Think Ahead ACCA

Enhancing confidence in audit: the Financial Reporting Council's audit enforcement procedures

A consultation issued by the Financial Reporting Council

Comments from ACCA

May 2016

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ACCA welcomes the opportunity to comment on the proposals issued by the Financial Reporting Council (the FRC) on 23 March 2016. The deadline for responses to the consultation is 4 May 2016 – providing only a six-week period, within which there have been three public holidays. It is also of great concern that this consultation is being issued so close to the implementation date in June 2016. It would have been useful if the consultation document had outlined the resource the FRC currently has in place to support the proposed Audit Enforcement Procedure, and to what extent it would be necessary for the FRC to recruit for new and additional roles, procure other resources, update existing internal documentation, etc. It is also unclear (either from this consultation or from the FRC's budget for 2016/17) what operational costs have been forecast to implement this proposed Procedure.

Nevertheless, we have endeavoured to provide a thoughtful and constructive response. In order to do so, our focus has been on the proposed Audit Enforcement Procedure itself, and we have looked to the explanatory material in the consultation document (including the guidance and policy documents in the appendices) wherever the Procedure is unclear. However, this should not have been necessary, and the final Audit Enforcement Procedure must be clear enough to stand alone.

OVERALL COMMENTS

While we acknowledge that the FRC has been hampered by not having the final legislation on which to base these proposals, we consider the consultation document lacks clarity, which presents a considerable challenge when combined with a very short consultation period. Our understanding is that the FRC is proposing a four-layer process (excluding the appeal process), in which there are three opportunities for the FRC to avoid the expense of a public hearing at a tribunal. Apart from the lack of clarity in the proposed Audit Enforcement Procedure, the process itself would be vulnerable to criticism of being cumbersome and lacking transparency and balance. It may also be criticised for handing too much power to Executive Counsel.

The proposed Audit Enforcement Procedure centres around alleged breaches of Relevant Requirements. The definition of 'allegation' in the Glossary (Part 1, paragraph 1) is drafted very widely, and could be seen as including many findings of an AQRT inspection. We believe that this is not the intention, and care must be taken in drafting the definition, in order to avoid unintended

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consequences. According to the Glossary, a Relevant Requirement includes a requirement under 'the Audit Regulations'. As 'the Audit Regulations' are not defined, we assume this to be an error, and that the Glossary should refer to requirements under 'the EU Audit Regulation'.

The scope of the proposed Procedure is also unclear in respect of the types of audit that would be covered by the Procedure. This is fundamental, particularly in light of our comments below concerning the initial stages of the Procedure.

Within section 1 of the explanatory material, the following sentence is central to what the Procedure is seeking to achieve, and our comments on the proposed Procedure are made with this in mind:

'*The FRC is committed to independent, effective, proportionate and consistent regulation across the sector and seeks to deliver this by way of a new procedure which balances an appropriate level of constructive engagement and the opportunity to resolve cases at an early, administrative stage with the availability of a full hearing by an independent tribunal*.'[1]

(There is no reference at all to transparency either in the proposed Audit Enforcement Procedure or in sections 1 to 4 of the consultation document.)

The proposed Audit Enforcement Procedure is complex. We understand it to be as follows:

STAGE 1: CASE EXAMINER

The Case Examiner determines whether an allegation should be referred for investigation or whether it may be disposed of by way of 'constructive engagement'. The level of qualification and experience of the Case Examiner is unclear, and yet the question of whether the FRC's Audit Enforcement Procedure in respect of PIEs should progress, or whether the matter may be resolved by constructive engagement would be 'entirely at the discretion of the Case Examiner'.[2]

Although the proposed guidance states that constructive engagement is suitable for minor, technical breaches, it does not state that it is *limited* to such cases,

[1] Consultation document, page 3
[2] Proposed guidance for Case Examiner, paragraph 12

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and we believe that excessive reliance is placed on the Case Examiner's judgement. Where the Case Examiner has decided not to refer an allegation to the Conduct Committee (or Investigation Committee), the proposed Procedure does not require that decision to be independently ratified. Neither does it require any publication of matters successfully disposed of by way of constructive engagement (eg breaches rectified, warnings given, etc).

