Noranne Griffith,

Review Panel Secretary

c/o The Financial Reporting Council

125 London Wall

London EC2Y 5AS

30th June 2017

Dear Ms Griffith,

Thank you for the opportunity to contribute to the review of sanctions imposed on auditors and actuaries under the FRC's current enforcement procedures. This covering letter and the response to the specific questions in attached consultation document have been developed jointly by The UK Shareholders' Association (UKSA) and The UK Individual Shareholders' Society (ShareSoc). Both organisations represent the interests of private shareholders who invest (directly or indirectly via nominee accounts) in public companies or in other forms of equity-based investment. Both are independently funded by concerned individuals who pay a membership fee.

In addition to our specific responses to questions in the consultation document, we have a number of general comments to make. These concern the need to ensure that the audit sanctions are perceived by investors and others to be fulfilling their purpose.

- **Definition of misconduct:** This is conspicuous by its absence in the consultation document. Those who search can find it in 'The Accountancy Scheme' document dated 1st July 2013 on the FRC's website. It defines misconduct as follows:

  "Misconduct means an act or omission or series of acts or omissions, by a Member or Member Firm in the course of his or its professional activities (including as a partner, member, director, consultant, agent, or employee in or of any organisation or as an individual) or otherwise, which falls significantly short of the standards reasonably to be expected of a Member or Member Firm or has brought, or is likely to bring, discredit to the Member or the Member Firm or to the accountancy profession."

  Although the words 'falls significantly short' are open to interpretation, this seems a generally appropriate definition which supports the key objective of the sanctions which is to 'protect the public and the wider public interest'. It would be helpful if it were clear that lack of detailed analysis and investigation, errors of judgement and a failure of curiosity by auditors (leading to a failure to ask the right questions) all fall within the above definition.

- **Accounting for culture:** We are not convinced that the objectives are being met as fully as we would wish. Ten years after the banking crash accounting scandals continue to emerge. There is now a widely held view that the banking crash was partly the result of a failure of corporate culture and, by implication, governance. The way in which supplier rebates were accounted for at Tesco and evidence of fraud at BT's Italian operations are two notable recent examples.

    - Terry Smith noted in September 2014, when Tesco issued two profits warnings within six weeks, that in fourteen of the previous eighteen years Tesco's free cash flow less its dividend was a negative number. In order to compensate for this and provide sufficient cash to pay the dividend the company borrowed. Debt rose from £894m in 1979 to £15.9bn in 2009. This is neither healthy nor sustainable. Those familiar with Tesco will also be aware that it was well-known for its famously aggressive stance with its suppliers on matters such as pricing and payment terms. Putting these two factors together one might have expected an enquiring and diligent audit team to look closely at issues such as the booking of supplier rebates.

    - Inappropriate behaviour at BT's Italian Division has resulted in an overstatement of earnings which has, apparently been taking place over a number of years. Write-downs are expected to exceed to exceed £530m. BT, a quasi-monopoly, is well-known for its cavalier attitude towards its customers and the way in which it has tested the patience even of Ofcom. It was also recently fined £42m for breaching contracts with telecoms providers.

    Both of these companies have consistently, over time, displayed culture and attitudes which might prompt auditors to take a closer look at accounting practices in these businesses. Accounting problems should not have come as a surprise. The public has been neither protected nor well served by the auditors in either case.

- **Penalties for failure:** We discuss the application of sanctions in our response to the consultation questions. However, in order to maintain public confidence in the system of sanctions, it is important that they are applied in a way that carries real force and meaning. Financial sanctions alone, particularly on the audit firm as opposed to individuals, have limited deterrent effect. The threat of suspension or disqualification for individuals is likely to carry much more weight. The same is true of a requirement on firms to state when bidding for work whether there have been any sanctions taken against the firm within, say, the last five years. If so they should be obliged to give details.

We do not believe that it is necessarily the role of auditors to report on corporate culture. However, we do believe that auditors should be mindful of the prevailing culture within a business when they take on and carry out the audit. Their assessment of the culture should help them to ensure that the audit is sufficiently rigorous to protect their ultimate clients, the investors.

Yours sincerely,

Peter Parry – Policy Director, UK Shareholders' Association

Cliff Weight – Policy Director, UK Individual Shareholders' Society

Independent review of the FRC's enforcement procedures sanctions.

Response from the UK Shareholders' Association and ShareSoc.

Question 1
Are the objectives set out in the Sanctions Guidance and Sanctions Policy satisfactory? If not, why not, and how could they be improved?

The objectives set out in paragraph 9 of the Sanctions Guidance for the Accountancy Scheme (which are the same in the Actuarial Scheme Sanctions Guidance) are set out in Appendix 2. The objectives of the Audit Enforcement Procedure specifically in relation to sanctions are encapsulated in paragraphs 11 and 12 of the Sanctions Policy (Audit Enforcement Procedure) which are, also, set out in Appendix 2.

