



ENHANCING CONFIDENCE IN AUDIT:
THE FINANCIAL REPORTING COUNCIL'S AUDIT ENFORCEMENT PROCEDURE

ICAS' RESPONSE TO THE CONSULTATION

Submission Date: 4 May 2016

ICAS is pleased to provide its comments on the Financial Reporting Council's (FRC) proposed Audit Enforcement Procedure.

Section 1 – Background to ICAS

With a Royal Charter granted in 1854, ICAS is the oldest professional body of accountants in the world. We were the first body to adopt the designation 'Chartered Accountant'. The designatory letters 'CA' are the exclusive privilege of our members in the UK.

We are a professional body for over 21,000 members who work in the UK and more than 100 countries around the world. We are proud that our CA qualification is internationally recognised and respected.

ICAS is an experienced and highly-respected regulator, with a wide and varied regulatory portfolio, including statutory delegated authority as:

- A Recognised Supervisory Body (RSB) for UK statutory company audit and local audit.
- A Designated Professional Body for incidental investment business (supervised by the FCA).
- A Recognised Professional Body for insolvency licensing and regulation (supervised by the Insolvency Service).

As an RSB, ICAS is well-placed to offer views on the FRC's proposed audit enforcement procedure. We have already contributed to the discussions over the UK's implementation of the EU Audit Regulation and Directive, and will continue to play an active role in the run-up to the effective date of 17 June 2016.

In responding to this consultation, we have taken account of our Royal Charter requirement to act in the public interest. We consider that the best way to protect the public interest in the context of audit enforcement is to ensure that the FRC's processes reflect regulatory best practice. In particular, we emphasise the need for enforcement which secures:

- Consistency
- Fairness
- Independence
- Proportionality
- Transparency

An enforcement process which adequately provides for these principles will also act in the best interest of regulated firms and individuals.

While we have responded separately to each of the consultation questions (**section 3**), we also include an executive summary (**section 2**) to highlight our key comments on the draft enforcement procedure (which we will refer to hereafter as "the Procedure").

Section 2 – Executive summary

ICAS' principle observations on the Procedure can be summarised as follows:

- (i) We support the FRC's aim of introducing an enforcement process which promotes independent, effective, proportionate and consistent regulation, with greater scope for sanctions to be agreed with respondents without the need for a tribunal hearing.
- (ii) We believe that more could be done to simplify the Procedure and recommend that consideration be given to streamlining the investigation and decision-making processes.
- (iii) We encourage the FRC to give more thought to the level of oversight of the decisions taken under the Procedure (with particular reference to oversight by non-accountants).
- (iv) We recommend that the final Procedure be subject to regular review and scrutiny, with feedback provided by all stakeholders.
- (v) We have strong concerns arising from recent discussions on funding the Procedure.

Section 3 – Responses to consultation questions

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

While we are satisfied that the Procedure adequately reflects the ARD requirements, we must caveat this by noting that, at the date of our submission, the legislation to implement the ARD is still to be finalised.

We believe that the FRC is correct to introduce a new enforcement process, rather than seeking to adapt its current processes to its new responsibilities. It is unlikely that either the Auditor Regulatory Sanctions Procedure or the Accountancy Scheme would be an acceptable model for the FRC's new responsibilities as the UK's Competent Authority.

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

We commend the FRC on its desire to introduce an enforcement process which ensures “*independent, effective, proportionate and consistent regulation*” (consultation, page 3). Any enforcement process which achieves these aims is likely to secure both protection of the public and fairness to respondents.

It appears that, in conceptualising the Procedure, the FRC has taken into account: (i) lessons it has learned through operating the Accountancy Scheme for public interest disciplinary cases (e.g. by providing greater flexibility in the process), and (ii) the investigation and disciplinary processes successfully operated by ICAS and the other RSBs.

(a) Non-tribunal determinations

One positive example is the significant emphasis which the consultation document places on the various means which the Procedure provides for concluding investigations without the requirement for a tribunal hearing. At the same time as protecting the public through timely determination of breaches of audit legislation, regulations or standards, this also benefits respondents by eliminating the significant time and cost requirements of a tribunal process.

While noting that there will be some instances where the public interest will require a public hearing of the issues, we support the principle of non-tribunal determination, as something which has been provided for in ICAS' rules and regulations for many years.

We do, however, consider that there are aspects of the Procedure which provide grounds for concern, and would recommend further consideration by the FRC to ensure that its aims are met.

(b) Input from complainers

The Procedure appears to make little or no provision for individuals who bring allegations to the attention of the FRC (i.e. complainers). We note, for example, that sections 8, 9 and 19 make no reference to submissions from complainers.

While we accept that most allegations are likely to arise in the context of FRC monitoring visits, there will undoubtedly be instances where complaints are intimated by other statutory auditors or members of the public. In order to secure transparency and fairness, it is important that the Procedure provides a mechanism for such individuals to contribute to the investigation process.

