

# Examining The Growing Strength Of FRC Enforcement Actions

By **Kathleen Harris, Sean Curran and Melissa Dames** (June 12, 2023)

As the U.K. Financial Reporting Council prepares for its transition into the Audit, Reporting and Governance Authority in 2024, it has continued to focus on its regulatory objectives and so far this year has shown an increasing appetite for enforcement.[1]

Given the current economic climate of inflation, increasing energy and business costs, and the tightening of purses for consumers and businesses alike, the likelihood of companies failing has increased. The FRC has turned its attention to auditors' responsibilities for identifying issues that indicate potential insolvency.

In order to encourage confidence by investors and others relying on corporate reporting, the FRC will want to ensure that audits are carried out effectively and accurately, and with the appropriate level of independent scrutiny of the audited businesses.

## New Investigations

This year alone, the FRC has opened investigations into three of the so-called Big Four accounting firms, i.e., Deloitte Touche Tohmatsu Ltd., Ernst & Young Global Ltd., KPMG International Ltd., and PricewaterhouseCoopers International Ltd., and their audits of companies that have subsequently failed.

In February, the FRC announced an investigation into PwC and its audits of the 2017 and 2018 year-end accounts of shopping center owner, Intu Properties PLC, following its collapse in June 2020.

In April, it was announced that EY is being investigated in relation to its audit of the year-end accounts for 2021 of online furniture retailer, Made.com Group PLC, which went into administration in November 2022.

More recently still, on May 9, the FRC launched an investigation into Deloitte arising from its audit of the consolidated financial statements of fashion retailer, Joules Group PLC, for the year ending May 30, 2021. Joules Group also went into administration in November 2022.

While these cases are likely to take some time to reach an outcome, the fact that investigations have been launched provides an indication of the FRC's focus, which is to ensure that auditors have in mind their responsibility to probe effectively the information provided by companies they are auditing, and to conduct such audits with due skill and care. They must also focus on identifying and reporting potential solvency issues.

## Recent Enforcement Actions

In addition to the new investigations that have been launched, the FRC has had a sustained period of imposing substantial levels of fines.



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The past three years have seen significant fines from the FRC totaling close to £67 million (\$83.5 million). All but four of the 26 fines handed out since the beginning of 2020 have been to the Big Four and Grant Thornton.

Deloitte received the largest fine to date from the FRC of £15 million in August 2020, with KPMG receiving the next two largest fines of £13 million in July 2021 and £14.4 million in May 2022.

This year has continued the theme of high-value fines, with the first five months of the year seeing total fines of more than £7.5 million. PwC was fined £5.6 million in respect of breaches associated with its audit of Babcock International Group PLC's financial statements for the year ending 2018, with two of its former audit partners receiving financial sanctions of £150,000 and £48,750 respectively.

In this case, the FRC identified breaches with respect to every area of audit investigated, including failures to follow basic audit requirements and overall showing a lack of competence, care and diligence.

Separately, KPMG has received two fines in respect of its audit of the financial statements of Luceco PLC for year-end 2016 and the inventory existence of TheWorks.co.uk PLC.

In respect of Luceco's audit, material misstatements were subsequently identified in the financial statements, which required restatement in 2017. The breaches when conducting the audit included various failures in respect of the audit procedures, such as a failure to review and critically assess the audit evidence provided.

For these failings, KPMG was fined £875,000, with the individual auditor receiving a fine of £35,000. With TheWorks.co.uk, the audit failed in a number of respects to ensure the accuracy of the audit and as a result it could not provide reasonable assurance that the financial statements were free from material misstatement.

As a result of these issues, KPMG was fined £1.024 million, with the individual auditor being fined close to £44,000.

This year's fines seem to be demonstrative of the increasing expectations placed on auditors, and in particular, the Big Four, when conducting audits. This is unsurprising, given the FRC's regulatory objectives to serve the public interest in setting high standards of corporate governance, reporting and audit, by holding to account those responsible for delivering them.

### **Enforcement Objectives**

The purpose of levying fines and other sanctions is both to sanction the culpable parties, but also to act as a deterrent for others in the auditing sector. Additionally, it assists the FRC to be able to dispose of cases quickly and with cooperation from those it is investigating.

As a result, many of the fines are accompanied by substantial discounts. Auditors who self-report, cooperate with the investigation and make admissions, frequently receive discounts on financial sanctions of up to 30%, with more available in certain circumstances.

Notably, the FRC also has a good track record of holding individual auditors to account for failings in audits, alongside their employer. The majority of recent cases have levied fines on individuals as well as the auditing business found to be at fault.

Moreover, the auditing firms are usually required to pay costs on top of the already substantial fines levied against them, with costs in some cases running into the millions of pounds, and not accounting for the firms' own costs as well.

Equally noteworthy is the FRC's increasing willingness to follow the cases of other regulators in order to hold auditors responsible for their role in other enforcement actions.

For example, there are ongoing FRC investigations into PwC and EY for their roles in auditing London Capital & Finance PLC, which itself is the subject of ongoing U.K. Serious Fraud Office and U.K. Financial Conduct Authority investigations into the sale of mini-bonds and ISA bonds by the company.

Similarly, in relation to completed investigations, in December 2021 the FRC imposed a fine of more than £3.3 million on KPMG for its failings in auditing financial statements made by Rolls Royce Group PLC.

The FRC findings related to the Serious Fraud Office's investigation into Rolls Royce, which resulted in a deferred prosecution agreement. The FRC identified that KPMG did not apply the appropriate level of professional skepticism or obtain and document sufficient audit evidence in respect of two sets of payments made by Rolls Royce to agents in India.

These payments ultimately gave rise to two of the 12 counts of bribery that formed the basis for Rolls Royce's deferred prosecution agreement.

The overall increasing strength and resolve of the FRC can only be intended to impress upon the audit sector the scrutiny under which they conduct audits and the requirements imposed upon them in conducting independent audits.

Published enforcement actions provide helpful information to the market to identify how to avoid running afoul of the regulator and should assist auditors across the sector in ensuring that they are compliant with their regulatory obligations.

### **Shifting to the ARGA**

Despite its recent flurry of enforcement activity, the powers of the FRC remain somewhat limited. At present, the FRC has no investigative or enforcement powers over individuals, such as directors of firms, if they are not members of the accountancy or actuarial professional bodies.

However, this is set to change during the course of 2024, when it is expected that the FRC will fully transition into the Audit, Reporting and Governance Authority.

The authority will be granted statutory powers to investigate misconduct and enforcement reporting obligations against individuals in certain firms, thereby closing the current gap in the FRC's powers.

The authority will also be granted broader powers to oversee auditing practices, in order to increase confidence in the auditing sector as a whole.

The FRC has already taken some steps toward regulating the broader market, with the recent publication of minimum standards for audit committees and the launch of a consultation on the Corporate Governance Code.

It remains to be seen whether the FRC can maintain its current trajectory of undertaking substantial enforcement actions as its remit expands following the transition into the authority.

Given the intention behind the creation of the authority, it is to be expected that this new regulator will continue the work of its predecessor, including a focus on ensuring effective enforcement.

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[1] <https://www.frc.org.uk/news/july-2022/frc-continues-significant-growth-on-road-to-becomi>.