Answer: The objectives as set out are satisfactory and we agree that:

'The primary purpose of imposing sanctions for acts of Misconduct is not to punish, but to protect the public and the wider public interest'

However, as discussed below, the threat of meaningful punishment for those who transgress is an important means of achieving this end.

Question 2
Is the Sanctions Guidance/Sanctions Policy (despite its different title, the Sanctions Policy does provide guidance to decision-makers.) satisfactory and fit for purpose in current circumstances?

Respondents are invited to state, for example, whether they think the Sanctions Guidance/Sanctions Policy are satisfactory and fit for purpose, and if not, why not, and how the Sanctions Guidance/Sanctions Policy should be improved. Respondents should state, for example, whether decision-makers should be provided with:

(a) guidance, either of the current or some other type;

(b) some form of tariff, possibly along the lines of the Guidance on Sanctions of the ICAEW; or

(c) some form of guideline which divides regulatory offences into categories and prescribes a range of penalties having regard to the aggravating and mitigating features of the offence within the category.

Answer: The guidance given (a. above) appears to be satisfactory as far as it goes. It is difficult to assess this fully without having been directly involved in using the guidance and applying it. However it appears to strike a fair balance between being excessively prescriptive on the one hand and unhelpfully vague or superficial on the other.

It would be helpful to give decision makers some form of tariff guidance (b. above). This might take the form of a number of examples or case studies. Appendix 3 suggests that something along these lines is already in place. However, the cases need a commentary to say why a specific tariff was applied plus an indicative range of tariffs (upper and lower limits) that might

reasonably have been expected in each case. This should reflect the fact that setting tariffs is a matter of judgement and balance rather than a simple mechanistic process.

Proposal (c.) above looks as though it would be helpful, possibly combined with our suggestion above for proposal (b.).

Question 3
In connection with the matters set out in relation to question 2 above, given the type and range of case with which the FRC is concerned, adoption of a tariff or detailed guidelines would be difficult. Therefore, if respondents think some form of tariff or guideline would be appropriate, the Review Panel would welcome any observations on the appropriate form and content they, or some other form of guidance, should take.

Answer: See response to proposals 2 (b) and 2 (c) above. The guidance needs to be structured in such a way that users can quickly identify those cases that are relevant to / similar to the one under consideration before looking more closely at the detail of each one in order to assess how far they resemble or differ from the case in hand. Software systems are readily available to help with identifying and 'matching' similarities between cases so that quickly identify relevant previous cases for guidance. Any such system should not be treated as a mechanism which provides 'the answer'. The final decision should be the judgement of the tribunal taking into account all the facts at their disposal.

Question 4
In imposing sanctions should decision-makers seek to place any particular focus on entities rather than individuals or vice versa?

In answering this question respondents are invited to explain (if either of these is their view) whether they think entities are dealt with too harshly compared with individuals or individuals too lightly compared with entities.

Answer: It is important that in any situation in which misconduct or negligence are proven to have taken place individuals are held to account. This means those who:

- were knowingly guilty of misconduct or negligence, and those who
- were responsible for the people whose conduct and competence fell short of expectations.

should have appropriate sanctions taken against them. If sanctions are designed primarily to protect the public and public interests (as suggested by the Objectives) then 'sanctions' here are likely to mean some form of temporary or permanent disqualification / suspension for these people.

It is important in this context that 'responsible individuals' includes those in senior positions who were responsible for defining the culture of the organisations and who, in their determination to, say, drive fee income growth and profitability, may have encouraged more junior staff to cut corners, turn a blind eye or go along with things that they knew to be wrong or inappropriate.

Firms should also be exposed to sanctions. Fines are almost certainly not the answer by themselves. A better approach would be to have a public register of firms (and individuals) that have had sanctions taken against them (e.g. reprimand or severe reprimand). It should also be obligatory for any firm bidding for work to have to state whether it has ever had any sanction

taken against it (regardless of whether the client ITT itself asks for this). In the most serious cases we would like to see more instances in which audit firms are prohibited from taking on new listed company audit clients for a specified period of time. Even if that period of time is relatively small, such as one month or three months, as a sanction we believe that it will be taken much more seriously by audit firms and the listed companies which engage them than a sanction such as a "severe reprimand".

Firms should also have to make good client losses resulting from negligence or misconduct. The extend of any 'making good' would need to vary depending on the extent of any contributory negligence or complicity on the part of the client.

Question 5
In relation to financial penalties should the FRC establish some starting point in respect of both individuals and entities?

