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Private and confidential
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Dear Ms Colban

Accountancy and Actuarial Discipline Board – Response to Consultation on Guidance for Prosecution Decisions under the Accountancy Scheme

INTRODUCTION

1. Ernst & Young LLP welcomes the opportunity to comment on the consultation paper Sanctions Guidance to Tribunals (Consultation) issued by the Accountancy and Actuarial Discipline Board (AADB) and AADB's proposed draft guidance (Guidance).

2. Unless the context suggests otherwise: (i) defined terms used in this letter shall have the same meaning given to them in the Consultation; and (ii) the principles and concerns we describe relating to sanctions against Member Firms apply equally to sanctions against individual Members.

SUMMARY AND RECOMMENDATIONS

3. We accept that it is, of course, appropriate that work which falls below the required standards is subject to regulatory scrutiny and sanction. We agree that it is desirable that Tribunals are provided with guidance on disciplinary sanctions. We are also in favour of guidance which directs Tribunals to impose proportionately severe sanctions on Members who engage in deliberate or intentional misconduct such as demonstrating a lack of integrity or on Member Firms which permit such behaviours to prevail due to the absence or the inadequacy of their internal controls.

4. We believe that the Scheme would benefit from a better definition of "misconduct"[1] to provide greater clarity and focus for both regulator and the regulated on the behaviours which are properly the subject of disciplinary proceedings and the sanctions regime. We note that AADB has issued a separate consultation which invites comments on the process by which AADB decides to investigate

[1] See the section "Scope of Misconduct" under the heading "Context" below

to which we will respond in due course. This raises a question as to the logical order of events. We would have thought it better to agree the scope of regulatory enforcement prior to concluding on sanctions. We comment on this further in our response to Question 2.

5. As an overall theme, we would welcome a more holistic approach for regulatory breach by accountants which reflects the wider context for sanctions and public censure in the accountancy profession and draws on the well-established monitoring and inspection regime. We believe that the AADB should look beyond monetary sanctions and consider the wider range of sanctions which Tribunals are able to impose. This would fit well with the principle that the primary objective of sanctions is to protect the public and not to punish. This is addressed in further detail below under the heading "Context".

6. We believe that any guidance to Tribunals which suggests that fines for misconduct should be based on a percentage of annual group revenue/income is flawed. This would inevitably result in arbitrary, inconsistent and disproportionately high fines, particularly for lower level misconduct where the conduct in question may not even give rise to liability in negligence. We also believe that fines for Member Firms by reference to a percentage of "annual group revenue" have the potential for a range of unintended consequences (see further our response to Question 6). In addition, the Consultation lacks clarity on the definition of the term "annual group revenue" and we believe that such uncertainty will lead to increased costs. In this connection, we understand that the Solicitors Regulation Authority (SRA) recently considered a percentage of revenue based approach to regulatory fines in respect of Alternative Business Structures but declined to adopt this approach due to concerns about certainty and costs.

7. We also believe it would be more proportionate and reasonable for guidance on sanctions to clearly distinguish between sanctions for lesser forms of regulatory breach and those for more serious misconduct. In all cases, we believe the Tribunal should have regard to the following:

   7.1. the aggravating and mitigating factors set out in the Guidance;

   7.2. the disciplinary record of the Member or Member Firm in question and its ability to pay the proposed fine; and

   7.3. in the case of Member Firms, the extent of its procedures and controls relating to the misconduct in question as evidenced by any relevant regulatory inspections.

8. In relation to the extent of Member Firms' procedures and controls, we note that the Scheme provides that Member Firms have a form of strict liability for acts and omissions of their people[2]. This is akin to a Health and Safety Executive prosecution. We believe it is desirable that a Member Firm has the benefit of a defence to prosecution if it can demonstrate that its procedures and controls relating to the misconduct in question were reasonably adequate, as evidenced by

[2] Referred to at paragraph 3.21 of the Consultation

regulatory inspections. This is on the basis that a Member Firm should not be unfairly penalised for the actions of a determined bad apple who evades reasonably adequate controls. Otherwise the Scheme is more severe than, for example, the Bribery Act which provides such a defence for a commercial organisation in relation to the acts or omissions of its associated persons (i.e. including its staff). A defence as outlined above would have the benefit of providing additional motivation to a Member Firm which has under-invested in their controls to up its game.