We believe that the early stages of the proposed Procedure are too heavily weighted towards early, economical resolution, particularly where the respondent is offered financial inducements to accept a Decision Notice. Willingness to cooperate with an investigation should be reflected in the award of costs. Such a mechanism is compatible with both the need for transparency and the desire to dispose of cases as efficiently as is appropriate.

The Case Examiner guidance should be referenced from the Stage 1 Procedure itself. The guidance should provide greater clarity concerning independent decision-making, transparency and the implications of an allegation being disposed of by way of constructive engagement (eg with regard to future allegations against the same respondent being received).

STAGE 2: ENFORCEMENT DIVISION

The reader must refer to the Case Examiner guidance in order to try to understand the process of referral to either the Conduct Committee or the Investigation Committee. The guidance suggests that a delegation (by the Conduct Committee, to the Investigation Committee) may be in place to cover certain types of case. But there is no indication of the types of case that might be appropriate for delegation. Without this information, the provisions appear to be unnecessarily complicated. We believe the Procedure and related guidance should describe referral by the Case Examiner only to the Conduct Committee, but include a provision that the Conduct Committee may delegate an investigation to the Investigation Committee (identifying the circumstances and types of case where this might be appropriate).

The investigation commences within the Enforcement Division. Executive Counsel sits within the Enforcement Division and is the decision-maker at this stage. However, the definition of Executive Counsel is 'a legally qualified officer of the FRC appointed to that office by FRC's Nominations Committee or the person or persons to whom the FRC Board or Executive Counsel delegates

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responsibility' This seems very broad, and we believe that the ability to delegate should not be included within the definition, given Executive Counsel's decision-making powers. We assume the proposed structure and operation of the Enforcement Division would be similar to that of ACCA's Investigations department, given that the FRC would be permitted to delegate the investigation work to an RSB at this stage.

The consultation document states that, where an investigation has been delegated to a professional body, the RSB is to provide the Investigation Report (defined in the proposed Audit Enforcement Procedure as the 'report finalised by the FRC following any submissions from the Respondent to the Initial Investigation Report') to the Enforcement Division for a decision on liability and, where applicable, sanctioning.[3] In fact, this should state that the RSB shall provide the *Initial* Investigation Report (or perhaps simply 'provide a report'), as it is after the investigation has been concluded by the Enforcement Division that the respondent is to be provided with the Initial Investigation Report by Executive Counsel.[4]

The Initial Investigation Report is defined in the Glossary as a report prepared by Executive Counsel. The investigation powers within paragraph 7 of the proposed Procedure may be exercised by the RSB[5], but there are further powers that are reserved for Executive Counsel '[i]n the course of his investigation',[6] which further suggests that the Initial Investigation Report (provided to the respondent) is the product of Executive Counsel.

Having considered any submissions from the respondent in response to the Initial Investigation Report, Executive Counsel must determine whether enforcement action should or should not progress. If it is decided within the Enforcement Division of the FRC that no action is to be taken, a 'Notice of Cancellation' is issued.[7] There is no requirement (or even discretion) to publish this notice, or to have the decision independently ratified.

If, in the opinion of Executive Counsel, enforcement action is required, a Decision Notice is issued, which includes details of findings and proposed

[3] Consultation document, page 7
[4] Proposed Audit Enforcement Procedure, paragraph 9
[5] Proposed Audit Enforcement Procedure, paragraph 6
[6] Proposed Audit Enforcement Procedure, paragraph 8
[7] This is sometimes referred to as a 'Notice of Cancellation' and sometimes as a 'Cancellation Notice' (which is the defined term in the Glossary).

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sanction. Although the respondent must agree to the entire Decision Notice for the 'Final Decision Notice' to be issued, it is unclear from the proposed Procedure how the Decision Notice and Final Decision Notice should be independently ratified. Our earlier comments concerning the respondent being offered financial inducements to accept a Decision Notice are particularly relevant here also. It should be sufficient that early cooperation with an investigation is reflected in the award of costs. However, as costs do not appear to be a feature of Decision Notices or Final Decision Notices at this stage, it is not possible to relate the award of costs directly to the cooperation of the respondent.