If respondents think that the FRC should establish some starting point, they are invited to articulate;

(a) how they consider that starting point should be measured for entities or individuals (e.g. by reference to specified monetary amounts, or a proportion of revenue, turnover, profit, audit fee, salary, income or something else);

(b) how the starting point should be determined; and

(c) what criterion/a should produce what starting point(s).

Answer: Fining of individuals are an acceptable form of sanction in that they are likely to likely to give pause for thought on the part of all individuals who may be tempted to misbehave or cut corners. However, the fines should be:

- paid by the individuals (not by their employer)
- set at a fairly low level but should vary depending on the severity of the misconduct.

Sanctions should operate rather like those for driving offences. More minor offences result in a fine and some form of 'black mark' (license endorsements). More serious offences result in a driving ban with all that this implies in terms of ability to work and to obtain insurance in future.

Fining of firms has limited impact. There are more effective sanctions that can be taken as outlined in the response to Q4 above.

Question 6
To what extent do current sanctions meet regulatory objectives? If they do not, why is that?

Answer: They fall short of meeting regulatory objectives – often by a large margin. The monetary penalties imposed so far on audit firms have been relatively minor compared with the revenues of such firms, and the non-monetary sanctions appear to have little impact on their reputations in the audit marketplace."

Question 7
In relation to financial penalties are they being set at the right level?

In answer to this question, respondents are invited to state;

(a) whether they think they are too low or too high, and

(b) by what criterion or on what basis they are considered to be inadequate or excessive and to what extent that is so.

Answer: See answer to Q 6 above. However, bear in mind that we are not great supporters of financial penalties. We believe that there are more effective sanctions that can be applied as outlined in the response to Q4 above.

Imposing fines on businesses in the financial service sector when they misbehave has become an almost automatic reaction from regulators. These may benefit the recipients of the money raised though fines (governments and regulators themselves) but, from an investor point of view) they have little impact on the offending firm and even less on the individuals who are responsible for the failings. Invariably it is the shareholders or owners of the business who end up paying the fine. This may be less true in the case of auditors as they are structured as LLPs and tend not to have external shareholders. However, the fact remains that most of the evidence points to the fact that sanctions against the corporate body have little impact in changing corporate culture and behaviour.

Question 8
If respondents think that financial penalties are too low is this because:

(a) failures of the type covered by the procedures require greater censure than is currently given;

(b) they are not commensurate with the revenue or profit earned by accountancy/audit firms or with the impact of the failures being sanctioned;

(c) they are insufficient to incentivise either high quality audit work/compliance with rules, regulations and standards;

(d) they do not promote public confidence; or

(e) some other reason?

Answer: We do not believe that the issue is one of whether financial penalties are too low. As indicated in the responses above, financial penalties are simply not the answer to the problem.

Question 9
What are the key elements in achieving effective deterrence?

Answer: There needs to be confidence in the public mind that all cases of audit failures which the FRC becomes aware of will be rigorously pursued.

Potential sanctions must be such that they will focus the minds of all concerned. Potential loss of employment and reputational damage are much more immediate and understandable to most people than the vague threat of a fine which will be paid by the company. The recent decision by the SFO to prosecute John Varley and three other former Barclays directors over the 2008 fundraising is already sending shock-waves through the City in a way that multi-billion pound fines at Lloyds and other banks for PPI miss-selling have never come close to doing.

Question 10
Do current sanctions in fact promote or incentivise good behaviour and promote public confidence?

Answer: It would appear not – on both counts.

Question 11
Should there be greater use of non-financial sanctions such as:

(a) the imposition of conditions on practice or exclusion either of the firm or the practitioner from practice in particular areas or requirement for further training; and/or

(b) an order for some form of restitution?

Answer: We favour greater use of non-financial sanctions. Options such as further training or restitution should always be considered. However, there is a need for subsequent third-party follow-up to check how effective such action has been in changing behaviour. It is not clear what attempts if any are made currently where such non-financial sanctions are used to see if behaviour has in fact changed.

Question 12
The Sanctions Guidance in support of both Schemes contains provision for a discount for admissions and/or settlement; see paragraphs 57 to 61 of the Accountancy Scheme Sanctions Guidance[2], as does the Sanctions Policy; see paragraphs 73 to 77. Are these provisions:

(a) operating satisfactorily; or

(b) inappropriate, and, if so, why?

Answer: We have no particular view on this.

Question 13
Are there some sanctions which could usefully be imposed which are not currently available?

Answer: See suggestions in response to Q4 above – in particular, the suggestion that firms which have had sanctions applied against them should have to declare this and give details when bidding for any new work. Such a requirement might apply to any sanction applied in the last ten years as this is the timeframe within which the audit contract must be retendered under recent EU-based legislation.