House of Commons
Treasury Committee

Audit and Accountancy

Oral and written evidence

Tuesday 9 February 2010

Witnesses:

Dr Steve Priddy, Director, Technical Policy and Research, Association of Chartered Certified Accountants (ACCA), Mr Ian Paterson Brown, Convenor of Ethics Committee and Chair of working group on the provision of non-audit services, Institute of Chartered Accountants of Scotland (ICAS), Mr Robert Hodgkinson, Executive Director, Technical, Institute of Chartered Accountants in England and Wales (ICAEW) and Mr Stephen Haddrill, Chief Executive, Financial Reporting Council (FRC)

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The Treasury Committee

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Contacts

All correspondence should be addressed to the Clerks of the Treasury Committee, House of Commons, 7 Millbank, London SW1P 3JA. The telephone number for general enquiries is 020 7219 5769; the Committee's email address is treascom@parliament.uk

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Oral evidence

Taken before the Treasury Committee

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Members present

John McFall, in the Chair

Nick Ainger	Mr James Plaskitt
Mr Colin Breed	John Thurso
Jim Cousins	Mr Mark Todd
Ms Sally Keeble	Mr Andrew Tyrie
Mr Andrew Love	Sir Peter Viggers

Witnesses: **Dr Steve Priddy**, Director, Technical Policy and Research, Association of Chartered Certified Accountants (ACCA), **Mr Ian Paterson Brown**, Convenor of Ethics Committee and Chair of working group on the provision of non-audit services, Institute of Chartered Accountants of Scotland (ICAS), **Mr Robert Hodgkinson**, Executive Director, Technical, Institute of Chartered Accountants in England and Wales (ICAEW) and **Mr Stephen Haddrill**, Chief Executive, Financial Reporting Council (FRC), gave evidence.

Q1 Chairman: Good morning. Welcome to Audit and Accountancy. We are very sorry that it ran on but, if you were listening to it, it was an interesting session. Can I start quickly: I have in front of me a selection of the consultation papers, the revised guidance, the working groups and statements that you and other relevant bodies have published following the credit crunch—they number 18 here. What have they achieved? Is this just to obfuscate and to keep the debate going and to make it so technical that we are going to forget about the issue?
Mr Haddrill: Firstly, it is clearly not to obfuscate. I think the starting point was that the audit process had not failed in the crisis but there was room for some improvement, so we needed to be very careful on what we consulted on and in drawing conclusions. A similar conclusion was reached in relation to governance that there was a lot that was right about governance in the UK but in some respects it had not served us well, so again we needed to be careful there. What we have done is, as you see, consulted, at the moment, on the corporate governance code and on the stewardship code, which I think is a very important counterpoise to the governance code because there is no point in having a comply and explain system on governance if there is nobody taking notice of what the explanations are from companies.

Q2 Chairman: My point, Mr Haddrill, is if you have 18 papers is this process robust enough because there are going to be lots of gaps?
Mr Haddrill: I think it is robust and it is not just the consultation papers that are going on; you are also seeing the work of the Audit Inspection Unit, which has been going on for several years now, and has been intensified over this period in looking at the audits of banks and the work of the audit firms. So it is underpinned by that whole regulatory system.

Q3 Chairman: I have in front of me "Helen Brand, CEO of ACA", and now Dr Steve Priddy turns up. Why has she been transformed to you? You are the technical man. Are you here to obfuscate?
Dr Priddy: I am the Technical Director here.

Q4 Chairman: Why is she not here?
Dr Priddy: I do not know. It is her diary.
Chairman: It is not a good way to treat the Select Committee, okay, so take it back to her, and I will look for a nice letter from her. Thank you.

Q5 Jim Cousins: Bank auditing both in this country and across the world is dominated by a tiny number of global firms and in this country they have the protection of limited liability. Is that right? Do we not have too few players in the market and are not the players we have too well protected?
Mr Haddrill: I do not think it is right in the sense that the law introduced the opportunity to negotiate proportionate liability with companies. That is not something that has actually been pursued so far, so they remain quite exposed in terms of liabilities. In terms of the number of firms, we believe strongly in competition and we would like to see more firms there, but in practice that is unlikely to happen. Therefore, the key challenge for us now is to make sure that those big four firms do not become a smaller number of firms, and that is why we pay so much attention to both audit inspection in the UK, to encouraging the improvement of governance of those firms, which we have just done through working with the Institute on a new audit governance code, and through encouraging genuine international regulation of audit because, as you say, they are big global entities.

Q6 Jim Cousins: How can regulation possibly be effective if regulation is, in a sense, protecting the existence of the big four accountancy firms?

Mr Haddrill: I would not say regulation is protecting their existence.

Q7 Jim Cousins: You have just said it is, that you cannot risk a situation where you go down from a big four to a big three.
Mr Haddrill: I said we wanted to take action in relation to the activities of the big four so that they do not go down to the big three. We are robust in our inspection regime and we would be robust if we found misconduct in pursuing that.

Q8 Jim Cousins: Is it not the practical reality that there are a number of legal actions now that are underway, most of them in the United States, a lot of them now directed at KPMG because of its activities, in fact some relatively small and non-headline here, American institutions that they audited? Are not those legal actions going to be a far more effective way of regulating, disciplining and improving the quality of auditing than anything you are likely to do?
Mr Haddrill: I think the liability that the firms hold is actually part of the system, and I would agree with you that if they get things wrong they are maybe taken to court so they will manage themselves in such a way as to try and make sure that they do not get exposed to that. So I do not think that, somehow, as a regulator we are in competition with the courts and the legal system. We are complementary.

Q9 Jim Cousins: Is it not the situation that the fees the big four accountancy firms are getting from banks are absolutely enormous and that you are limited in what you can do as regulators because you have to protect them? We have a classic cartel.
Mr Haddrill: I do not think that is right. Certainly the fees that they get are large, and our expectation is that those large fees get invested into the business, and it is one of the things we look at in terms of the training of the audit teams and their investment in improving audit quality. That is one thing that we do expect to see. The other thing we expect is that they pursue their work with a high level of ethical standards.