STAGE 3: ENFORCEMENT COMMITTEE

Unless it is agreed, between the Enforcement Division and the respondent, that the case should be referred directly to the Tribunal, the next stage of referral is to the Enforcement Committee. It is proposed that Executive Counsel may also refer a matter to the Enforcement Committee where a respondent has failed to comply with a Final Decision Notice. However, we believe it is inappropriate to reopen the case once a Final Decision Notice has been issued. Failure to comply should amount to a new allegation.

The Enforcement Committee meets in private, and decisions are made by the Committee on a predominately paper-led basis. This may be likened to ACCA's Consent Orders Committee although, in our opinion, Stage 2 above is more akin to a consent order stage. The consultation document claims that, while this is an additional layer in the proposed Procedure, this is to 'encourage a pragmatic, streamlined and proportionate resolution to disputed Executive Decision Notices'.[8] We believe that this explanation does not justify the additional layer; if the consent of the respondent has not been obtained prior to this stage, a proportionate and streamlined approach would be to advance to a public hearing. While we acknowledge that the respondent may *agree* with Executive Counsel to move directly to the Tribunal stage, there does not appear to be provision for the respondent to *require* it.[9]

The proposed Procedure suggests that the notice of referral to the Enforcement Committee would invite the respondent to provide written representations, but it also states that the Enforcement Committee may subsequently seek further

[8] Consultation document, page 8
[9] Proposed Audit Enforcement Procedure, paragraph 13(c)

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information.[10] It is important that the respondent has the opportunity to see and comment on any further evidence obtained by the Committee.

As drafted, paragraph 20(c) of the proposed Procedure contradicts paragraph 19(a). We believe that this layer should not remain within the Procedure. Instead, the Enforcement Committee (if sufficiently independent) may serve to ratify the decisions made by the executive at Stages 1 and 2 above.

As drafted, it is not clear on what grounds the respondent may appeal a Final Decision Notice (which may have been issued simply because the respondent failed to respond to the earlier Decision Notice). The issue of appeal from a Final Decision Notice at this stage (within 28 days) is complicated by the requirement that the FRC 'publish mandatory announcements as soon as reasonably practicable immediately after the person sanctioned has been informed of the decision'.[11]

Prior to issuing a Final Decision Notice, and publication of the decision, nothing is in the public domain. Therefore transparency is lacking, which is of particular concern given that the FRC's executive may offer an 'early resolution discount' at various stages. These factors, taken together, might create an impression that a breach of a Relevant Requirement is being 'brushed under the carpet'. We believe it might also present a risk that the public would perceive a lack of rigour (contrary to the public interest) or, alternatively, a lack of fairness towards the respondent, who may prefer to proceed to an open hearing, rather than undergoing pressure to accept a Decision Notice at the various stages.

STAGE 4: TRIBUNAL

We are satisfied that the Tribunal process is similar to the FRC's existing arrangements, and that the appointment of Tribunal members demonstrates appropriate independence, which will enhance public confidence in audit. While we acknowledge the costs necessary to hold public hearings in respect of PIE audits, we believe the reputational benefits for the profession exceed the costs. The same cannot be said in respect of Stage 3 above.

With regard to independence of the Tribunal (and the Appeal Tribunal), we note that '[t]he persons who may be appointed to the Panel shall include, but not be

[10] Proposed Audit Enforcement Procedure, paragraph 18
[11] Publications policy, paragraph 10

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limited to, persons having legal and auditing expertise and experience'.[12] While we agree that the Tribunal Chair must be a lawyer, and that those with audit experience should not be in the majority, the confidence of the public would be enhanced if members of the wider accountancy profession were also not permitted to form the majority.

