29 June 2022

Darren Jones MP
Chair of Business, Energy and Industrial Strategy Committee
House of Commons
London
SW1A 0AA

Dear Darren,

SELECT COMMITTEE ENQUIRY: FRC FINES MONEY

Thank you for your letter to our then-President, Will Brooks, on 19 May. As Will has now handed over as President, his successor, Julia Penny, has asked that I respond on her behalf. I attach a short summary giving answers to your three questions, but I would also like to take some space to set out the wider context.

Case background

You wrote following media coverage of the sanctions which the FRC had asked a Disciplinary Tribunal to apply in a case involving KPMG, a former KPMG partner, and several former KPMG employees. This related to the provision of allegedly false and misleading information and documents to the FRC when, as part of its annual inspection process, it reviewed two audits carried out by KPMG – one of which was the 2016 audit of Carillion.

For clarity, the preparation of Carillion's financial statements for the period 2014 to 2017 by its own finance directors, and the audit of those statements by KPMG, are the subject of separate investigations by the FRC, both initiated in 2018 and currently ongoing. These cases are being conducted under the FRC's Audit Enforcement Procedure (AEP), which means that any fines imposed will go to HM Treasury. You may also wish to note that the Official Receiver is separately pursuing a legal claim through the High Court for very substantial damages on behalf of the creditors of Carillion (I will expand on this later).

Funding FRC investigations: the Accountancy Scheme and the Audit Enforcement Procedure

Even from this small sample, you can see that the arrangements for funding this side of the FRC's work are complicated and, frankly, anomalous. There are two principal regimes: alongside the AEP mentioned above the earlier Accountancy Scheme still operates in certain circumstances. This was set up in 2004 in the aftermath of a series of corporate scandals (including the Maxwell companies, Polly Peck, Equitable Life and BCCI) and the legal basis for how it was to be funded was set out in Schedule 10 of the Companies Act 2006: the six participating professional bodies (including ICAEW) were fully liable, up front, for the costs of investigations conducted by the regulator (now the FRC) into their members or member firms. In return, if and when an investigation was concluded in the regulator's favour, recovered case costs were reimbursed to the relevant professional body, together with whatever fines were levied by a Tribunal.

The Accountancy Scheme was therefore designed to pay for investigations by the regulator without recourse to the taxpayer. In achieving that objective, it clearly imposed significant uncertainty and risk on the professional bodies. Two high profile examples to illustrate this well.

In the case brought in 2006 by the FRC following the collapse of the Mayflower Group, the Tribunal dismissed the complaints against PwC (an ICAEW member firm) and the *de facto* finance director of Mayflower (a member of another participating professional body, the Association of Chartered Certified Accountants). The Tribunal went on to award costs of nearly £1 million to the respondents. At one point it seemed as if ICAEW, having funded the FRC's investigations, and having received no recoveries because the cases had failed, would also have to pay the costs of nearly £1 million which the Tribunal awarded to the respondents.

The other example is the investigation which the FRC started in June 2016 into the conduct of KPMG's audit of HBOS plc for the year ended 31 December 2007. This was an extensive (and expensive) case conducted under the Accountancy Scheme, and as such, the costs were passed to ICAEW. However, in September 2017 the FRC closed the investigation without any complaints being brought, having concluded that there was not a realistic prospect of an Adverse Finding against KPMG.

More generally, between 2004 and 2016, ICAEW paid the FRC a total of £32.4 million in case costs while receiving £8.5 million in recoveries and £14.8 million in fines. To mitigate this exposure and safeguard the financial stability and viability of the Institute, the four largest member firms (PwC, EY, Deloitte and KPMG) have voluntarily paid ICAEW an annual levy, each contributing in advance a quarter of a proportion of the anticipated total case costs for the year.

The FRC introduced the AEP in June 2016 to supersede the Accountancy Scheme for audit cases, and under this the professional bodies receive only the associated case costs. Since then, the only investigations carried out under the Accountancy Scheme have been audit cases under way before the AEP started, and non-audit cases. For instance, the sanctions announced by the FRC in early June against PwC in relation to its audits of Galliford Try and Keir (respectively fines of £5.5 million and £3.35 million, before adjustment) were issued under the AEP, and that money will pass to HM Treasury.

