 above. Additionally, whilst we recognise that discussions in this regard are ongoing, we are of the view that the Procedure should have greater clarity in respect of the scope of the FRC powers. The Procedure should explain in clearer terms that the FRC is empowered to deal with serious breaches relating to the statutory audit of PIEs only, with a presumption that all other enforcement matters, including

non-statutory audit services, will be handled by the RSBs. Clarity in respect of the division of the FRC and the RSB's powers to investigate and to undertake enforcement proceedings is clearly in the interests of all.

Furthermore, it appears that the FRC will not have powers to pursue enforcement measures under the Procedure against the preparers of financial statements (or company directors who have related responsibility under the Companies Act). This means auditors are more likely to be subject to sanctions than those who actually have responsibility for the financial statements. Additionally, whilst some of those involved in the preparation of financial statements may be subject to the existing Scheme or an RSB's own process, many directors are not members of any professional body. Those directors that are members of RSBs would be sanctioned under the existing Scheme against the higher threshold of 'misconduct'. Furthermore, for other directors the applicable disciplinary regime under the Companies Act 2006 and Company Director Disqualification Act 1986 is significantly higher than that proposed approach under the Procedure. There needs to be sufficient balance between disciplining Statutory Auditors and ensuring that the preparers of financial statements remain accountable. We would welcome clarification on this point.

Q4: Do you have any other comments about the proposed Procedure?

We have made some specific comments in relation to certain of the proposed Rules in Appendix B.

We also have a few general points to make regarding the proposed Procedure below.

Audit quality

Whilst we welcome the Procedure and note its potential effect to encourage greater dialogue and resolve issues before any enforcement process, it would be helpful if it was explicitly identified how the Procedure will promote and achieve improvements in audit quality, and, similarly, improve the FRC's regulation of the statutory audit of PIEs. Moreover, in light of the full range of breaches which may be subject to enforcement and potentially penalise the individual, we are conscious that the Procedure should not operate so as to dissuade audit talent from joining the profession.

Co-ordination with other regimes

We are conscious that the scope of the enforcement process in the Procedure might impact on the operational effectiveness of the current Scheme which focuses on misconduct as opposed to a breach of the Relevant Requirements. We understand there is presently no proposal to withdraw the Scheme and therefore we would be grateful for any clarification on how the regimes are to be satisfactorily aligned.

Investigations at an early stage

It would be helpful to understand whether the present FRC investigations that are at an early stage (for example, a draft complaint) will proceed under the Procedure or the current Scheme. The Procedure should have greater detail and clarity on how the Procedure will apply for cases currently in different stages of progress and precisely the trigger point for current cases to move to the Procedure (if at all).

Independence of the Enforcement Committee

The Procedure would benefit from an express statement that the Enforcement Committee is independent from the Executive Counsel, and owes a duty to reconsider for itself the appropriateness of any Executive Counsel Decision Notice. Further, the Executive Counsel and the Enforcement Committee should be required to disclose any substantive contact between them, to avoid any perception of unfairness, and to make certain that the Respondent has the opportunity to respond to any submissions made by the Executive Counsel. This was an issue prior to the reform of the FCA (then FSA) Regulatory Decisions Committee following the Strachan Review in 2005.

Further, adopting the FCA model, in order to ensure that the Enforcement Committee is properly able to challenge the Executive Counsel, it should be required to obtain independent legal advice (either an in-house lawyer with no

involvement in the investigation, separate from the Executive Counsel and reporting only to the Committee or external solicitors or counsel not instructed by the Executive Counsel) to assist its review. The experience of the FCA and regulated firms following the publication of the Strachan Review is that such independent legal review has greatly increased the quality of FCA decision-making and reduced the number of unsustainable cases. Good quality and properly tested decisions are firmly in the public interest and much more likely to be upheld by the Tribunal (or quickly result in settlement).

Q5: Do you have any comments on the proposed funding arrangements?

We agree broadly with the approach for the proposed funding arrangements. We agree that fines could reasonably be used to meet the cost of future cases, however, we suggest that the Procedure outlines how any fines recovered by the FRC could also be used constructively for the improvement of audit quality.

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Appendix B – Comments on Procedure Rules

1. *Rule 2: Case Examiner*. Express provision should be made for the role and function of the Case Examiner to be carried out independently and impartially, and subject to oversight as opposed to control or direction by any of the Committees or the Executive Counsel.

2. *Rule 4: The decision to investigate by the Case Examiner*. The test for an investigation is unduly easy to satisfy as noted in Appendix A. Additionally, when considering the necessity to investigate, the Case Examiner should be under a duty to consider whether the case is suitable for constructive engagement or no further action. Further, the Case Examiner should only proceed with an investigation relating to a question of audit judgement or professional opinion where there is evidence that suggests the auditor has failed to comply with a reasonable or substantial body of professional opinion.

