BRIEFING - THE FRC

December 2018

WHAT IS IT?

The Financial Reporting Council (FRC), is an independent watchdog in the UK and Ireland set up in 1990 to regulate auditors, accountants, and actuaries. In its own words, the FRC seeks to promote transparency and integrity in UK accounting, auditing and actuarial work and is aimed at investors and those who rely on company reports, audits and risk management.

ROLES AND RESPONSIBILITIES

There are various tasks which fall under the FRC’s remit including setting standards for corporate governance, accounting, assurance and actuarial work. Primarily however, the FRC monitors and enforces accounting and auditing standards and oversees the various regulatory bodies (for example, the ICAEW). Pursuant to this role, the FRC is the UK’s ‘Competent Authority’ for regulation and oversight of statutory audits.

INVESTIGATION AND ENFORCEMENT PROCEDURES

The Accountancy Scheme

All investigations commenced prior to June 2016 are considered under the Accountancy Scheme. The Accountancy Scheme also remains applicable for those investigations that do not fall within the ambit of the AEP procedure discussed below.

In brief overview, all members and member firms fall within the remit of the Accountancy Scheme, including members acting in a Finance Director capacity. However, to trigger an investigation, there are two requirements:

- A ‘public interest test’ i.e. whether the issues raised are of such importance that they affect the public interest, or whether a hearing is desirable in the public interest; and
- The presence of ‘misconduct’, including any act or omission or series of acts or omissions in professional activities or otherwise which ‘fall significantly short’ of the standards reasonably to be expected.

As to the former, this is likely to be satisfied in the event of a corporate collapse or the discovery of a serious accounting irregularity. As to the latter, this requires more than mere negligence, crossing a threshold of “real seriousness”.

The Audit Enforcement Procedure (AEP)

In June 2016, the FRC launched its new AEP to deal with enforcement in relation to statutory audits of Public Interest Entities (PIEs). PIEs are companies listed on the London Stock Exchange, credit institutions, insurance businesses (including Lloyd’s Syndicates), and AIM companies with a market capitalisation of £200 million plus.

Figure 1 on the next page indicates when the AEP will be applicable. If any of the three rules referred to are absent, the Accountancy Scheme may be applicable.
Rule 1: Was the complaint or referral made to the FRC on or after 17 June 2016?

Rule 2: Is the member or member firm occupying the role of statutory auditor?

Rule 3: Is the entity which was the subject of the statutory audit a PIE?

AEP triggered

Figure 1.

Unlike the Accountancy Scheme, there is no test for ‘misconduct’. Instead, the FRC will consider whether there has been breach of a ‘relevant requirement’. While the definition of ‘Relevant Requirement’ is lengthy, (see Regulations 5(11) and 11(5)(b) of the Statutory Auditors and Third Country Auditors Regulations 2016), this includes:

- All ‘relevant standards’ as depicted at Regulation 4, including “integrity, objectivity, professional competence, due care and professional scepticism”; and
- Parts 16 (Audit) and 42 (Statutory Auditors) of the Companies Act 2006.

As such, unlike under the Accountancy Scheme, liability may either by strict or arise out of perceived negligence.

Figure 2 below sets out the four stages of an AEP investigation.

Stage 1: Initial enquiries - Case Examiner to consider whether information available “raises a question as to whether [the auditor] has breached a Relevant Requirement”. If so, case will be referred to Conduct Committee who will decide whether to (a) refer the case to the Executive Council; and (b) publish the fact of the investigation.

Stage 2: Investigation - undertaken by the Executive Council, including lawyers and forensic accountants, culminating in an Investigation Report. Once concluded, a Decision Notice will be issued setting out adverse findings and proposed sanction. If accepted, the process ends here.

Stage 3: Enforcement Committee - if the Decision notice is not accepted, the Enforcement Committee will reconsider the matter and may issue a further Decision Notice. If accepted, the process ends here.

Nb. This stage can be omitted in favour of moving straight to Stage 4.

Stage 4: Tribunal - where the respondent rejects all or part of the Decision Notice(s) issued, the matter will come before the Tribunal.

Figure 2.

All Final Decision Notices and rulings of the Tribunal will be published. However, the FRC retains a discretion to publish:

- The commencement of an investigation;
- The outcome of an investigation where a Sanction has not been imposed;
- Acceptance or declinature of a referral for investigation from another regulatory body.
The FRC also has powers under the AEP to impose an Interim Order, at any stage before the issuance of a Final Decision Notice. The Interim Order may restrict the activities of the AEP respondent while the investigation or proceedings are ongoing where the FRC consider “there are reasonable grounds to consider the Respondent may be liable to enforcement action and it is in the public interest or in the interests of the Respondent.” Whether the AEP respondent ‘may’ be liable to enforcement action is not a particularly stringent test. Therefore, while an AEP respondent may apply to have an Interim Order revoked, given the low threshold applied by the FRC, challenges seem unlikely to succeed.

This multi-step approach provides a number of opportunities to engage with the Regulator, which may allow a number of matters to be addressed privately (even if the final outcome is made public). In turn, this could provide opportunities for early settlement at a discount, but it is unclear how this may work in practice. On the other hand, the number of stages means that the process can be drawn-out, leading to prolonged uncertainty and increased costs.