Q10 Jim Cousins: Excuse me. KPMG got £9 million from auditing HBOS. How much of that went back into improving audit quality?
Mr Haddrill: I cannot tell you exactly.

Q11 Jim Cousins: Perhaps you could let us know, because that would be really helpful. Ernst & Young got $27.8 million for auditing Lehman Brothers. Could you find out for us how much of that fee went back into improving audit quality?
Mr Haddrill: It is not my job to defend the fees of the audit firms.

Q12 Jim Cousins: You have advanced a justification for the size of the fee in terms of reinvestment in audit quality. I have asked you one or two direct questions that follow from that and it is reasonable to expect an answer.
Mr Haddrill: No, I am not justifying the size of the fee; I am saying that we, as a regulator, expect audit firms to invest in quality, to invest in the training of their staff and to invest in their ethical systems as well. I am not saying that any particular size of fee is the right size of fee.

Q13 Jim Cousins: If a regulator says that one of the justifications for the fees is reinvestment in audit quality, it is perfectly legitimate for this Committee to say to you: "Okay, how much of those fees went back into audit quality?"
Mr Haddrill: No, sorry, I think you are misinterpreting what I said. I am not justifying the level of their fees at all; I am saying that we expect them to invest in those activities.

Q14 Jim Cousins: How do you carry out that expectation?
Mr Haddrill: We audit what they do, we inspect what they do, we look at the extent to which they are managing their risks, and we look at the extent to which they are investing in those activities.

Q15 Jim Cousins: So why can you not tell me how much of the £17 million that Deloitte got for auditing Royal Bank of Scotland went back into improving audit quality?
Mr Haddrill: Because what we do is look at the firm as a whole and we also look at particular audits, but in terms of the level of investment by the firm as a whole in those activities that would make sense, not the level of investment in relation to a particular audit.

Q16 Sir Peter Viggers: Following the Enron scandal accountants moved out of consultancies. In the year 2000 something like 300% of audit fees by comparison were consultancy work, in 2009 they were 70%, and now all the accountants are moving back into consultancy. Are you confident that this is a sensible step?
Mr Haddrill: This is something that we are taking a very close look at. The committee made a recommendation on non-audit service fees and non-audit service work, and the consultation on that has just closed and the FRC will be reaching a conclusion on that over the next two to three months. I must make that clear. As you say, the level of non-audit service fees in relation to audit fees has fallen quite significantly, and we were certainly very pleased to see that. The question is to what extent is it ticking up now, and I do not think we yet know the answer to that, and whether it is going to be a sustained change. If it is going to be sustained, we would be concerned about that because we want to see—and I think investors want to see—that the balance is very much in favour of the fees they earn from audit rather than the fees they earn from other activities.

Q17 Sir Peter Viggers: You do not know whether they are expanding or not? KPMG have said they plan to treble their consulting revenues to

£600 million. PricewaterhouseCoopers are planning to take on a further 300 consultants in the next 12 months. This is a matter of public record. Did you not know that?

Mr Paterson Brown: I think there is an important issue here with regard to the fragile state of the economy at the present moment. There are a lot of companies turning to, if you like, advisers. Therefore, in a lot of companies the auditors are one source of advice that is close to the company and able to provide support, and I think in the current situation, if you like, where we do not want global economies to go back into recession (or indeed, worse than that) it is important advisory services are there, and I think they will tick up in the short term. I think the issue is that the controls and balances are there to make sure that the balance of these is correct going forward.

Q18 Sir Peter Viggers: Your organisation, Mr Paterson Brown, had a working group studying this general issue of audit and non-audit. Who sat on that working group?

Mr Paterson Brown: There were 14 of us. We had a balance of academics, institutional investors and corporates, and the big four were represented as well, but there were 14 of us and they were in the minority.

Q19 Sir Peter Viggers: Your recommendations were to audit committees. Would it not have been more effective to make recommendations to the auditing firms themselves?

Mr Paterson Brown: To the extent that we went through the process I think that, if you like, the issue for us, having done a robust debate which included, I may say, all of the members of the group, was that we had an issue with regard to the difference between perception and reality. The perception out there with regard to certain factions is that, if you like, there is a problem with regard to non-audit services. We believe the reality is that the safeguards are in place and that actually what we need is greater transparency, disclosure of policies and procedures, improved analysis of audit fees and non-audit fees and enhanced corporate governance. To that extent, we think some of this, if you like, comes back to the companies and the audit committees, and we believe that those findings will be supported when the work comes out in a couple of weeks' time.

Q20 Sir Peter Viggers: Mr Haddrill, your organisation put out a press release in November warning audit firms about providing internal and external audits. Why do you think that audit firms need to be warned about taking on internal and external audit when you do not need to warn them about taking on consultancy work? Is there not a similar risk there?

Mr Haddrill: The concern is that the audit firm is not taking on work which could compromise their ability to do a proper audit. I would say the issue is whether they are taking on consultancy work which is particularly relevant to the audit and gets them into the position of auditing their own work. That is what we are trying to avoid. We have made clear in our ethical standards that is something that auditors need to avoid and need to think very carefully about, and in the inspection work that is something we pay a lot of attention to.

Q21 Sir Peter Viggers: It seems that the profession is accepting the need for greater transparency, so can I ask each of you whether you would support greater transparency of auditor remuneration in the company's annual report, showing more details of the non-audit services provided to the company, and more disclosures from auditors themselves giving information as to their various undertakings. Would you support greater transparency?