9. In our view, the distinction between lesser and more serious misconduct should be made by reference to the five levels of misconduct described at paragraph 4.17 of the Consultation (we note that the Consultation applies these classifications only to the second mechanism but we believe they are capable of being applied to whichever approach is adopted). For lesser forms of misconduct, where a financial sanction is appropriate, we suggest a fixed fine. This has the benefit of clarity, certainty and efficiency. For more serious misconduct (level three and higher), depending on the level of seriousness, the Tribunals should have regard to relevant engagement revenue/income or a multiple thereof in determining the appropriate level of sanction. As well as proportionality and fairness, this has the benefit of increased simplicity over calculation of the fine by reference to "annual group revenue".

CONTEXT

10. We are concerned that the approach taken in the Consultation and Guidance has not been moulded to the accountancy profession. We believe that the question of the effectiveness of regulatory sanctions as a deterrent to Members and Member Firms engaging in "misconduct" requires a more holistic review. This review should include consideration of the following matters:

    10.1. the scope of misconduct and the behaviours which ought properly to be the subject of AADB proceedings;

    10.2. the factors which give rise to misconduct;

    10.3. the existing deterrents to misconduct and wider context applicable to the accountancy profession in which sanctions operate as deterrents to misconduct; and

    10.4. the consideration of a wider "toolkit" of potential sanctions which are designed to seek to ensure corrective actions and better protect the public.

11. We set out a few observations on these points below.

Scope of misconduct

12. The Scheme's original definition of "misconduct" encompasses any "*conduct in the course of a firm or member's professional, business or financial activities which falls short of the standards reasonably to be expected of a firm or member*". Whilst the decision to proceed with an investigation requires satisfaction of the public interest test, subject to that, any technical breach however insubstantial and of limited consequences is capable of constituting "misconduct".

13. We note that the Scheme's definition of "misconduct" is a departure from the position under case law which provided that for an act or omission to amount to regulatory breach, such act or omission had

to fall *significantly* short of the standard of the reasonable average. There was an evolving line of authorities on this from cases like Mayflower, Capital Corporation and Barings which stated that only where there is a significant departure from the standard of conduct reasonably to be expected can a tribunal be confident that conduct falls sufficiently outside a range of conduct which might be regarded as acceptable practice.

14. Revising the definition of "misconduct" in line with the case law would bring greater clarity regarding the nature of cases which AADB is likely to prosecute and which are properly the subject of disciplinary proceedings.

Factors giving rise to misconduct

15. Accountants' behaviours which give rise to disciplinary proceedings tend to be quite different from the behaviours of other sectors where there is a history of deliberate or intentional misconduct. For those other sectors, the regulator's primary objective is to ensure that sanctions are sufficiently severe so that the expected gains from deliberate decisions to flout the rules do not outweigh the risks.

16. Most disciplinary cases involving accountants relate to unintentional oversight or well-intentioned errors of judgment on matters of fine sensitivity as judged with hindsight. There could be a range of underlying causes including insufficient investment in internal controls and quality and risk management teams, overtrading or insufficient understanding of a client's business. We are not aware of any AADB or Joint Disciplinary Scheme cases which have involved deliberate or intentional misconduct.

17. Despite the absence of such cases, the Consultation appears to have adopted the approach applied by regulators which often encounter deliberate or intentional misconduct. This one size fits all approach is flawed as it is not calibrated to the accountancy profession. It fails to acknowledge the differing risks and behaviours that different regulators have to deal with. We expand on this point in our response to Question 2 but in summary, we do not believe that the proposed approach is well suited to the accountancy profession.

Existing deterrents and the wider context

18. Member Firms and Members are acutely aware that if they fall short of the standards reasonably expected of them, this is likely to be detected and subject to internal investigation and applicable legal and regulatory regimes. There are serious consequences for Members who fall short of required standards, including internal review, performance management, financial sanction and possible dismissal from the member firm. In addition, both Members and the Member Firm may have to deal with complaints, claims and regulatory proceedings. Therefore, the possibility of AADB disciplinary proceedings and related sanctions is one of a range of serious consequences for Members or Member Firms whose services fall short of the standards reasonably expected of them. Leaving to one side professional pride and the desire to provide high quality work which is inherent to the vast majority of professionals, Members and Member Firms are, irrespective of sanctions, highly motivated to meet and exceed the standards expected of them to avoid risk to their reputation and livelihood arising from the consequences if they do not.