3. *Rule 8(a): On-site inspections*. This rule could be interpreted as providing a power to compulsorily enter physical premises. Recognising that should the FRC start conducting 'dawn raids' on PIEs that is likely to cause enormous reputational harm to such companies and instability in the capital markets, we suggest it should be clear that the FRC has no power to compulsory obtain entry to client sites.

   Such actions may cause analogous detriment to audit firms and the wider profession, and to this end, the rules should provide for proper independent safeguards, akin to those accompanying the issue of a search warrant:

   - an on-site inspection should only be carried out where it is necessary and the information could not be obtained by a request for documents or materials;
   - notice should be provided, unless there are reasonable grounds for believing that evidence would not be preserved if notice was given; and
   - any decision to carry out an on-site inspection should be subject to prior independent authorisation. The FRC should be subject to a duty to make full and frank disclosure on any such application for authorisation.

4. *Rule 10 and Rule 15*: These provisions ought to include a power for extensions of time to be granted in appropriate cases. As a general comment, we also consider that time-lines should be similarly applied to the FRC.

5. *Rule 15 and 18(b): Executive Counsel's Decision Notice*: All Decision Notices should include reasons and include separate disclosure to the Respondent of all relevant material, including all material held by the FRC that is adverse to its case. The language of proposed Rule 18(b) is inadequate because it is ambiguous ("*may be considered relevant*") and disclosure is not given until *after* referral has been made to the Enforcement Committee. A similar, and we suggest preferable, model is section 388(1)(b) of the Financial Services and Markets Act 2000:

   "(1) A decision notice must—

   (a) be in writing;

   (b) give the Authority's reasons for the decision to take the action to which the notice relates;

   (c) state whether section 394 applies;

   (d) if that section applies, describe its effect and state whether any secondary material exists to which the person concerned must be allowed access under it…"

6. *Rule 17*: "*Does not agree*" would be a more neutral formulation than "*has refused to agree*".

7. *Part 4: Enforcement Committee*: Please see our comments in relation to the independence of the Enforcement Committee in Appendix A above. In this regard we note, the problem that used to occur was of private communications and submissions being served on the Regulatory Decisions Committee ("RDC") by FSA and Enforcement, and confidential attempts being made by Enforcement to rebut submissions made by individuals and firms. This led to strong adverse judicial criticism by the Financial Services and Markets Tribunal in *FSA v Legal & General* and was thereafter ended.

8. *Rule 19*: We suggest it would be preferable for the Enforcement Committee to allow the hearing of oral evidence where appropriate. By way of analogy, it is relatively common for an accused person to speak personally to the FCA Regulatory Decisions Committee in financial services proceedings to explain their conduct. Whilst we agree that a mini-trial is inappropriate, the Committee should be free to determine the most fair and appropriate procedure it wishes to adopt in each case.

9. *Rule 20*: We consider that a short oral hearing ought to be a routine part of larger cases heard in the Enforcement Committee. Experience of the FCA's RDC indicates that many issues of over-charging, regulatory over-reach or poorly evidenced decisions are identified and resolved at an early stage by the RDC at their oral hearings. The clarifying value of a short oral hearing is often considerable, not least because it enables the Executive Counsel and the Respondent to confront any difficulties in their case at a brief hearing held at a relatively early stage.

10. *Part 5*: *The Tribunal*: The Tribunal should be given express power to summarily dispose of any allegation made in a Decision Notice which has no real prospect of success. Although we doubt that such a power would be regularly used, it would be valuable if a weak charge was pursued and could well save considerable sums. The power should be reciprocal: if a firm or individual auditor had no real prospect of successfully defending a point, a system allowing a summary finding should also be in place.

11. *Rule 31(b) and Rule 77: The allegations and amendments*: The Rules ought to expressly state that the allegations made in the Enforcement Committee's Decision Notice may not be expanded by the Executive Counsel by way of amendment or otherwise. It would otherwise be possible for the Executive Counsel to introduce (or reintroduce) allegations that have been rejected or not even considered by the Enforcement Committee, thus circumventing this important stage of internal review.

12. *Rule 35*: Given that other legal systems may not adopt the same standards of proof required by English courts, a foreign conviction ought to be evidence of the fact of the conviction but only *prima facie* evidence of the facts found to have been proven by the foreign court. If it were otherwise, a firm or individual auditor could be fixed with unfair findings made abroad.

13. *Rule 44*: There is no objection to the Tribunal being differently constituted for the purposes of Case Management, but the composition of the Tribunal must remain the same throughout the final hearing.

14. *Rule 47*: *Hearing in private*: This should be extended to permit a private hearing where necessary to protect the public interest. Further, the rule ought to be framed in terms of a discretionary "*may be held in private*", not a mandatory "*shall*". It ought to be for the Tribunal to exercise its discretion to balance the Respondent's interest in privacy as against the public interest in an open, public hearing.