Mr Hodgkinson: Yes, and I think, going back to your figures of 300% to something like 70%, that applied to individual companies, the ratio between the non-audit fees and audit fees. What has happened is there has been a real transformation in practice which has not been communicated appropriately. We have had a lot of reform and change in substance, but actually—and it was evidenced by the reaction of this Committee and others—the perception has not changed. It is important that there be transparency. There are absurdities in the present disclosure, like most people would regard work on an interim set of accounts by auditors as audit work but it gets classified as non-audit work. There is a host of anomalies which mean that, quite rightly, people look at what has been disclosed and say, "Has a lot changed?" If I could just make a comment about what you said earlier about the growth in the firms. There is no plan that I know of for firms to increase, as a matter of policy or strategy, the ratio of non-audit fees to audit fees. We are talking about the total business and we will be talking about business done for non-audit clients. That is just to clarify the comparison made between the press announcements and the issue of non-audit fees on audits.

Q22 Sir Peter Viggers: Disclosure, Dr Priddy?

Dr Priddy: Yes, I totally agree with Robert.

Mr Haddrill: Yes, I think disclosure is very important. Just to pick up a point that was made before, it is both disclosure by the auditor and disclosure by the audit committee of what its policy is. I think the two have to go together.

Mr Paterson Brown: It goes to the very core of the working group report.

Q23 John Thurso: Can we go on to the question of fair value mark-to-market accounting and pro-cyclicality? Perhaps we will start with you, Mr Hodgkinson. Do you think that fair value accounting will always result in an element of pro-cyclicality? Is it inevitable?

Mr Hodgkinson: This question of pro-cyclicality, as you know, has been subject to a lot of attention, and it is fair to say that the professional standard-setters before this crisis probably had not given it enough attention. There is a very good speech, which I am sure you are aware of, that Lord Turner gave at the ICAEW a couple of weeks ago setting out a very clear analysis of how the model that was used for providing against loans and the model that was used for marking certain instruments to market could contribute to pro-cyclicality. That is a good analysis. I think what we need to look at, though, and be careful about in our research, is whether that actually happened in practice, because there are within individual entities ways that some of them do not respond to fair mark-to-market accounting in ways which lead them to get over-exuberant, but there are controls that are in place as to how regulatory capital is calculated and controls in UK company law as to how dividends are based on accounts. There are safeguards in there. Yes, there is a tendency towards pro-cyclicality, but I think we should be looking at the safeguards and the alternatives to mitigate those effects rather than say that mark-to-market accounting is a bad thing. As Lord Turner acknowledged in his speech. There are reasons why it is very good.

Q24 John Thurso: It has the opposite ill-effects of historical cost, basically.
Mr Hodgkinson: Yes.

Q25 John Thurso: In one it lets management get away with being too optimistic, the other lets the market get away with being too optimistic.
Mr Hodgkinson: There is also an issue that if you allow people to hold assets at way below their market price then you give them discretion to manage their earnings, because all they need to do is release a flow of under-valued assets and managed earnings, which isn't what investors would want.

Q26 John Thurso: So we know the danger but, on balance, we think it is the least of the two. The FSA proposed that, basically, we go to two lines for loan loss provision, so you have the one which is historical, which says that is what has happened, and the other which is an estimate and basically tries to aim off on the market's optimism, as it were. Do you think this will be (a) more informative for investors and (b) help mitigate the risk?
Mr Hodgkinson: It is a suggestion which has been around for some time. We are quite sceptical about it because we think that presenting two numbers risks confusing people and, heaven knows, we are concerned enough about the complexity of financial reporting without having the complexity that that introduces. I think the approach which the IASB has been taking, which is trying to find a way in the published accounts that are useful to investors, of introducing an economic approach to provisioning, rather than the "incurred loss" approach, is trying to tread a middle path. It is always possible for regulators to have their own overrides and rules which modify the reported numbers, so it would be really hard trying to find a single number in the accounts, otherwise people will just say: "Which one are we supposed to look at?"

Q27 John Thurso: Anybody else?
Mr Haddrill: We have to watch within the incurred loss approach that we do not ask it to do more than it is capable of doing, because the incurred loss can still only be recognised at a particular time by banks as their market changes, so we could still have volatility even with an incurred loss approach. The point Robert makes very well is that there is only so much accounting can do here, and there is much that regulators may well have to do on top of the accounting provisions in terms of asking the banks to reserve against losses that are arising. We should certainly not devise accounting rules that apply to the whole of the economy just to sort out the problems of the banks. If the regulators are asking for more capital to be put aside because they perceive particular risks applying to banking or particular banks, the disclosure issue is, how does that get fed through into the accounts? We need to see disclosure of the consequences of the regulator's decisions.

Q28 John Thurso: At the heart of this is the whole thing Warren Buffett always used to come up with, which is that in the short-term the market is a voting machine but in the long-term it is a weighing machine. What we are seeing is that the pure voting has got very little relevance to actual underlying value; it is whatever people are prepared to pay in the market, and if it goes across a year and everybody gets a big bonus they pump that back in, whereas what we need is the weighing machine approach somehow to be reflected. Can accounts ever do that or is that always going to be a matter of judgment for investors?
Mr Haddrill: I think accounts are always, to some extent, going to be a record of what happened the year before, but there is also the report at the front end, the directors' statements, and what you are getting with more fair value is that there is more judgment in the accounts and more reliance upon understanding of the business strategy in order to interpret the members. There needs to be more understanding of the business strategy. We therefore feel that the quality of the front end of the report and accounts is very important and maybe the auditors should have a bigger role in ensuring what the management is saying about where it is going than they have done so far.
Mr Hodgkinson: Could I add another perspective on this? Stephen is quite right to say that the context in which you report the accounting numbers is important, but I think it is also important to recognise that the accounting profession as a whole has a range of users of information; they need to be given information which is fit for purpose. We have tended to have a debate over the past year about there being only one set of numbers, and there is a fight for who kind of controls the steering wheel: is it for investors or is it for regulators? I think it is more constructive to say that you have, as far as possible, a core set of numbers and then you make it very clear to those involved in remuneration decisions or distribution decisions or regulatory decisions the

limitations of the information for their purpose. I think we need to get away from this idea that if there is more than one number then somehow we have let people down or it is duplicitous—actually, people have different purposes—and I think acknowledging those differences, rather than just saying: "The numbers are for the investors, everyone else forget about it", is not helpful.