19. As a result of the reputational and other risks of work which falls below the requisite standard, Member Firms they have made significant investments in internal quality and risk management teams and enhanced internal controls to help weed out behaviours which might give rise to regulatory breach. Internally, quality and risk management for Member Firms is a key priority. This has been confirmed by the profession's oversight bodies and regulatory inspection reports.

20. Therefore, the starting point as regards existing deterrents is a Member Firm's internal procedures and controls. A Member Firm's internal controls are, in the context of public interest entity audit work, subject to an existing detailed monitoring and oversight regime led by the Audit Inspection Unit (AIU). We have a number of points on this:

    20.1. Member Firms and many of their people are members of the relevant professional bodies in the UK which impose rigorous professional conduct requirements, regulate and inspect all parts of their businesses;

    20.2. Member Firms are inspected against the International Standard on Quality Control 1 (ISQC1) which requires audit firms to "*establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partners are appropriate in the circumstances*". ISQC1 requires an audit firm's quality control systems to address leadership responsibilities for quality within the audit firm, ethical requirements, client acceptance and continuance, engagement acceptance, human resources, engagement performance and monitoring;

    20.3. In relation to leadership responsibilities, ISQC1 requires audit firms "*to establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements. Such policies and procedures should require the firm's chief executive officer (or equivalent) or, if appropriate, the firm's managing board of partners (or equivalent), to assume ultimate responsibility for the firm's system of quality control*"; and

    20.4. ISQC1 is primarily aimed at the Member Firm's audit practice but it also applies to those parts of our business that (i) support auditors like our tax teams and our actuaries; or (ii) provide audit related services. Member Firms typically apply the spirit of ISQC1 across their entire business because it is more practical to do it that way. The oversight regime for public interest entity audits where most AADB cases will tend to arise involves annual inspections with published findings. These published findings have consequences for the Member Firms involved including reputational damage for negative findings.

21. Whilst internal controls are regularly tested, reviewed and monitored (internally and externally), it is near impossible to eradicate errors as judged with hindsight in services which involve judgments on matters of fine sensitivity. Bearing in mind the volume of work undertaken by Member Firms, instances of regulatory breach are uncommon and do not indicate a lack of credible deterrent to misconduct.

22. We note that the Consultation provides that systemic weakness in Member Firms is a factor which exacerbates the seriousness of the misconduct. However, it is not clear that the extent of the Member Firm's controls and the AIU's oversight of will equally be taken into account in mitigation.

We believe that appropriate weight should be given to a Member Firm's controls as evidenced by external regulatory monitoring and oversight reports.

Wider toolkit

23. AADB should have regard to the cause of the regulatory breach and the sanction which is most likely to protect the public as well as deter recurrence. We understand that none of the regulators which are equivalent to AADB in the U.S., Australia, Canada or South Africa apply a percentage of revenue/income as the basis for calculating any fines imposed on accountants. Some of these regulators do however have available other sanctions such as education, supervision for Members and third party reviews and prohibitions on accepting new clients for Member Firms.

ANSWERS TO SPECIFIC QUESTIONS

Question 1

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

24. We agree with the objectives. However, in light of the points above, we think the approach to sanctions needs to be reconsidered.

Question 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?

25. A clear framework for sanctions is desirable. However, the suggestion of a revenue based fining mechanism for accountants' misconduct seems to have been lifted from regulatory schemes where the regulator's primary objective is to deter intentional misconduct.

26. Regulators such as the FSA or OFT which regularly deal with intentional and profit-driven misconduct need a sanction regime which results in the imposition of substantial fines on organisations which make substantial profits from misconduct to deter future misconduct. The FSA sanctions regime provides for firms to be fined up to 20% of relevant business revenue.

27. In the consultation process which led to the current FSA sanctions regime, the FSA supported their approach citing the OFT October 2009 paper – An assessment of Discretionary Penalties Regime. This paper is directed to anti-trust activities where the deterrence sought is against a deliberate decision to flout the rules in light of expected gains.

28. However, there is no culture of deliberate or intentional profit-driven misconduct in the accountancy profession. We are unaware of any such case before the AADB or its predecessor, the Joint Disciplinary Scheme. The targets of the AADB are nearly always only secondary actors whose 'failures' often result from well-intentioned judgment errors (as judged with hindsight) or technical breaches of standards or regulations with little or no causative impact. Such well-intentioned judgment errors are inherently incapable of being deterred by higher fines.