We agree with the grounds on which a Tribunal's decision may be appealed by the respondent. However, we note that the grounds for appeal do not include an error of fact.[13]

We disagree that an interim order may be subject to appeal. An interim order should only be imposed in order to protect the public during the course of an investigation and possible hearing expected to extend over a long period. Therefore, an interim order must take effect immediately, but be subject to periodic review.

APPEAL STAGE

In addition to the comments made above regarding rights to appeal a decision of the Enforcement Committee, and the need to protect the public by way of interim orders, we are concerned that the Chair of the Appeal Tribunal may refuse permission to appeal, and the respondent would have no right to review by the convened Appeal Tribunal. We believe this could be achieved cost effectively; but denying this right impedes transparency and threatens confidence in the Procedure.

Throughout the proposed Audit Enforcement Procedure, the impact on publicity (and therefore transparency) of the appeal period of 28 days appears to have been overlooked.

SPECIFIC ISSUES

In this section of our response, we address the five questions set out on pages 9 and 11 of the consultation paper, to the extent that they have not been answered within our overall comments above.

[12] Tribunal and Appeal Panel terms of appointment, paragraph 2
[13] Proposed Audit Enforcement Procedure, paragraph 61

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

We are not aware of any aspects of the proposed Audit Enforcement Procedure that would be inconsistent with the requirements of the ARD. However, the proposed drafting of the Audit Enforcement Procedure and the related guidance lacks clarity, which is contrary to good regulatory practice.

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

In addition to specific concerns expressed above, lack of clarity throughout the proposed Procedure and supporting guidance has the effect of further diminishing fairness to respondents. In addition, the lack of clarity (and transparency) impedes confidence in audit (from the public perspective), and so is contrary to the public interest. In particular, the additional layers within the proposed Procedure, together with private 'hearings' and the production of Decision Notices, are not compatible with the principles of better regulation, even though we understand that they represent an attempt to encourage early, efficient disposal of a case.

The consultation document makes no reference to the timeliness of considering allegations, investigating possible breaches of Relevant Requirements, and bringing disputed cases to hearings. It appears that, despite previous concerns about the time taken for FRC (and RSB) investigations to be completed, and cases disposed of, the proposals suggest that the FRC is content to add further processes and interventions.

It also appears that there is no restriction on the matters that may be disposed of by agreement between the FRC's Enforcement Division and the respondent, or by decisions made in private hearing. Having regard to the principles of open justice and public confidence, it is our view that disciplinary matters relating to PIEs should generally be ventilated in public. As currently proposed, there is a risk that the Procedure would be perceived as the profession 'looking after its own'. While we accept that the publication of decisions may ameliorate some of these concerns, in our opinion, the right balance has not been struck in the proposed Procedure.

The Sanctions policy (appendix G) does not adopt a bottom up approach which, in our view, is best practice in relation to disciplinary matters. Although the

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proposed Procedure defines the 'Sanction Policy' (which should be 'Sanctions Policy') within the Glossary, there is no reference within the proposed Procedure to that policy document.

With regard to the sanctions themselves[14], we believe that neither publicity (paragraph 93(c)), nor a declaration that the statutory audit report does not satisfy the Relevant Requirements (93(d)), is a sanction. Instead, we consider these to be administrative measures, which are often necessary to provide appropriate transparency and to protect the public. Although they are included, together with sanctions, under article 30a of the EU Directive, the Audit Enforcement Procedure would be clearer if the purpose of these measures was explained.

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

We have already commented at length concerning the detail that is missing and the general lack of clarity in the proposed Audit Enforcement Procedure and the accompanying guidance and policy documents. Transparency is a fundamental requirement of good regulation, and we believe this is lacking in the consultation and is likely to be lacking in the conduct of the Audit Enforcement Procedure in practice, if it were implemented in the manner proposed. For example, the consultation document is very unclear about the point at which the public should become aware that an investigation is taking place (or has taken place).

The Audit Enforcement Procedure should be accompanied by indicative timeframes. We believe that the number of layers within the proposed Procedure would not serve to streamline the process, but would lead to confusion – both within the process and among members of the public.