Q29 John Thurso: We are tight for time, so can we go on to the next issue? Stephen Haddrill, perhaps I can ask this of you: have you had any feedback on your revised guidance on the going concern issue?
Mr Haddrill: The feedback has been positive and seems to be being adopted effectively, so we feel that is satisfactory.

Q30 John Thurso: Can I, just for the form, ask the rest of you if you have any feedback to give me?
Mr Hodgkinson: I think that everyone concerned thinks it has been a big success, and I think it is a big success in an important way because it shows that the accounting firms, the accounting profession and the regulator all realise that they were potentially brewing a systemic problem here because individuals reporting on individual banks and individual entities could have created a systemic problem because of the going concern regime. I think identifying that everybody needed to understand what the reporting meant and also realise the importance of banks helping businesses clarify their facilities and everyone helping people to think through their business plans helped to avoid a systemic problem. It is easy to focus on systemic problems that have happened, but we have not had a systemic problem of mass qualification of accounts or modifications leading to a collapse in confidence.

Q31 John Thurso: The core point, really, is what we are seeking is to get away from that cosy relationship where the chairman of the audit committee and the senior partner of the audit sit down together and—if not manage—make sure that everything is all right, to something where the auditor really feels quite free and has a clear responsibility to say and enter things in different degrees of tone without it bringing the whole edifice collapsing down.
Mr Paterson Brown: To the extent that I am currently a finance director and was previously a finance director in the City of London, with regard to a listed 250 company, the cosy relationship between the audit partner and the chairman, I think, is a perception rather than reality.

Q32 John Thurso: I have sat on a number of audit committees and watched it happen.
Mr Paterson Brown: It does not happen in the areas I have been involved in. What I would say is that by flagging the issue at an early stage and by getting everyone focused on it, if you like, there were more than actions taken with regards to discussions; a lot of money was raised by companies in the marketplace with regards to rights issues, there was a lot of discussion with regard to banks, with regard to banking, a lot of action was taken with regard to the going concern, and I think by getting issues out on the table early and getting people sensibly discussing them we, if you like, headed off a lot of problems that may have emerged and, thankfully, did not.

Q33 Chairman: Stephen Haddrill, you talked about the Audit Inspection Unit as a way of keeping tabs on the auditor. Is that correct?
Mr Haddrill: That is their role.

Q34 Chairman: In its 2007 report on PwC the Audit Inspection Unit found that PwC audit staff were selling non-audit services to audit clients. As you know, that is not allowed. A year later they were still doing it. So do audit firms have any regard for the AIU's findings?
Mr Haddrill: We believe that they do. Being only two months into the job I am a bit reluctant to comment on two years ago.

Q35 Chairman: But the case I have put to you—
Mr Haddrill: I understand that. We pursue the questions that are raised in each inspection report the following year to make sure that there is follow-up and that we are satisfied with that and that we continue to do that.

Q36 Chairman: It did not happen in this case.
Mr Hodgkinson: It did happen in the sense that we have continued to pursue it.

Q37 Chairman: They are still doing it. What is the use of the AIU if they are still doing it?
Mr Haddrill: Because we have highlighted it; we have raised it.

Q38 Chairman: There is no use highlighting it if there is no behavioural change.
Mr Haddrill: I think there has been behavioural change in this case. I will ask the firm to respond to that, but what we have put in the public domain is an anxiety and I think that is of considerable interest.

Q39 Chairman: Do you have any sanctions?
Mr Haddrill: We have sanctions if there is misconduct, and I think one of the things that we are increasingly concerned about is that we have got a sort of nuclear sanction in relation to the firm but we do not have an intermediate set of proportionate sanctions.

Q40 Chairman: You said earlier, and I just make the point, that there is a difference between perception and practice. The perception is that this is going on, but in this case the practice is that it is going on as well. If the AIU does not have decent sanctions to do anything about it, it just seems as if things will be business as usual.
Mr Haddrill: I think I am agreeing with you that there should be a more flexible set of sanctions rather than removing an auditor's licence to practice.

Q41 Nick Ainger: Mr Hodgkinson, in our report on the banking crisis and corporate governance, you came forward with five suggestions about strengthening the links between auditors and the FSA. We have seen the written response from the FSA. How is it actually working out in practice?
Mr Hodgkinson: First of all, thank you for referencing those suggestions. I think that we need to disaggregate them a little bit because there are different powers the FSA has unilaterally to change things, because some are in company law and some are about international agreements. Just to give some examples of things changing, I think it is worth saying that the FSA now supports supervisors with an accounting review team, and that there is an expectation that there are annual meetings, at least, on institutions, and they have doubled or tripled the use of section 166 reports, and that is quite a change in practice. These things take time, but I think they are indicating a change in the right direction. Also, we established towards the end of last year an Audit of Banks working party, which we expect to report in April this year, which will have had the input we said was necessary when we made our submission to the committee of a wider group of stakeholders as to whether this potential expansion of the role was seen as being helpful That is something which is ongoing.

Q42 Nick Ainger: The annual meeting which takes place between the auditors and the FSA, where is that in relation to the audit itself? How close is it? Is it immediately before, is it immediately after or is it during? When does it happen?
Mr Hodgkinson: I think it is fair to say that I am not a bank auditor and privy to those, so it is difficult for me to comment on that.

