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For the attention of Anna Colban, Secretary to the AADB
By E-mail: a.colban@frc.org.uk

10 July 2012

Dear Sirs

AADB Consultation Paper - Sanctions Guidance to Tribunals

We appreciate the opportunity to comment on this consultation paper from the Accounting and Actuarial Discipline Board (AADB). Since the consultation was published, the AADB's powers have been transferred to other bodies under the new FRC structure as a result of the FRC Reforms recently approved by the Government. However, for convenience, we have continued to refer to the AADB throughout this response.

We have considered all eleven questions in the consultation paper and our specific views on these are included in the Annex to this letter. We have also considered the 'Indicative Sanctions Guidance' presented in Appendix A of the consultation paper. 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.

Enhanced transparency in disciplinary matters will assist stakeholders

As stated in our recent response to the FRC Reforms consultation (dated 9 January 2012), we believe the FRC, as a credible regulator for accounting and audit, should have a range of sanctions available to it that are exercised in a proportionate manner. Accordingly, we are in principle supportive of changes that will enhance the efficiency of the conduct and disciplinary processes.

As noted in our response to Question 1, we support the objective of providing disciplinary tribunals with written, publicly-available sanctions guidance. As well as informing tribunals, this will aid transparency for all stakeholders and should enable interested parties to follow and understand the sanctions decisions made by tribunals. We also welcome the fact that the guidance allows for early settlement of cases by mutual consent - this will be of benefit to all parties, in particular with regard to costs.

We do, however, have significant concerns as to the prominence given in the consultation paper to the principle of deterrence, as opposed to the other principles which it is acknowledged should underpin any regulatory sanctioning regime. We are also concerned at the lack of any apparent analysis or research concerning the value of deterrence in a professional disciplinary context and the types of sanction which are effective.

We also have concerns regarding the definition of 'misconduct' under the Scheme, although we will be addressing these in our response to the separate consultation document issued last month by the FRC on changes to its disciplinary Schemes. We believe the term 'misconduct' is a misnomer, given the very wide range of conduct which it seeks to cover. The suggested mechanisms for calculating the *starting point* for financial sanctions compounds the problems caused by the 'misconduct' definition, as it bases all cases, whether they are comparatively trivial or grave, on the same financial metrics.

Monetary sanctions should not be punitive and should be related to the harm caused, not size of firm

In the proposed guidance the principle of deterrence seems to be accorded greater prominence than that of proportionality. A sanction should be proportionate to the seriousness of the misconduct and the harm caused thereby. It should not be linked to the size of the firm in question (as is suggested, for example, in paragraphs 3.17-3.18 of the consultation document). In respect of paragraph 9 of the Indicative Sanctions Guidance, we do not agree that sanctions should have a punitive effect.

While we agree that monetary sanctions should form part of the range of sanctions available to tribunals and that such sanctions may be entirely appropriate in some cases, they should not be applied in a disproportionate way. Moreover, we do not consider that natural justice is served by applying higher monetary sanctions on a firm merely because of its size, rather than by reference to the nature of the offence and the harm caused. Further, we do not agree that the ability to pay should be a proper basis for increasing what would otherwise be the tariff for the relevant conduct.

We would add that such analysis as we have undertaken of the sanctions regimes applicable to the accounting profession in most other major economies is that size criteria are not applied in the determination of monetary sanctions. Similarly, sanctions regimes applicable to other like professions in the UK do not, so far as we are aware, employ size criteria in the determination of monetary sanctions.

We do not consider that it is appropriate to determine sanctions based on the revenue of an entire firm or "group". For example, the profit-sharing arrangements in our firm mean that all partners in our firm are already impacted as a result of *any* fine being levied on the firm for misconduct. However, levying a fine based on the revenue of the whole firm has the effect of 'punishing' a non-audit business which for a failure in the audit practice. Perversely, the consequence of the proposal is that the greater the size of the non-audit business, the greater the punishment (for the same level of harm caused by the audit practice). This is clearly

unfair on a firm which may have a larger and more successful non-audit practice and runs counter to the efforts by the Government to promote business success and growth in the UK economy.

Our understanding is that basing sanctions on the revenue of an entire firm is not the approach taken by, for example, the Financial Services Authority (FSA) in recent sanctions imposed on financial services firms. Fines have been determined by the FSA related to the specific area of the business where the failings took place. We see no justification in departing from this premise, if indeed it were considered appropriate to base monetary sanctions on a firm's financial metrics, which we do not support.