(c) Lack of oversight

The ICAS investigation process provides that no complaint may be dismissed without review and approval of members of our Investigation Committee. In particular, we ensure that all complaints are assessed by public interest members of the Committee (i.e. non-accountants). While we are happy to delegate considerable responsibility to members of staff, we believe that it is in the best interests of all the parties to a complaint to provide a level of oversight of all decisions.

The Procedure appears to be lacking in respect of oversight. By way of two examples:

- (i) There is no scope for review if a Case Examiner decides that the information received by the FRC does not amount to an allegation (section 3(b)).
- (ii) Once an allegation has been referred to the Conduct Committee, it may then be dismissed by Executive Counsel without any scope for further input from the Conduct Committee (section 14(a)).

In particular, we note that the role of the Executive Counsel within the Procedure vests a considerable amount of power in a single individual, which is relatively unusual in modern regulatory practice

While we are confident that the FRC will always ensure that the individuals employed as Case Examiners and Executive Counsel are suitably experienced and skilled, there is a definite possibility that public confidence in the enforcement process will suffer if a decision to do nothing is not subject to some level of independent scrutiny.

We expect that members of staff would welcome the additional level of protection which an external review of decisions inevitably brings.

(d) The role of the Executive Counsel where an investigation has been delegated to an RSB

The Procedure allows the Conduct Committee to delegate the investigation of an allegation to an RSB (section 4(b)). We understand that the legislation will provide that only the investigation may be delegated, with the power to determine the allegation remaining with the FRC.

If an investigation is delegated to an RSB, it will be undertaken in accordance with the RSB's standard process, which will likely require input from Chartered Accountants and public interest members (i.e. non-accountants) serving on a committee.

Upon concluding its investigation, the RSB will submit a report to the Executive Counsel, including its recommendation for determining the allegation. In accordance with section 14, the Executive Counsel has the power to accept or reject the RSB's recommendation.

It is difficult to see how the Procedure will act in the best interests of the public and respondents if the opinion of an individual employed by the FRC can override the views of Chartered Accountants and non-accountants serving on the investigation committee of an RSB. While it is possible that this is an unintended consequence, it does raise obvious questions over the fairness of the Procedure.

Given the requirements of the ARD, it may be that the only way to address this issue is to provide for greater oversight of decisions, as more fully set out in the previous section of our response.

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

ICAS respectfully concludes that the Procedure would be improved if the following observations are taken into account by the FRC:

(a) Simplification of the process

Our first observation upon reviewing the Procedure was that it is quite difficult to follow, with an investigation involving sizeable cast of participants at the FRC, including:

- Case Examiner
- Conduct Committee
- Enforcement Committee
- Executive Counsel
- Investigation Committee

While supporting the FRC's aim of allowing allegations to be determined without the need for a tribunal hearing, we believe that the Procedure could be simplified by merging or eliminating one or more parts of the process.

Drawing on the concerns we have already set out in respect of the lack of oversight of decisions, we suggest that the following would represent a better approach for the Procedure:

- (i) Allegations (and potential allegations) are investigated by Case Examiners/Executive Counsel.
- (ii) Upon completion of an investigation, a report is passed to the Conduct Committee to determine whether there are grounds for enforcement action.
- (iii) The Conduct Committee may dismiss the allegation, agree a sanction with the respondent, or make a formal complaint to a Discipline Tribunal.

Such an approach would be capable of incorporating some level of flexibility to enable minor issues to be dealt with more expeditiously.

If the FRC insists on implementing the Procedure in its current form, we strongly recommend that the accompanying guidance documents include a flow-chart, or some other pictorial reference, to allow users to better understand how investigations work in practice.

We fear that, as presently drafted, the Procedure fails to meet the required standard for transparency; simply on account of its complexity.

(b) Constructive engagement

Information which comes to the attention of the FRC may avoid being subject to formal investigation if the Case Examiner is able to resolve matters through 'constructive engagement' with the respondent.

As ICAS operates a conciliation process in connection with complaints, we are happy to support this measure in principle. We would, however, recommend that the FRC provides more information in respect of constructive engagement. In particular, we believe it needs to be made clear that only minor issues will be deemed appropriate for resolution through this process; a serious breach of regulations, standards etc should always be referred to the Conduct Committee.

Again, emphasising the importance of oversight of decisions, we suggest that the FRC introduces a mechanism through which matters resolved through constructive engagement are subject to review (with input from non-accountants). This will be necessary to assist the FRC in responding to accusations that a potential allegation has been 'swept under the rug'.

(c) Interacting with the RSBs

With the FRC and the RSBs now more equally involved in audit regulation, there is a strong need for measures to be put in place to ensure an effective exchange of regulatory intelligence.

So far as the Procedure is concerned, we believe there should be an explicit requirement for the FRC to notify the relevant RSB as soon as it receives information about a firm or individual that is authorised by the RSB. Thereafter, the FRC should update the RSB on the progress of the investigation, confirming as and when the matter is determined.