Q43 Nick Ainger: Does anybody else know when these meetings take place? Perhaps you can let us know on that because, obviously, the concern would be that maybe if something is shown up and the meeting does not take place for six months, nine months or whatever, then the FSA is not made aware of this.
Mr Hodgkinson: I am sorry; I think there is a well-established regulatory framework so that where there are things which need to be brought to the attention of the regulator then there are professional obligations to do that. It is also important to say that auditing these businesses is a round-the-year activity, not only in relation to quarterly statements from the US but half-year announcements, and the fact that you cannot complete the audit in a few weeks after the year-end. I think we can give an assurance, even without having detailed knowledge of the timing, that those sorts of concerns that you raise should not worry the Committee too much.

Q44 Nick Ainger: Can I ask the rest of the panel then have you seen a change in the relationship between auditors and the FSA since our report?
Mr Haddrill: I think what we have seen is the FSA paying more attention to the auditors' knowledge of what they are saying and to that information set alongside the direct supervisory reports that the FSA gets itself.

Q45 Nick Ainger: So there has been an improvement in those relationships?
Mr Haddrill: I think the FSA is certainly paying more attention to that.

Q46 Nick Ainger: If another bank were to fail or get into serious difficulty, would it be absolutely clear now who was responsible for telling whom about what the problems were? That was part of the problem with Northern Rock.
Mr Hodgkinson: It is quite a rich question which makes some assumptions about what happened in Northern Rock. What is important is to recognise that there is a greater acknowledgement of how two different functions, one a regulatory function and one an audit function, which are distinct but are both based on having an understanding of risk, can benefit from dialogue. I think if we look at the collapses that we saw, I do not think it was a conclusion of the committee that they were caused by the auditors, nor was it a crucial fact in those failures that there was not communication between auditors and the FSA. I think what we were trying to do was talk about, in our suggestions, ways in which there could be extra safeguards and greater confidence so that when people asked, "What liaison is there between FSA and auditors and how do they mutually benefit each other?" there was a better answer. I think there will be a better answer in future.
Mr Paterson Brown: I think it is not just the FSA and the auditors; it is the FSA, the companies and everything else. Working currently in a regulated business, the level of communication is hugely different now with the FSA from what it was 18 months, two years ago.

Q47 Chairman: We asked a question about the big four going to the big three, but what steps have been taken to increase competition?
Mr Haddrill: There was the market report that was produced between the FRC and the Department some three years ago. There were 15 recommendations there, they have been implemented and we will be reporting on their effectiveness in the coming year.

Q48 Chairman: So four years later you are reporting on their effectiveness. The APB ethical standard four prohibits a firm from accepting a client if the fees are more than 10% of the audit firm total annual fees. Does this unhelpfully restrict competition in the accounting world?
Mr Haddrill: I do not think it restricts competition. I think if there is one area where we would certainly like to see competition grow it is in relation to the smaller end of the listed market. If you look at the AIM market you see auditors abounding other than just the big four. If you look at the 350 around the

FTSE you do not see that. Actually, I think there is not just a challenge to regulators to encourage companies there to look outside the big four, I also think there is a challenge to investors to encourage it as well.
Mr Hodgkinson: Could I just make an observation: the point you make is a good one which shows that there are conflicting regulatory objectives and public policy objectives because the reason that 10% rule is there is for independence, and the appearance of independence. Yes, you are right that if an audit firm which does not have a very major client is looking to enter that market you could create problems, so there are conflicting public policy objectives.

Q49 Chairman: Can we take it that you disagree with the Governor of the Bank of England then when he says that to rely on Chinese walls is a triumph of hope over experience?
Mr Haddrill: He said that in this context?

Q50 Chairman: The institutions. What about you, Dr Priddy? We have not got you here for nothing!
Mr Haddrill: I think that one of the things that we are consulting on in relation to this whole question of non-audit services, and which we will reach a conclusion on, is whether there is sufficient clarity in the ethical standards about what non-audit work can be accepted and whether there are tight enough lines around the quantum of fees from one set of activity versus another. To that extent I would agree with the Governor that there is always a question to be looked at as to whether you actually need harder black letter rules.
Mr Hodgkinson: I think the experience of firms—and it is supported by the inspection regime—is actually the accounting firms do have a good record in relation to Chinese walls, and the system, again, has other objectives, because in terms of making available to corporates a variety of services in a market which is to the proportionate degree regulated and director choices are limited, if you are going to do that in as limited a way as possible that supports economic prosperity then you have got to have some trust in safeguards. It would be very easy to have no trust in any safeguards but just constrain economic activity in a way which would not be helpful; it is a balance.

Q51 Chairman: You deal with ethical issues as well, Dr Priddy, do you not?
Dr Priddy: Yes.

Q52 Chairman: Chinese walls and the Governor?
Dr Priddy: I think the point that I would make is that at the heart of this is a commercial decision between the audit firm, the board of directors and shareholders, and all those key players have something to play in that commercial decision. I think when you look at the way services are procured, audit committees will look very carefully at the best person to provide the services, and my experience is that Chinese walls do work very well.

Q53 Chairman: There have been recent instances where a firm has been advised to go into administration and those advisers have overseen the administration and made large amounts of money. As the Chairman of Woolworths said, is this not a clear case of a conflict of interest?
Mr Paterson Brown: I think in business life one comes across conflicts of interest all the time. One needs to clear them and one needs to make sure the appropriate safeguards are in place, and one moves on. To think that you can go through your business life without coming across a conflict of interest is impossible at a senior level; what you need to make sure is—

Q54 Chairman: Hold on, hold on. If you are going to advise an entity to go into administration and then you are going to oversee that administration, maybe your initial advice could be a little bit wonky. If there is a conflict of interest there why do you not separate it? Those giving the advice and those undertaking it at a later date, surely that is a real clear conflict of interest there. It is not good enough just to say: "There are conflicts of interest in life every day; let's forget them; let's get on with business".
Mr Paterson Brown: No, the comment was that the advice with regard to going into administration can be given with the safeguards in place. Having gone into administration that work can be done, if you like, having exercised the safeguards with regard to the original decision. I do not see that the two need to be completely linked.