However, despite the scaling back and partial phasing out of the Accountancy Scheme, in recent years its underlying economics - as they applied to legacy audit cases and non-audit investigations - have changed dramatically. There are several reasons for this, but undoubtedly a key factor has been the independent review of FRC sanctions led by Court of Appeal Judge Sir Christopher Clarke, which reported in November 2017. Among its proposals was a tougher approach to financial sanctions, suggesting a benchmark of £10 million or more for cases involving seriously poor audit work carried out by a large firm. ICAEW publicly opposed that recommendation at the time, but subsequent FRC Tribunals have certainly embraced it. As a result, the money coming to ICAEW from fines imposed in cases conducted under the Accountancy Scheme has increased very significantly. Between 2017 and 2021, ICAEW paid the FRC a total of £38.89 million in case costs while receiving £21.7 million in recoveries and £78.4 million in fines.

ICAEW Board position

Last year, ICAEW's Board considered whether it would be appropriate for ICAEW to pass on the money it received from fines imposed under the Accountancy Scheme as *ex gratia* payments to external parties and concluded unanimously that it would not. I should add that the Board has been advised that any such payments are unlikely to be permissible under the terms of our Royal Charter.

More generally, the Board noted that the Accountancy Scheme was set up as a disciplinary scheme, not a compensation scheme: there was no intention that the FRC, the RSBs or the Government usurp the role of the Courts which have traditionally ruled on claims relating to the negligent or reckless actions of professionals - including auditors. Regarding actual or potential fines under the Accountancy Scheme in relation to Carillion, the Board is aware that there is a parallel action being pursued by the Liquidators of Carillion in the High Court against KPMG seeking over £1 billion in damages to compensate the Carillion creditors for the losses they suffered because of the alleged actions or omissions of KPMG.

ICAEW's use of the fine monies

The money from fines is not used to offset ICAEW's operational expenditure but is allocated to our reserves and it supports our wider Charter commitment to serve the public interest. In the past this has included technical support for charity trustees, resourcing our Practice Assurance Scheme to sustain the quality of service provided by small and medium firms, and part-funding of the independent review of the quality and effectiveness of audit conducted by Sir Donald Brydon at the request of BEIS. At the onset of the pandemic in 2020, ICAEW decided against applying for government funding under the Coronavirus Job Retention Scheme and the later Job Support Scheme, concluding that doing so while we had healthy reserves would sit uneasily with the spirit of our Charter obligations.

The recent strengthening of our reserves by money received from fines under the Accountancy Scheme has coincided with the launch of our ambitious ten-year strategy, which positions ICAEW as the national champion in a fiercely competitive global market: by size of membership in 2030, we aim to be one of the six largest accountancy professional bodies in the world – but with regards to quality and prestige we will be second to none. That will take both boldness and financial resilience.

Our Board is now completing a formal review of how we will use our reserves to accelerate the strategy, but over the next few years this is likely to include a monitoring and reporting regime to support the more rigorous programme of mandatory continuous professional development (which we will introduce in 2023 to better assure the ethical and technical excellence of our 163,000 members) and major increases in our support to the Fraud Advisory Panel (as part of the profession's heightened commitment to fight economic crime) and the Accounting for Sustainability initiative (helping to inspire action by finance leaders to drive a fundamental shift towards resilient business models and a sustainable economy). Alongside that we are planning to establish a bursary programme for UK and international students from disadvantaged backgrounds to study and train for careers in chartered accountancy.

We will also need to provide for future consolidation within the UK professional body sector, starting with our planned acquisition of the Chartered Institute of Public Finance and Accountancy. ICAEW was the first professional body in the world to achieve carbon neutrality, but we are committed to moving to net zero as quickly as possible. With that in mind, the Board has agreed in principle to use some of our reserves to transform how our estate and business operations consume and use energy. Finally, following the very successful initial phase of the RISE project, within which ICAEW works with accountancy firms to expand the employment aspirations of school students in the so-called 'education cold spots' around the country, we are now planning to expand the programme to reach 100,000 young people every year.

Conclusion

It is very unlikely that any further large fines will come to ICAEW from the FRC as there is now no audit case in its pipeline which pre-dates the AEP. We expect the powers which the proposed Audit Reform Bill will give the new regulator (the Audit, Governance and Reporting Authority, due to replace the FRC) to supersede the last vestiges of the Accountancy Scheme as they apply to non-audit cases.

The Accountancy Scheme has already outlived its usefulness: it has always been something of a lottery, and for a very long period it operated to the considerable financial disadvantage of ICAEW. In the last few years, the opposite has been true, and we are using the increased level of fines imposed by FRC Tribunals to help deliver our long-term strategy, consistent with our Charter commitment to serve the public interest.

Yours sincerely

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ANNEX to ICAEW Response to BEIS Select Committee enquiry dated 19 May 2022

Question 1. How much money has the ICAEW received from FRC in fines and cost rebates in the past five years?