15. *Rule 57*: *Interim Orders*: Given an interim order may have a very serious effect on a firm or individual, the rule ought to be amended to make clear that no interim order should be made save to the extent that no other measure would adequately protect the public interest during the interim period.

16. *Rule 62*: *Permission to appeal*: Appeals are of limited scope and therefore ought to be capable of being listed and heard expeditiously. In our experience, a permission stage adds considerably to costs without adding any meaningful element to the decision-making process. Further, where the permission decision is inadequate, it may lead to claims for judicial review. We are not aware of any evidence that the appeal

process has been misused so as to necessitate a permission filter stage. Therefore, it would be in the interests of all to instead list appeals promptly and case manage them effectively.

17. *Part 8*: *Reconsideration*: The reconsideration provisions are inappropriate and undermine the fairness and finality of the Procedure. Furthermore, Rule 67(a) is unclear: the FRC has no power to appeal from the FRC's own decision, so it cannot be appropriate for this to be a basis of reconsideration. The test of a "*new allegation*" in Rule 76(b) is too low and the only proper basis on which such reconsideration should be permitted is on a fair and equal basis with the right of a Respondent to appeal – the discovery of "*significant and relevant new evidence which could not have been adduced previously*" (Rule 61(d)).

18. *Rule 87: Costs*: The Rule ought to be amended to make clear that the power of the Tribunal to award costs ought to be limited to costs that are necessarily, reasonably and proportionately incurred.

19. *Rule 89: Costs awards to the Respondent*: Noting that the FRC's costs are funded by the industry, if the FRC fails in a regulatory prosecution it ought to meet the reasonable and proportionate costs of the firm or individual. As a matter of fairness, the burden of a failed enforcement procedure, where allegations are not proven in the Tribunal, ought to be borne by the industry as a whole, not the individual or firm.

20. *Rule 90*: *Assessment of costs*: Rule 90(c) should be amended so as to require that the person carrying out the assessment is skilled and competent in the assessment of costs. Appropriate persons might include a retired costs judge, or a professional costs draftsman.

21. *Rule 91*: The Enforcement Committee and the Tribunal ought to be under an express duty to give reasons for any decisions they make.

22. *Appendix C: Conduct Committee Guidance* (paragraph 8): The reference to an "*absolute discretion*" is not a concept recognised in English law and should be amended.

23. *Appendix E: Tribunal and Appeal Panel Terms of Reference*: We disagree with the restriction on any practising auditor being appointed unless he or she has not conducted an audit, or had voting rights in an firm or done any work for a firm for 3 years. As drafted, the effect will be that no senior and currently qualified individual will be appointable. For example, an internationally recognised audit expert, who is retired but carries out consultancy work for audit firms would be excluded. Senior national and international experts would also be excluded. The arrangements should not merely permit but encourage current senior leaders of the profession to become members of the Tribunal. Indeed, we consider that such current expertise is essential to high-quality decision-making.

24. *Appendix F: Unrepresented Respondents*: Although this is unlikely to be of direct concern to Deloitte, it is appropriate that the guidance is amended to confirm that the duty of the Executive Counsel when proceedings against an unrepresented respondent is to act with fairness and to ensure that all arguments, including those which are exculpatory or favourable to the unrepresented respondent are accurately and fully presented to the Tribunal.

25. *Appendix G: Sanctions Policy*: We support a system of incentives for early co-operation and settlement. However, the policy should be adjusted to provide for a full reduction equivalent to Stage 1 where a firm or individual invites the Enforcement Committee or the Tribunal to consider withdrawing allegations and is substantially successful at reducing the scope of allegations or their alleged severity. In such circumstances, the firm or individual will have been acting reasonably in continuing to challenge the allegations and full credit is therefore appropriate.

    In addition, in our view it would be preferable to reduce non-financial penalties for co-operation. Where the protection of the public requires a stringent sanction (perhaps in the case of persistent dishonesty

incompatible with the carrying out of audit work in the future), such a sanction is not prevented by an early disposal adjustment.

26. *Appendix H: Publications Policy*: It is not in the public interest to publish a Decision Notice made by the Executive Counsel, which has not had the benefit of review and reconsideration and challenge by the Enforcement Committee. The wording of 5(a) should be amended so that it only applies to "Final Decision Notice" so it is clear that publication is limited to a Decision Notice that has been accepted by the Respondent.

The guidance should be amended to add a duty to publish information about a Notice of Cancellation where a Decision Notice has previously been published or reported, and a duty that any publication is in terms that are accurate, fair and reflect the findings of any Tribunal decision, and in particular explains whether any allegations made by the FRC have been rejected either by the Enforcement Committee or by the Tribunal. The Enforcement Committee should be required to approve press releases. The review of which should be taken by a team independent of the Executive Council, given the potential for unjustified reputational harm and market effects caused by unbalanced press statements.