Q55 Jim Cousins: Following the Chairman's issue there, is this whole area of abusive pre-pack insolvencies and the relationship with advice from auditors that goes into this something you are looking at?
Mr Haddrill: It is not something I have looked at in my current job; I certainly looked at it in my previous one, at the ABI, where we were concerned about whether a pre-pack was, effectively, in the interests of the owners of the business.

Q56 Jim Cousins: Pre-packs are an absolute outrage and they are spreading like wildfire. Clearly, people are being advised to set them up.
Mr Haddrill: I think pre-packs are (I do not know whether I would use the word "outrage", but let's use it) an outrage where they are set up for a purpose which is not in the interests of the people who have a relationship with a company as investors and so on. If, however, it can be set up in a way where there is proper disclosure, the business remains in being as a result, and people remain in employment, and everybody understands what is going on, then I think it is potentially a good thing.

Q57 Mr Love: Insolvency practitioners have always argued that if you look at the evidence pre-packs are good for the creditors, especially the smaller creditors. Is there any validity to that argument?

Mr Haddrill: You are taking me into territory where I think it is probably best that I do not answer from an FRC perspective because that is not part of our responsibility now. I was looking at it in relation to having experience in the insurance industry before, in a previous job.
Mr Hodgkinson: If it would help—and it is not something on which I am deeply knowledgeable—to provide the Committee with further information we would be happy to do that.

Q58 Chairman: There does just seem to be a little degree of complacency here.
Mr Hodgkinson: It is probably just a degree of unfamiliarity with the territory.

Q59 Chairman: We have been told that there has been a real transformation in practice. Can each of you set out one of the most significant things achieved since the credit crunch? Why do we not start with Dr Priddy, then he can get full marks for being here today.
Dr Priddy: Thank you very much. I think one of the things that has come through for me as being a really good advance is the role of the audit committee and the duties of the audit committee within the new corporate governance codes that have come through. I think this is a really good, positive step forward, it does highlight much more clearly the role of the audit committee, and I think that is very good. I think, also, the guidance that has come through on going concern is very important, and that has also been a great progress as a result of this crisis. Those are two things I would flag.
Mr Haddrill: I would mention two things. I think within governance the much clearer focus on risk, the rise of the risk committee within the businesses and the appointment of people to make sure that boards really understand risk. Also, I think, from our perspective in relation to audit on an international level, the growing liaison between auditor regulators on an international basis.
Mr Paterson Brown: Obviously I came in to chair this working group and, therefore, have not been involved as far back as other people. I think what I would say is that, if you like, post-2002 we have seen a change in the world with regard to governance and with regard to regulation, et cetera, and I think we need to keep moving down the transparency, disclosure and governance route. I do not think we have ended the journey.
Mr Hodgkinson: I am a little bit hampered being the last but, maybe, rather than talking about specifics, the important thing is that this, as the Committee summarised, was not primarily an audit crisis, but the challenges, for example, that you laid down in your nine recommendations have caused us a lot of reflection: the value of audit; risk management responsibilities; liaison with regulators and auditors, and going concern. These are important issues which I think we have been forced to reflect on; in particular the question that Mr Thurso raised about thinking about pro-cyclicality and the impact on the accounting profession not just on a micro level relating to individual entities but thinking about the consequences. I think that consciousness is something that will lead us to do a lot of work over the next few years.

Q60 Mr Love: The word "rotation" has not come up as yet. I wondered whether you felt (I am asking you collectively) that rotation has a larger role to play than it currently has done up to the present time.
Mr Haddrill: Certainly the decision has been taken not to relax on rotation and there was pressure—

Q61 Mr Love: Should we strengthen it?
Mr Haddrill: I do not think we need to strengthen it because we looked at both sides of it when we reviewed it, but I certainly think that one of the things that has come out of the work over the last couple of years is we should not be relaxing it.

Q62 Mr Love: Does anybody have a different view?
Mr Hodgkinson: Are we talking about rotation of auditors?

Q63 Mr Love: Yes, rotation of auditors.
Mr Hodgkinson: I think that as an issue for regulatory change it is not considered a live one. What I would emphasise is that rather than looking at these ways of constraining activity to build confidence we have to have the audit firms and the profession building their own confidence. We have not mentioned the publication by FRC and the ICAEW two weeks ago of an audit firm governance code. It is all about the profession taking its own responsibility to build confidence rather than waiting for another regulatory constraint or limitation. I think it will be seen more actively . . .

Q64 Chairman: At the beginning I said you had 18 working papers. I would like to see some coherence in that and that it is not just 18 disparate pieces of work. If I take you back to the genesis of our concerns it was where we saw that within days of getting a clean bill of health from the auditors many banks simply collapsed. We said the fact that the audit process failed to highlight developing problems in the banking sector did cause us to question exactly how useful audit currently is, and I think that is still a live question for us. I think there is a problem in terms of perception and reality, and you have quite a bit of work to do there. I would hope that the successor Committee to this in the next Parliament looks at this and we keep engaging on that so that we do have more clarity and transparency in the process and have a real understanding of exactly what an audit is about and how we ensure that we have real time information that is shared so that if the business models are skewed or wonky something can be done about it.
Dr Priddy: Can I just say something from an international perspective, because Stephen did refer to that? We have been doing some round tables across different territories and I was in the Ukraine the week before last. Around the table we had people from the World Bank, people from the audit profession, people from the regulators and people

from business. One of the points that was made very clearly there is that the way the UK works in terms of its audit framework, in terms of Companies House and having transparency of accounts, and so on, is something that other countries in the world look to with great envy.

Q65 Chairman: Maybe with regard to the Ukraine the UK does do it better—I do not doubt that—but I think we need our own standards and the standards need to be raised, Dr Priddy. We want, as a Committee, to engage with you in that exercise.

Mr Hodgkinson: Can I also say that we did not have time to talk about the activities of the Audit Quality Forum, which was set up five years ago to raise these issues amongst all the stakeholders in audit. Although we have not got time to go through the work that has been done since last year on this, there are important initiatives which I think respond to your challenge, and, again, we would be quite happy to update you.