We believe the majority of matters with which the AADB will be dealing relate to human error on the part of the firm or member. Given that neither firms nor members set out to make errors, we do not consider that increased financial penalties will deter or prevent future human errors.

The importance of other deterrents, particularly the impact on reputation, should be recognised

In our view, the guidance should reflect the fact that there are significant factors other than monetary sanctions that serve as a powerful deterrent to misconduct.

The most critical of these is the impact of an investigation and/or adverse finding on the reputation of the firm and the individuals involved.

The mere fact that it is known in the financial and business communities that an investigation is in process has a severe effect on reputation. If fault is subsequently found and any sanction imposed, further reputational damage will be suffered. The power of such adverse publicity and the consequent loss of reputation should not be overlooked or underestimated. It is difficult to value the cost of such reputational damage, but it can be significant and lasting. (It is instructive that it was loss of reputation, and the resulting loss of confidence in the firm by its clients, that precipitated the demise of Arthur Andersen post the Enron debacle, albeit that this was within the context of criminal, rather than professional disciplinary proceedings.)

The deterrent effect of the reputational damage and the very public forum in which these matters proceed, including the notices the AADB publishes announcing its investigations, and, where applicable, the filing of charges, are in themselves significant deterrents. The Macrory final report of 2006 '*Regulatory Justice: Making Sanctions Effective*' noted that the publication of enforcement action, such as improvement notices, was an appropriate means of demonstrating to industry that the regulator will take action and of publicly holding industry to account for its behaviour. The impact of a reprimand or severe reprimand alone should not be underestimated. The deterrent effect is particularly powerful for the accounting firms which fall within the remit of the AADB, being the relatively small number of firms which undertake listed company audits (and any other audits which might fall within the purview of the AADB).

There is always wide press interest and reporting around AADB actions and the effect on client confidence should not be underestimated. Firms' clients quite legitimately are concerned to understand more about these matters and partners spend considerable time and effort addressing queries and concerns from existing and potential clients, even at the investigation stage of an AADB matter. The level of client interest and concern is all the more so in the event of adverse findings.

The types of companies whose audits are within the purview of the AADB are sophisticated purchasers of audit services and are wary of firms or audit teams that have had any involvement in disciplinary matters. This in turn affects firms' ability to win new business from other potential clients in the market place as they can be far less attracted to a firm which may be facing/have faced disciplinary issues. It could also have an impact on a firm's ability to recruit and retain staff.

Our analysis of the sanctions regimes applicable to auditors in major economies is that the regulators generally have a range of sanctions available to them. These may include: remedial measures (such as additional training or enhanced review processes); termination of the audit engagement; reprimand or public censure; suspension of individuals or firms for a limited period or permanently; revocation of audit licence; and monetary sanctions. In most countries, monetary sanctions are not applied as a 'headline' deterrent.

Accordingly, we believe it would be appropriate for the AADB, through its sanctions guidance, to ensure tribunals fully appreciate and take account of the very significant deterrent effect of the impact of the AADB process itself upon a firm's reputation.

We would be pleased to discuss our views further with you. If you have any questions in the meantime regarding this letter, please contact Owen Jonathan (0207 804 3199), Philip Mills (0207 213 2561) or Graham Gilmour (0207 804 2297).

Yours sincerely

PricewaterhouseCoopers LLP

ANNEX

PwC detailed responses to the questions in the Consultation Paper

1. Do you agree with the Board's objectives and approach to sanctions guidance?

- We agree that disciplinary tribunals should have written, publicly-available sanctions guidance to which to refer. As well as informing the tribunals, this will aid transparency and assist all stakeholders in understanding the sanctions decisions made by tribunals.

- We agree also with the proposal to have a principles-based approach to the sanctions guidance. In particular, we support the articulation in the consultation document and in paragraph 10 of the Indicative Sanctions Guidance of the six principles from the Macrory report of 2006.

- However, in relation to the principles of the sanctions policy (and the General Principles relating to Sanctions section at paragraph 3.14 which include the principles of proportionality, deterrence and public confidence), we consider that these should also include the principle that the purpose of sanctions should not be punitive. We note that paragraph 3.6 refers to the case of R (on the application of Coke-Wallis) v The ICAEW [2011] UKSC1. The Supreme Court ruled in that case that "*the primary purpose of professional disciplinary proceedings is not to punish but to protect the public, to maintain public confidence in the integrity of the profession and to uphold proper standards of behaviour*." However we are concerned that the effect of the Indicative Sanctions Guidance, particularly in terms of the proposals concerning the calculation of financial sanctions, appears to be primarily punitive.