As the RSBs will be regulating non-PIE audit work, such information from the FRC will be important to ensuring a joined-up approach between regulators.

(d) Partial acceptance of findings by respondents

Section 17(a) of the Procedure provides that a matter shall be referred to the Enforcement Committee if the respondent does not agree with the Executive Counsel's "*entire decision*". There is a similar provision in Section 23 for decisions of the Enforcement Committee.

We simply note that the Procedure as presently drafted does not clarify what will happen if a respondent accepts a finding in part. While we assume that this would have implications for costs if a case is ultimately considered by a Discipline Tribunal, the FRC may want to express its position more explicitly.

(e) Review of Procedure

As the introduction of the Procedure will mark a significant change in UK audit regulation, with a considerably expanded role for the FRC, we strongly recommend that it be reviewed on a regular basis for the foreseeable future, with all participants (including the RSBs) being given a reasonable opportunity to provide feedback.

It may be that procedures which make sense on paper present unintended challenges when put into practice. The FRC will need to be quick to remedy any such difficulties.

In particular, we note our view that the various guidance documents included with the consultation are presently somewhat vague in their drafting. While this is understandable when the processes to which they are to apply have yet to be put in practice, there will be a clear need for revising and updating as soon as the Procedure has been fully tested.

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

As we have included our views on the Procedure in our responses to other consultation questions, we would like to take this opportunity to comment on the future of the Accountancy Scheme.

As noted in the final paragraphs of page 6 of the consultation document, the legislative changes raise questions over the extent to which the FRC should continue to deal with public interest cases which do not involve statutory audit.

ICAS' view is that, in addition to what is to be covered by the Procedure, the FRC should have the ability to investigate:

- (i) RSB members involved with the preparation or presentation of financial statements of PIEs, where the audit of the PIE is under investigation by the FRC.
- (ii) Matters which are referred to the FRC for investigation by the RSB, at its discretion.

If a change to the FRC's remit can be agreed with the RSBs, we would question whether there is a need to retain a separate Accountancy Scheme beyond conclusion of its current complaints.

It would clearly be in the best interests of all stakeholders to minimise the number of different concurrent enforcement processes. Consideration should be given to whether the Procedure could be amended to incorporate this new remit.

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

We have commented separately on the proposed Budget and Business Plan 2016/17. We remain concerned about the financial burden being placed on the audit profession and the apparent exponential growth of the FRC budget requirements.

We understand that the FRC is no longer actively considering a levy on the profession, and instead that the additional funding requirements for 2016/17 will be passed directly to the RSBs, to allocate at will across our regulated population. Many of the additional activities of the FRC relate to PIE audit regulation, which is not a regulated activity that is uniformly spread across the RSBs and our firms. ICAS would have preferred a levy approach, as this would have provided a more proportionate funding mechanism, and would have been less likely to place an unfair burden on small and medium sized audit firms.

In the context of this current consultation, we will focus on the proposals relating to the Procedure. As we now know, the outcome of the recent funding discussions with BIS will have a direct impact on future funding over the short term, and very possibly over the long term. If fine income deriving from the Procedure falls to be passed to the Secretary of State for BIS, we consider that this must lead to a fundamental review of the funding approach.

Funding of case costs is a significant risk to the sustainability of the profession; the RSBs cannot be left in a position whereby the profession is permanently left to bankroll the investigation and disciplinary activities of the FRC unless adequate arrangements can be put in place to ensure that costs are always recovered in full.

To date, no Tribunal has awarded significant costs, meaning that the funding body has been reliant upon financial penalties as a means of securing a net position over the long term.

The proposal that the profession should not benefit financially from audit failure is, we think, acceptable and probably sound. The proposal that the profession should be solely responsible for funding case costs, with no or little prospect of ever achieving full cost recovery, is just unacceptable.

A possible compromise would be to ensure that the funding RSB body has priority over the financial penalty where the Tribunal does not make a full award of costs. The amount of the funding RSB's claim over the financial penalty would be equal to the difference between the costs awarded and the costs incurred by the RSB, thereby ensuring that the funding body is always in a net position on conclusion of a case. Admittedly, this approach would not address the issue of unrecovered costs where the FRC pursues a case and fails to secure an outcome. This aspect would need to be explored further.

While we do recognise that the landscape has changed very quickly for everyone, the long term sustainability of the profession must be paramount. We therefore look forward to ongoing discussions with the FRC in relation to the funding arrangements

Finally, we raise our concern that the Procedure appears to make no provision for investigation costs to be recovered as part of a non-tribunal determination. This is in contrast to our investigation process (and, we understand, the processes of the other RSBs), which allows ICAS to recover costs as part of a settlement agreement.

We can see no clear reason to require costs to be excluded from such resolutions, and note that their absence would considerably prejudice the RSBs, as funders of the investigation.