Q66 Chairman: It is still a work in progress.
Mr Hodgkinson: Work in progress.
Chairman: Thank you very much.

Written evidence

Written evidence submitted by Actionaid

Country-by-country Reporting

The hearing announcement indicates that, "the Committee will also be seeking information on any recent developments in audit and accounting, with a particular emphasis on regulation and the future role of auditors in banks and other financial institutions."

ActionAid would like to draw the committee's attention to a recent development in international accounting standards regarding which the Committee may wish to seek the witnesses' opinions. This is the development of a country-by-country financial reporting standard, which now looks increasingly likely in two forums:

— The OECD and the UK's Financial Secretary to the Treasury, Stephen Timms, have indicated that an internationally agreed best practice standard for country-by-country financial reporting should be developed, as part of an update of the OECD's Guidelines for Multinational Enterprises.[1] This follows a meeting on 27 January of the OECD's Committee on Fiscal Affairs and Development Assistance Committee.[2]

— The International Accounting Standards Board is this month expected to publish a discussion paper on a new financial reporting standard for extractive industries (IFRS6) which will include consideration of a country-by-country reporting standard.

Suggested questions:

1. How will the development of a voluntary standard at the OECD be bedded down into industry practice, given that the latter is based on mandatory IFRS rules?
2. What steps is the accounting profession taking to support the development of a country-by-country reporting standard?

Background

At the beginning of last year, ActionAid estimated that Africa alone would lose some US$49 billion of external revenue as a result of the financial crisis and recession, including falls in overseas aid, export earnings, remittances, foreign direct investment and other sources of external income. The crisis has shown the fragility of a development strategy based only on finance from overseas, and demonstrated the importance of developing countries strengthening their domestic sources of revenue.

Rather than acting to facilitate stronger domestic financing for development, the current system helps those who seek to avoid their financial obligations in developing countries. Developing countries lose valuable revenue through tax evasion and avoidance which is frequently channelled through tax havens. The government estimates that developing countries lose between $50 billion and $280 billion through tax avoidance and evasion.

The first step in the fight against the global pandemic of tax evasion is to lift the veil of secrecy over corporate tax payments. Currently multinational companies are—broadly speaking—only required to report their financial results on an aggregated basis. Introducing a requirement to break this information down on a country-by-country basis would: give tax inspectorates in developing countries more information on which to prioritise their investigation of potential instances of MNC tax evasion; give governments, media and civil society the information they need to map and understand the patterns of capital flight due to tax avoidance and evasion; have a strong preventative effect on MNC profit-shifting.

Supplementary written evidence submitted by the Institute of Chartered Accountants in England and Wales

In May 2009 the Treasury Select Committee put a number of challenges and recommendations to the accounting profession as part of its ongoing enquiry into the banking crisis.[3] In addition the FRC are ascertaining facts around the publication of the Valukas report on Lehman.

During my oral evidence to the Committee on 9 February 2010 I undertook to come back to you on a number of specific areas:

— dialogue between auditors and the FSA on systemic risk issues;

— the work of the Audit Quality Forum; and

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[1] The Financial Secretary's speech to the OECD meeting can be read here: http://www.hm-treasury.gov.uk/speech_fst_270110.htm

[2] OECD brings country-by-country tax reporting a step closer, *The Guardian*, 28 January. http://www.guardian.co.uk/business/2010/jan/28/oecd-country-by-country-reporting

[3] Banking Crisis: reforming corporate governance and pay in the City—Ninth Report of Session 2008–09—12 May 2009 (the Ninth Report).

— how insolvency practitioners manage conflicts of interest.

Appendix 1 addresses the first two points as well as progress made against other areas the Committee asked us to consider in its Ninth Report. Appendix 2 sets out a short explanation of the conditions under which insolvency practitioners are licensed.

Progress is being made on a number of important fronts:

— the Walker recommendations provide a clear governance framework for major financial institutions;

— there is increased dialogue between auditors and the FSA on systemic risk issues;

— detailed recommendations for improved disclosure, transparency and governance around non-audit fees have been published by ICAS;

— independent research undertaken for the ICAEW Foundation has identified important areas for improved application of the Combined Code by listed entities;

— on the back of extensive input from the profession updated guidance for preparers and auditors on going concern was issued by the Financial Reporting Council;

— ICAEW is assisting audit firms implement the new clarified International Standards on Auditing; and

— a governance code has been introduced for auditors of listed entities.

Everyone in the financial reporting chain has an important role to play as we move towards economic recovery and a return to business confidence. ICAEW is committed to playing a full part in this process.

APPENDIX 1

PROGRESS ON RECOMMENDATIONS FROM THE NINTH TSC REPORT 2009

Paragraphs 35–43 of the Ninth TSC Report of May 2009 raised a number of specific issues for the auditing profession. The progress we have made on each of these issues is set out below:

35. We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. We are perturbed that the process results in “tunnel vision”, where the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.

The audit profession has been reflecting hard on what steps can be taken to help mitigate future systemic failure of the kind that has characterised the banking crisis. This is more than a question about audit quality and the financial statements of individual financial institutions. In December 2009 the Audit Inspection Unit of the Financial Reporting Council reported “the overall quality of major public company audit work to be fundamentally sound”[4] and that “firms generally continue to take appropriate action…to respond to increasing turmoil in financial markets and the onset of the economic downturn.” It is also a question about whether auditors can do more to help identify potential systemic risk areas—something the current reporting model was not designed to pinpoint. Since the Committee published its Ninth Report, the Audit Quality Forum (www.icaew.com/aqf) has brought together auditors, investors, corporates, regulators and wider market participants specifically to debate the potential role of auditors in helping to identify systemic risk. The output of that debate has been fed through to regulators and policy makers in order to help inform public policy development. ICAEW is also consulting on Audit of banks: lessons from the crisis which will examine how the role of bank auditors could change, for example around information exchange between audit firms and the FSA. We aim to publish our recommendations in April.