- Paragraph 3.12 states that *"The Board concluded that a principles based approach rather than a tariff based approach would be more likely to provide the flexibility the AADB was seeking and that this should be supplemented by a mechanism for calculating fines to assist Tribunals in deciding what level of fine might be appropriate in a particular case."* We believe that setting a calculation methodology is inconsistent with the notion of issuing 'guidance' and that Tribunals should have the necessary flexibility to approach each case on its own facts. It is not appropriate to apply the same method of calculation (even with appropriate mitigation and aggravation factors) to cases involving, on the one hand, innocent error which might constitute negligence and, at the other end of the range, conduct that is deliberate or reckless.

2. Do you agree that Tribunals need a clear framework for sanctions which reflects the nature of its cases and the wider context in which the accountancy profession operates today?

- Whilst we believe it is helpful for there to be clear guidance, we consider that tribunals are best placed to decide what is appropriate having regard to all the relevant facts and that the guidance should not be as prescriptive as the current draft of the Indicative Sanctions Guidance as far as calculation of financial penalties is concerned.

3. Do you agree that the sanctions imposed by Tribunals should act as a credible deterrent and be proportionate to the seriousness of the misconduct and to all the circumstances of the case, including the financial resources of Members and the size and financial resources of Member Firms?

- Whilst we agree that the disciplinary scheme as a whole should function as a credible deterrent, sanctions are only a part of the deterrent and we agree that they should be proportionate to the seriousness of the misconduct.

- Monetary sanctions should form part of the range of sanctions available to tribunals. While monetary sanctions may be appropriate in some cases, they should not be applied in a disproportionate way. We do not consider that natural justice is served by applying higher monetary sanctions on a firm by reference to its size, rather than in relation to the nature of the offence and the harm caused.

- As explained in our covering letter, we also believe that the sanctions guidance should give greater recognition to the fact that there are very significant factors, other than monetary sanctions, that serve as a more powerful deterrent to misconduct. In particular, the mere fact that it is known in the financial and business communities that an investigation is in process has a damaging effect on the reputation of the firm in question. The fact that the hearing takes place in public with the consequent emotional strain on the individuals who have to account for their conduct carries a very powerful deterrent effect. Where fault is subsequently found and sanctions imposed, further reputational damage occurs with the publication of these matters. So there are multiple deterrents. Because of this, there is a real danger of creating a punitive regime if the size of fines is increased in the manner proposed. Fines which are significantly in excess of those which have been awarded historically are not necessary in terms of pure deterrence. The deterrent effect of the scheme as a whole is already powerful and we do not believe there to be any strong evidence to the contrary.

4. Have we included the sorts of factors in the sanctions guidance that you would expect to see taken into account by Tribunals?

- We consider that the six-step process set out in paragraph 4.1 of the consultation document and in paragraph 22 of the Indicative Sanctions Guidance is appropriate. This process provides a logical framework by which the AADB can explain and communicate the decision process followed by the tribunal in each case and will assist stakeholders in understanding the decisions made by tribunals.

5. Are there any factors you believe Tribunals should take into account when deciding sanctions that we have overlooked?

- The consultation paper states in paragraph 4.7 that systemic weaknesses in the systems, procedures or internal controls of the Member Firm should be viewed as an aggravating factor. Consistent with our view that misconduct (and hence the AADB sanctions regime) should not be construed to include, for example, relatively inconsequential failures to apply audit standards, we also believe the guidance should be carefully calibrated so that the firm (and the partners as a body) are not unreasonably punished in relation to acts which the firm could not reasonably have prevented. Not all failures are symptomatic of a systemic problem in the firm. The regime should incorporate criteria by which to assess whether the firm managed its audits in an appropriate way.

- We consider that the consultation document fails to recognise that enormous personal consequences are imposed upon those individuals who are subject (whether personally or as team members, where a firm is being pursued) to investigations and the processes that may then follow them.

6. Do you agree that there needs to be an adjustment in the level of fines imposed in AADB cases?

- There is no need to increase fines in order to enhance deterrence. The scheme as a whole already constitutes a significant deterrent, certainly in respect of those firms who are most likely to come under the scrutiny of the AADB.

- We do not support the need for an "adjustment" in the level of fines in AADB cases, especially when there are only a handful of decided cases at this point.

- As noted in our covering letter, we are concerned that the proposed guidance does not give sufficient weight to the principle of proportionality. Undue prominence is given to monetary sanctions as a deterrent and less prominence to the other forms of deterrent that are in our view of equal or greater significance (in particular the damage to public reputation arising from knowledge that an investigation is being conducted).