29. We note that AADB has recently issued a further consultation which invites views on a number of issues including the test it applies in deciding to launch an investigation. This consultation is welcome and we will respond in due course. However, we wish at this stage to note the following issues:

    29.1. It is acknowledged at paragraph 3.24 of the new consultation that there is a lack of clarity about the sorts of cases which AADB investigates. Greater clarity and consensus about the behaviours and cases which AADB wishes to deter is welcome. Such greater clarity would enable a more meaningful dialogue regarding the effectiveness of existing and proposed sanctions;

    29.2. It does not seems logical to conclude a consultation on sanctions prior to the consultation on how AADB decides to launch an investigation. If the suggestion is that Members and Member Firms ought not to be concerned about the risk of a revenue based fine for a relatively low level misdemeanour because AADB will in future be more selective about the cases it prosecutes, this is of limited comfort; and

    29.3. Whatever the outcome of the new consultation, Member Firms and Members will be liable to sanctions for "misconduct" as defined and therefore it would be helpful to refine the definition to be clearer about the behaviours which ought properly to be the subject of disciplinary proceedings.

Question 3

Do you agree that the sanctions imposed by the 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?

30. The AADB Tribunal in the 2011 JP Morgan Securities Limited Client Money case (JP Morgan case) considered and rejected without hesitation as "irrational" a submission that a financial penalty for defective audit or reporting should be linked to the percentage of revenue based penalty imposed on the client. The Tribunal accepted that quite different considerations apply to the primary actor and its regulator from those which apply to auditor or reporting accountant. We agree with this analysis.

31. As regards the relevance of resources in setting a fine, the Scheme currently does not limit the fine which a Tribunal may impose. Tribunals considering such an unlimited power are guided by case law[3] which sets out the relevant principles. In the JP Morgan case the Tribunal summarised the relevant principles as follows:

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[3] The principles stated in R v Howe & Co (Engineers) Ltd [1999] Cr App Rep (s) 37 cited in R v Balfour Beatty Rail Infrastructure Services Ltd [2006] EWCA Crim 1586

31.1. Breaches of the regulatory legislation were particularly serious because they were the foundation of the health and safety of the public.

31.2. Historically fines have been too low.

31.3. 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.

31.4. It may be appropriate to consider how far short the defendant fell of the appropriate standard.

31.5. A breach with a view to profit seriously aggravates the offence.

31.6. The degree of risk and the extent of the danger, specifically whether it is an isolated failure or one continued over a period.

31.7. The defendant's resources and the effect of the fine on its business - factors to be borne in mind

31.8. Prompt admission of responsibility and a timely plea of guilty; steps taken to remedy deficiencies; a good record.

31.9. The objective of the fine should be to achieve public safety and bring that message home to those who manage a corporate defendant and also its shareholders.

31.10. The stated objective means that consistency of fines between one case and another and proportionality between the fine and the gravity of the offence may be difficult to achieve.

31.11. A more serious view can be taken of breaches where there is a "significant public element". The fact that a risk has by good fortune or otherwise not eventuated or has eventuated with less serious consequences than might have occurred is a relevant factor.

32. We note that most of these principles are reflected in the Consultation and Guidance[4]. However, the Board appears to have reached a conclusion regarding the lack of a credible deterrent to misconduct without due regard to the context within which sanctions operate to deter accountants' misconduct. In addition, it seems to us that the emphasis on the wrongdoer's financial resources risks the loss of perspective on the nature and cause of the misconduct and the degree of the departure from the acceptable norm.

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[4] See response to Question 5

Question 4

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

33. Yes, most of the relevant factors are included. We suggest additional factors in our response to Question 5.

Question 5

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

34. We believe that a Member or Member Firm's record should be taken into account in determining the sanction.

35. It is worth noting that even if the prospect of substantially higher fines was capable of deterring accountants' misconduct, as regards accountancy firms and other professional services firms, by the time a disciplinary proceedings are concluded and a fine is levied, any retention applied to partner drawings has been released and the relevant persons responsible for the relevant misconduct will have left the Member Firm. In such cases only partners and staff with no connection to the misconduct in question would face the consequences of the sanction on the Member Firm.

Question 6

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

36. We refer to our recommendations above.

37. A one size fits all approach to sanctions which proposes fines based on revenue for all misconduct is too rigid and will be prone to challenge as unfair and disproportionate. In the JP Morgan case, the Tribunal demonstrated that it was well aware of the context for the fine it imposed and considered arguments for a step change in the level of fines by reference to the change in size and scale of the work undertaken by the Member Firm with the relevant client and adjusted for inflation. It is clear that the Tribunal did not feel bound by precedent.