A Decision Notice, issued by Executive Counsel or by the Enforcement Committee, may be rejected by the respondent, in which case the matter would progress to the next stage. It is, effectively, a consent order, although it arises through a Decision Notice, rather than by positive consent. This different emphasis may be important given the lack of transparency of the Enforcement Division and the Enforcement Committee (which meets in private and considers cases on paper only). Given the apparent intention of the current proposals, we

[14] Proposed Audit Enforcement Procedure, paragraph 93

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would recommend incorporating into the Audit Enforcement Procedure a comprehensive and clear consent order regime, which would include full publication of the facts, the sanction and the identity of the respondent.

In respect of interim orders, there is a need to better align Part 6 of the proposed Procedure to the relevant stages of the Procedure at which application for an interim may be appropriate. Part 6 should also set out, in clear terms, the test that must be met in order for the Enforcement Committee or the Tribunal to make an interim order (from which there should be no right of appeal). An interim order will often have a significant impact on the respondent and others. Where such an order is necessary, it will be imposed prior to the conclusion of a full hearing, and so transparency concerning the protection of the public is essential. The Audit Enforcement Procedure would be further streamlined (and the public and the respondent better protected) by requiring all interim order applications to be heard by a full Tribunal.

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

We believe there must be more clarity concerning the use of undertakings. The Procedure must clearly differentiate between:

1. undertakings that are provided as part of constructive engagement, and

2. those that are required to be given by the respondent at the sanctioning stage.[15]

The latter must always be subject to publicity and, given that these allegations concern PIEs, it may be argued that undertakings given during the course of constructive engagement should also be published.

It is unclear why the proposed Procedure requires a schedule of costs to be served no less than 24 hours before the hearing. This presents a threat that hearings may be adjourned, the enforcement process may be prolonged, or claims may be made by one of the Parties to challenge the fairness of the process.

[15] Proposed Audit Enforcement Procedure, paragraph 94

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

Underpinning the FRC's funding arrangements must be the principle that costs are met by those who benefit from the functions of the FRC and those who cause unnecessary costs to be incurred. The question of fines is a separate one, and we support the principle that a regulator should not benefit from any fines imposed by it, as this may be perceived as compromising the impartiality of the regulator in performing its disciplinary function.

The FRC exists, as the sole competent authority for audit regulation in the UK, to promote high quality corporate governance and reporting to foster investment. Therefore, the beneficiaries of the FRC's Audit Enforcement Procedure are the general public and the PIEs in which they may invest. Therefore, we suggest that the anticipated costs of operating the Audit Enforcement Procedure should be borne by those PIEs – either directly, or through the firms that audit them.

In contrast, principles of fairness dictate that case costs must be met on a 'polluter pays' basis. This must relate to costs awarded against the FRC, as well as those awarded against a respondent. Therefore, the FRC must maintain the reserves necessary to meet such costs should they be awarded, or else have access to 'emergency funding'. We believe that an initial accumulation of the appropriate level of reserves (a 'case costs fund'), like the operating costs, should come from the PIEs who will benefit from the enhanced confidence in audit.

The provisions in paragraphs 85 to 90 of the proposed Audit Enforcement Procedure only refer to costs awarded by a Tribunal. In the interests of fairness, any Final Decision Notice agreed by the respondent must include reasonable costs incurred during the investigation process. Then, the recovery of costs from the RSBs (which will, in turn, recover costs from the relevant respondents) must occur following a full account of investigation costs incurred by the RSBs. For all costs to be appropriately recovered, a Final Decision Notice, at any stage, must include the award of costs, as well as sanction. An alternative mechanism would be for the FRC to recover costs from respondents, according to the Final Decision Notice, and to remit any investigation costs of an RSB to that body. We believe this to be a more transparent and streamlined approach.

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As stated in our response to the FRC's Draft Plan and Budget, there is a strong case for greater financial accountability by the FRC. As an agent of the Secretary of State and the sole competent authority for audit regulation in the UK, it is appropriate to consider whether the FRC should be a statutory body, bringing its existence (and financial accountability) onto a firmer footing.

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