There are two principal schemes by which FRC investigations are funded by the participating professional bodies (including ICAEW): the Accountancy Scheme (introduced in 2004) and the Audit Enforcement Procedure (which partially superseded the Accountancy Scheme in 2016).

The legal basis for how the Accountancy Scheme was to be funded was set out in Schedule 10 of the Companies Act 2006: the six participating professional bodies (including ICAEW) were fully liable, up front, for the costs of investigations conducted by the regulator (now the FRC) into their members or member firms. In return, if and when an investigation was concluded in the regulator's favour, recovered case costs were reimbursed to the relevant professional body, together with whatever fines were levied by a Tribunal.

Under the Audit Enforcement Procedure, the participating professional bodies are also fully liable, up front, for the costs of investigations conducted by the FRC into their members or member firms. However, in return they receive only the associated case costs, and the money from any fines levied by the Tribunal pass to HM Treasury.

- Between 2004 and 2016, ICAEW paid the FRC a total of £32.4 million in case costs, and received £8.5 million in recoveries and £14.8 million in fines.

- Between 2017 and 2021, ICAEW paid the FRC a total of £38.89 million in case costs, and received £21.7 million in recoveries and £78.4 million in fines.

Alongside the cases conducted by the FRC between 2004-2021, ICAEW's own disciplinary scheme, handling all cases relating to ICAEW firms and members not outsourced to the FRC, has operated at an annual loss of £2 million - £2.5 million throughout this period.

Question 2. What does the ICAEW use this money for?

The money from fines is not used to offset ICAEW's operational expenditure but is allocated to our reserves and it supports our wider commitment to serve the public interest as required by our Royal Charter. Past and currently planned uses of our strategic reserves include:

- Part-funding of the independent review of the quality and effectiveness of audit conducted by Sir Donald Brydon at the request of BEIS.

- Supporting ICAEW's Practice Assurance Scheme (which provides ICAEW member firms and practising certificate holders with a framework of principles-based quality assurance standards to operate by) by providing participants with access to Bloomsbury Professional's comprehensive online library.

- Supporting charity trustees in the conduct of their legal and financial responsibilities by providing free-to-access training and reference materials, regardless of ICAEW membership.

- Assuring the technical and ethical excellence of ICAEW members by establishing a monitoring and reporting regime to underpin a more rigorous programme of mandatory continuous professional development.

- Significantly increasing our funding for the Fraud Advisory Panel (as part of the profession's heightened commitment to fight economic crime) and the Accounting for Sustainability initiative (helping to inspire action by finance leaders to drive a fundamental shift towards resilient business models and a sustainable economy).

- Expanding the RISE programme (in which ICAEW works with accountancy firms to expand the employment aspirations of school students in areas identified by the Department for Education as 'education cold spots') to reach 100,000 young people every year.

- Providing for future consolidation within the UK professional body sector, starting with our planned acquisition of the Chartered Institute of Public Finance and Accountancy.

- Providing bursaries for UK and international students from disadvantaged backgrounds to train for careers in chartered accountancy.

- Accelerating ICAEW's move to net zero by investing in the transformation of how our estate and business operations consume and use energy.

Question 3. Why does the ICAEW consider it to be appropriate to accept this money rather than allowing for the proceeds of these fines to be used to compensate shareholders and creditors?

The Accountancy Scheme - the funding regime under which fines are passed back to the participating professional bodies - was designed to pay for investigations by the regulator without recourse to the taxpayer: it was never intended to operate as a mechanism for claiming or awarding compensation. This distinction is well illustrated by cases such as Carillion (where an action being pursued by the Liquidators in the High Court against KPMG seeking over £1 billion in damages to compensate the creditors for the losses they suffered because of the alleged actions or omissions of KPMG) and Patisserie Valerie (where reportedly the £200m claim brought against Grant Thornton by the Liquidators has been settled). Last year, ICAEW's Board considered whether it would be appropriate for ICAEW to pass on the money it received from fines imposed under the Accountancy Scheme as *ex gratia* payments to external parties and concluded unanimously that it would not. The Board has been advised that any such payments are unlikely to be permissible under the terms of our Royal Charter.

It is very unlikely that any further large fines will come to ICAEW from the FRC as there is now no audit case in its pipeline which pre-dates the AEP. We expect the powers which the proposed Audit Reform Bill will give the new regulator (the Audit, Governance and Reporting Authority, due to replace the FRC) to supersede the last vestiges of Accountancy Scheme as they apply to non-audit cases.