38. We note that five "levels" of misconduct are set out at paragraph 4.17 of the Consultation. We note that level one involves isolated, unintended conduct where potential harm is limited in degree and that levels one and two appear to involve conduct which does not cause actual harm or amount to negligence. It seems inherently disproportionate that behaviours for which the law would not permit a claimant to recover damages are capable of a finding of "misconduct" which could result in a fine based on percentage of annual group turnover.

39. If percentage of annual group turnover/income fines for all levels of misconduct are implemented the Guidance will result in disproportionate sanctions and inevitably in appeals with increased costs for all parties.

40. AADB should bear in mind unintended consequences of fines which are based on percentage of turnover/income:

    40.1. the firms which will be most at risk of heavy fines will be less profitable firms with fewer resources which have under-invested in risk management systems and procedures and legal and regulatory teams, operate on smaller margins and have fewer partners among whom to spread the fine. This may result in less competition for higher risk work;

    40.2. more profitable firms with greater resources will be more prepared to fight disciplinary cases and may be more likely to appeal judgments of first instance Tribunals which will increase all parties' costs. In circumstances where there is a desire to streamline the disciplinary process, this will not assist;

    40.3. the same misconduct will result in significantly different levels of fines depending on the which Member Firm or Member is involved;

    40.4. revenue is, of course, not evidence of a Member Firm's profitability and ability to pay a fine and we refer to the importance of Tribunals having regard to ability to pay above in the Summary and Recommendations section; and

    40.5. less profitable firms with fewer resources may be unfairly intimidated into settlements.

Question 7

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

41. Please see our response to Question 9.

Question 8

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

42. Each of the three mechanisms proposes to use percentage of turnover/income as a reference point for fines in all cases of misconduct. We do not believe that this approach is suitable for the accountancy profession.

43. We note that the "relevant business" qualification which applies in the FSA regime[5] has not been carried through in any of the three fining mechanisms proposed in the Consultation. This could lead to the disproportionate outcome that a more substantial fine is imposed on secondary actors than the FSA regime would impose on primary actors.

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[5] See response to Question 2

Question 9

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

44. We refer to our recommendations above.

45. We note that the equivalent US disciplinary regime for accountants provides for a maximum fine per finding of $250k (individual) or $2m (corporate) maximum fine for lower level misconduct and $750k (individual) or $15m (corporate) maximum fine for more serious misconduct. The Solicitors Regulation Authority recently consulted on its sanctions regime and had sought percentage of revenue based fining but in light of representations has agreed a maximum fixed fine. The Legal Services Board's representations in connection with turnover based fines focused on the difficulties and therefore increased costs for determining fines which involve calculation of profit/revenue.

Question 10

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

46. No. Further, where costs have been wasted by a Member or Member Firm where complaints are overblown or due to the manner in which a complaint has been prosecuted this should be taken into account in reducing the fine.

Question 11

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

47. Clearly it will be more difficult for a Member Firm or Member to cooperate when litigation is threatened or on foot. There should be no adverse consequences for failure to cooperate in such circumstances. The guidance should be clear about how civil liability its costs and impact on those concerned including compensation paid is relevant to sanctions.

48. There is a suggestion in the Consultation that guidance is needed due to a number of cases which are coming to Disciplinary Tribunal. If the object of the new Guidance is deterrence it should give the profession a chance to change behaviours to reflect the changed regime. Tribunals should have regard to the policy on imposing penalties which was in force at the time the Member Firm or Member committed the breach.

Conclusion

49. It is in all parties' interests for AADB to issue helpful guidance which promotes proportionate sanctions which "fit the crime". We think the logical order of events is for the position on the scope of AADB disciplinary proceedings to be clarified before the position on sanctions is concluded. If Guidance is issued which the majority of Members and Member Firms accept as reasonable in the context of the accountancy profession, this will avoid protracted argument in disciplinary

proceedings, appeals and the additional costs which follow. We accept that the production of such guidance is not straightforward but, in our view, the approach taken requires a structural rethink.

50. We appreciate AADB consulting on this matter and look forward to reading AADB's analysis of responses received. We assume that this and the other responses will be posted on the FRC's website in due course. For the avoidance of doubt, this letter is not intended to be confidential.

51. If you would find it useful, we would be happy to discuss any of the points we have raised above further with you or your colleagues.

Yours sincerely

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