**RIGHTS OF THIRD PARTIES**

There is no guidance in place on how to address accusations that are indirectly made against third parties, or the rights of third parties directly or indirectly identified, as part of either the Accountancy Scheme or the AEP. In theory, this could lead to third party intervention in the form of a judicial review, or potential actions against the AEP respondent, for example, for defamation or breach of duty. Lawyers will need to bear in mind the potential rights of third parties who might be affected by the publication of a settlement agreement and/or Final Decision Notice.

**SANCTIONS**

Sanctions under the Accountancy Scheme and AEP are broadly similar. New guidance for sanctions under the Accountancy Scheme and a new Sanctions Policy under the AEP was published in April 2018 and took effect on 1 June 2018.

Potential sanctions under the Accountancy Scheme include:

- A Reprimand or Severe Reprimand;
- Conditions;
- Fines;
- Order requiring member/member firm to waive or repay fees incurred;
- Order that the member’s/member firm’s practising certificate or licence be withdrawn and/or that the member/member firm be ineligible for a practising certificate or licence for a specified period.

Potential sanctions under the AEP, which can be imposed singularly or in combination with one another, include:

- Notice or Statement requiring cessation or abstinence of conduct giving rise to breach of relevant requirements;
- Order for mitigation of conduct giving rise to a breach of the relevant requirements;
- Temporary (up to three years) or permanent prohibition on carrying out statutory audit work and/or signing audit reports;
- A declaration that the Statutory Audit does not satisfy relevant requirements;
- Order requiring AEP respondent to waive or repay fees incurred in connection with carrying out the Statutory Audit;
Temporary (up to three years) prohibitions on individuals:
- Acting as a member or management body of a firm eligible for appointment as a statutory auditor;
- Acting as a director or otherwise being concerned in the management of a PIE

Financial penalties;
Conditions;
Exclusion as a member of a Recognised Supervisory body.

Key changes arising out of the new guidance effective from June 2018 includes:
- An increase in fines to GBP10m+ for seriously poor audit work by a ‘Big 4’ firm;
- Exclusion from the accounting profession for a minimum of 10 years for dishonesty;
- Greater use of non-financial penalties; and
- Sanctions that reflect the level of cooperation by respondents.

Prior breaches are likely to be an aggravating factor but will be considered in context of similarity, time elapsed and remedial action taken.

Flexing its new powers, the FRC imposed a GBP10m fine on PriceWaterhouseCoopers (PwC) following a two year investigation into PwC’s audits of BHS, only days after the new guidance came into effect. While this was reduced to GBP 6.5m for early settlement, the primary GBP10m amount is reflective of the upward trajectory on fines levied, particularly against the Big 4.

WHAT’S NEXT?

In 2017, MPs accused the FRC of being “useless” and “toothless” during a parliamentary hearing following its delay in opening an investigation into KPMG’s audit of HBOS and its subsequent decision to close the investigation into KPMG’s audit of HBOS without sanction.

Similarly, a joint select committee report produced in May 2018 into the downfall of Carillion deemed the UK audit market a “cosy club incapable of providing the degree of independent challenge needed” and accused the FRC of being too passive and reactive to make effective use of their powers.

An independent review of the FRC was announced on 18 May 2018 and will be led by Sir John Kingman. The review will consider, among other matters, whether the FRC is ‘fit for the future’ including an examination the FRC’s (a) role and purpose; (b) effectiveness; (c) potential role in preventing corporate failure; (d) legal status and relationship with the government; and (e) governance and leadership.¹

Pressure on the regulator inevitably leads to pressure on the regulated and the FRC have begun taking steps to try and quieten critics and restore confidence in it as an effective and efficient regulator. In December 2017, it was reported that the FRC’s enforcement team has more than tripled in size over the past five years, including bringing lawyers and forensic accountants in house. This growth is likely to continue.

The FRC has recently set out a list of powers which it considers it requires to carry out its functions effectively. In particular, it seeks greater powers to scrutinise and challenge the leadership and senior management appointments of larger accountancy firms and the ability to investigate and discipline directors who are not accountants. Other powers requested include:

- The ability to warn investors when it comes across issues in audits of companies which appear to be at risk of collapse;
- Increased monitoring powers in respect of those parts of the annual report which deal with governance - presently the FRC has no power to challenge these aspects of the annual report;
- A new statutory investigation regime to streamline the AEP and the Accountancy Scheme into one process.

No doubt these requests will be considered as part of the Kingman Review.

COMMENT

It seems inevitable that the Big 4 firms will come under increased scrutiny and face the threat of greater fines. However, in context of the turnover for these entities, fines alone may not be seen to represent a meaningful deterrent. There continues to be disparity in the consequences of an FRC investigation into a Big 4 firm as opposed to a small or medium sized firm. While we may see an increase in non-financial penalties such as restrictions on accepting certain clients, or imposition of training requirements in an attempt to counter this issue, due to the power and influence of the Big 4 firms in the statutory audit market this appears unlikely and we expect that fines will continue to be the main form of ‘punishment’ for these firms.

The FRC has shown that is willing and able to step up enforcement action in the face of parliamentary criticism and will fight for its place as a leading regulator in the accounting arena. However, it faces huge challenges in the context of the statutory audit market, including the dominance of the Big 4. As such, in an effort to ‘prove its worth’ we can expect to see more investigations, increased publication of investigations and monitoring and a continuation of the upward trajectory of fines.

FURTHER INFORMATION

To find out more about our services and expertise, and key contacts, go to: kennedyslaw.com

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