- We note the references in paragraph 4.9 of the consultation paper to "market concentration" in the audits of publicly listed companies in the UK. The audit market for listed companies is presently being investigated by the Competition Commission and we believe it is inappropriate to comment on such matters in this consultation process.

- It is not the case, as implied by paragraphs 4.9 and 4.10 that audit fees have risen dramatically in recent years. Where individual audit fees have been increased to any significant degree, this relates invariably to the fact that more extensive procedures are required to be performed on the audit.

- The smaller size of a firm should not mitigate nor should the larger size of a firm aggravate the size of a fine. The same standard of behaviour should be expected from all of the firms which the AADB will be considering investigating – the sanction should be related to the seriousness of the misconduct and any harm caused, rather than the size of the audit firm.

- Regard should also be had for the fact that the firm in question may be or have been subject to a civil claim for damages.

- Where a Tribunal decides to impose a financial sanction, ability to pay will be a consideration when assessing the level of a fine. However, we believe that any guidance in this regard should be to the effect of reducing the level of a fine to accommodate the fact that an individual or firm does not have the ability to pay the amount in question. We do not agree that ability to pay is a proper basis for increasing what would otherwise be the proportionate penalty for the relevant conduct.

- We do not believe it is appropriate to assert in paragraph 4.10 that *"fines at historic levels would not be proportionate to the current environment in which Member Firms operate, would not be adequate to incentivise the right kind of behaviour and would therefore fail to fulfil the need for a credible deterrent to future misconduct."* For the reasons outlined above and in our covering letter, we do not consider there is a need to increase fines from historic levels to add any deterrent effect. There are already very powerful deterrent effects inherent in the current arrangements.

- The previous bank of JDS decisions, over which very careful thought was given by the Tribunals in question, should not in our view be dismissed as paragraph 2.6 of the guidance tends to do. This includes the thought given to the appropriate amounts of financial sanctions, having regard to all the evidence presented to the Tribunals concerned. Furthermore, no consideration is given in the consultation document to the fact that a number of the penalties levied by the JDS were reduced on appeal.

- The levels of even historic fines are already far higher than fines for other professions in the UK; and fines for audit practices in other parts of the world, save the US.

- Accordingly "adjusting" fines upwards to any significant degree would make the overall sanction primarily punitive, infringing the principle articulated by the Supreme Court (set out at 3.14 of the consultation document) that "*the primary purpose of professional disciplinary proceedings is not to punish…"*

- Finally, as we indicated in our covering letter, we believe the majority of matters with which the AADB will be dealing relate to human error on the part of the firm or member. Given that neither firms nor members set out to make errors, we do not consider that increased financial penalties will deter or prevent future human errors.

7. If so, what adjustment do you consider to be appropriate?

- Please refer to our response to Question 6 above.

8. What is your view of the alternative mechanisms proposed for calculating fines?

- For the reasons set out in our response to Question 6 above, we question the appropriateness of the proposed adjustment in the level of fines. We do not believe that any of the mechanisms set out in paragraphs 32-33 of the Indicative Sanctions Guidance in Appendix A are appropriate as they all seek to base the calculation of the starting point for fines on a percentage of a financial metric of the member firm or member concerned, which we believe to be a flawed approach. If any guidance at all is to be given about the proposed size of fine (and we have our doubts as to whether this is necessary as we believe tribunals are perfectly capable of forming their own views) we believe it would be preferable to suggest some bands which have numerical upper and lower limits, depending upon the seriousness of the conduct concerned.

9. What level of turnover/income do you consider would be appropriate in respect of each mechanism?

- Paragraph 4.16 suggests that "group turnover" should be considered as a starting point (we assume this means the aggregate turnover of a firm operating in the UK and not on any wider international basis of independent firms in a network). We do not consider that it is appropriate to calculate fines as a percentage of the revenue of a national firm, including those parts of the audit firm's business that are separate from audit.

- Moreover, from a practical perspective there would be too many permutations and variations depending on firm structures and imposing a "one-size-fits-all" solution seems simplistic. The Tribunal in the recent JP Morgan Securities matter agreed with the principle stated in *R v Howe & Co (Engineers) Ltd [1999] Cr App Rep (S) 37* and cited by Lord Phillips LCJ in *R v Balfour Beatty Rail Infrastructure Services Ltd [2006] EWCA Crim 1586* that *"it is not possible to assert that a fine should stand in any specific relationship with a turnover or net profit of the defendant. Each case must be dealt with according to its own circumstances*." We believe that this principle should be enshrined in the sanctions guidance.

- The profit-sharing arrangements in our firm (and we presume the same applies in some other firms) mean that in any event all partners in the firm will in any event be affected financially as result of any fine being levied on the firm for misconduct. We believe that to be sufficient in terms of any need to 'socialise' the impact of a financial penalty against the firm. However, levying a fine based on the revenue of the whole firm has the effect of 'punishing' a non-audit business for failures specifically related to the audit practice. This would have the perverse consequence that, the greater the

size of the non-audit business, the greater the punishment. This is not a fair basis for a sanction.

- We are not aware of sanctions regimes applied to the audit profession in other major jurisdictions where the revenue of the entire business is used in calculating fines. Nor are we aware of sanctions regimes for other professions or other regulated sectors in the UK where this approach is taken.

- Other regulatory regimes such as that of the Financial Services Authority (FSA) take a different approach, focusing on the particular business where the issue has arisen rather than seeking to sanction a group of businesses or an entire financial institution. A recent example is the Final Notice issued by the FSA in relation to Mitsui Sumitomo Insurance Company (Europe) Ltd of 8 May 2012, where the fine was calculated based on the company's relevant revenue for its non-Japan Interest Abroad insurance business, rather than its whole revenue.

- Accordingly, and despite our fundamental contention that it is not appropriate to base the calculation of fines upon financial metrics, if any financial metrics are to be used, the AADB should only consider mechanisms to calculate fines based on the area of business where the misconduct took place (for example, where appropriate, the fees from the relevant client for the particular engagement concerned or the fees from that type of business). In practice there may be difficulties in putting precise boundaries around the area of business and the revenues generated, but this would in our view be preferable to a regime that indiscriminately penalises the growth of successful non-audit businesses (at a time when economic growth is much needed).

10. Do you agree that Tribunals should not take account of the costs that they are considering awarding against a Member or Member Firm when determining the appropriate level for a fine?

- No, we believe that in each case a Tribunal should take into account all relevant factors when determining monetary sanctions, including the level of costs that may have been awarded.

- We disagree with paragraph 4.21 that the deterrent effect of a fine would necessarily be diluted if Tribunals were to reduce the size of the fine (or at least to take an appropriate reduction into account) on the basis that the Member or Member firm would be ordered to pay significant costs to the AADB.

- As noted above, larger fines in themselves are not needed in order to create an appropriate deterrent. The very process of a publicly announced investigation, any adverse finding and any consequent sanction are each powerful deterrents for the firms covered by the scheme. Moreover, the size of the costs can in some cases be very significant and as such the imposition of costs is a sanction in itself and therefore a further deterrent. Costs should therefore be considered carefully alongside any fine which is to be imposed.

11. Do you have any other comments about the proposed structure or content of the sanctions guidance?

- The guidance should include a clear statement that financial penalties against auditors/audit firms should not be linked at all with whatever penalty may have been imposed on the audit client by its regulator. This was something the Tribunal in the JP Morgan Securities matter stated very clearly and we believe that without its inclusion in the guidance unnecessary time and money will be spent in seeking to argue that some links should be made between the two. (We suggest that regard be had to the arguments made in paragraphs 23-43 of the tribunal's Decision in the matter of the AADB and PwC in relation to JP Morgan Securities Limited.)

- We would like to see the AADB and its successor take action against those who perpetrate fraud and wrongdoing within companies whose actions (often in collusion with others) are the primary cause of losses to shareholders. The sanctions guidance needs to take account of such behaviour, particularly where those involved are senior members of management. It should also acknowledge that just because an auditor does not discover fraudulent behaviour does not equate to audit failure warranting sanction on the part of the auditor.

- We note that the European Commission published in November 2011 legislative proposals which may impact on the way auditors are regulated throughout the European Union (EU). This includes proposals (Articles 61-67 of the proposed Regulation on specific requirements regarding statutory audit of public interest entities) in relation to the sanctions regime that may apply if auditors breach the provisions of the Regulation.

- The FRC and AADB should consider the relative merits of pressing ahead with further changes in the UK's disciplinary and sanctions regime, in light of the fact that the scheme has been altered on a number of occasions and those previous changes need to bed down, and the possibility of having to make further changes in a relatively short timeframe in order to accommodate requirements issued by the EU. In this connection we note that a further consultation paper has now been issued by the AADB relating to the Scheme.