36. We are not convinced that auditors are particularly well placed to provide additional assurance regarding the risk management practices of financial institutions. Bearing in mind the view of the Chief Executive of the Financial Reporting Council, that auditors were not competent to perform such a role, it would be perverse to come to any other conclusion. A better way to ensure that banks manage their risks would be to concentrate on the banks’ own internal risk management functions, complemented by more invasive regulation of risk by the FSA.

It is clear that a number of major financial institutions failed to identify and manage effectively the possibility of systemic risk in the run-up to the economic crisis. The Walker recommendations, published in November 2009 are designed to address this problem. Last year the ICAEW Foundation commissioned independent research on the governance regime across the wider listed company sector. The research, which was published in September, concluded that while the current governance framework is fit for purpose, listed entities need to be more rigorous in their adherence to the Combined Code. We are now working with the FRC on its current review of the Turnbull guidance on risk management and internal control to embed

[4] Audit Inspection Unit 2008–09—Audit Quality Inspections, An Overview—7 December 2009.

changes proposed by Walker and the FRC. While the Committee is correct that the banks themselves and their regulators are best placed to ensure effective risk management, the assistance that auditors can provide is being explored as part of our work on Audit of banks: lessons from the crisis referenced above.

37. The FSA's piecemeal approach to garnering auditor knowledge about individual banks indicates to us a wasted opportunity to improve the effectiveness of bank supervision. In future, the FSA should make far more use of audit knowledge, on a confidential basis. We are grateful for the response by the ICAEW in bringing together audit firms and drawing up some suggestions to strengthen links between the FSA and auditors. We recommend that the FSA should respond to each of the five suggestions made by the ICAEW.

This area forms an important part of our consultation on the Audit of banks: lessons from the crisis referenced above. We will report in detail to the Committee in April.

38. We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.

It is clear that non-audit service provision remains a source of concern to the Committee. Responses to the recent Auditing Practices Board consultation in this area suggest that, while there remain some perception issues around non-audit services, neither companies nor the majority of investors believe that such services adversely affect audit quality. What is also clear is that auditors, corporates and regulators need to do more to explain the current regime to investors and other stakeholders. Recent work in this area published by ICAS makes an important contribution in this regard. A great deal has been achieved since the collapse of Enron and the banking crisis has been the first major test of the ethical standards on auditor independence that were put in place at that time. The evidence we have seen to date indicates that this new regime—which defines threats and related safeguards, appropriate prohibitions and audit committee review—is working. In our view enhanced disclosure of audit committee process and the reasons for auditors performing non-audit services, not prohibition, is what is needed and we look forward to working with regulators and standard setters to make this happen.

39. The Financial Reporting Council should build on steps it has already taken to ensure that users of accounts are sufficiently well informed about going concern considerations that the issuance of modified audit opinions does not result in undue panic. With a view to the longer term, we believe there is a case for the FRC to consider the introduction of a graduated ladder of concern, along the lines suggested by Professor Power. We would welcome a system whereby the auditor could transparently express an opinion on a bank's future, without triggering emergency action by the FSA.

The regime that has been established in this area by the FRC in response to the credit crunch now deals effectively with this issue and provides for the graduated ladder of concern recommended by Professor Power. The real risk over the last 24 months was that investors would take fright at the increased occurrence of modified audit reports. The proactive steps the profession took during this period to explain what these modifications meant in practice helped prevent a wider systemic problem arising. The issue has not gone away. Research undertaken by Deloitte states that the level of audit reports modified for going concern issues for listed corporates rose to 8% during the recession demonstrating that UK preparers and auditors have been taking a robust stance on going concern. Wider awareness of the issues however, has helped maintain economic confidence.

40. We believe that the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way. At the moment, financial reports can be used for finding specific bits of information, so are useful for reference, but they do not tell the reader much of a story. We would like them to read less like dictionaries and more like histories. A useful approach would be to insist on all listed firms setting out their business model in a short business review, in clear jargon-free English, to detail how the firm has made (or lost) its money and what the main future risks are judged to be.

As the Committee rightly identifies, one of the key lessons from the economic crisis is that financial reports need to provide a stronger more useful narrative. On 5 March the FRC finished consulting on a revised UK corporate governance code. The draft proposals include a requirement that listed companies explain their business model and overall financial strategy in clear and concise terms that provide such a narrative. Once the outputs from this consultation have been incorporated into the Listing Rules the challenge for the profession will be to ensure that the resulting reports avoid anodyne boiler plating in favour of something that meets the aspirations of the Committee. We are aware that BIS is also looking at improvements to narrative reporting.

41. Fair value accounting has led to banks publishing some very dispiriting financial results, but this is because the news itself has been bad, not the way in which it has been presented. The uncomfortable truth for banks is that market participants had over-inflated asset prices which have subsequently corrected dramatically. Fair value accounting has actually exposed this correction, and done so more quickly than an alternative method would have done. Important features of accounting frameworks are that they encourage transparency and consistency across firms and asset classes. But it is a bridge too far to expect them to also lead to intelligent decision-making. We do not consider fair value accounting to be a suitable scapegoat for the hubris, poor risk controls and bad decisions of the banking sector.

Over the course of the past 18 months the ICAEW has been a consistent and vocal advocate of the issues identified by the Committee. We will continue to make the case.

42. We consider that fair value accounting has featured an element of pro-cyclicality through its inter-linkage with the Basel capital requirements. This is not a fault of the accounting standards, but rather a result of published accounts being used too crudely in the calculation of regulatory capital requirements. The primary audience of accounts are the shareholders, who have a desire to see the true worth of their firm. The FSA, as the banks' supervisor, is a secondary user of the accounts, and has a legitimate interest in ensuring that firms are run prudently. This is not the same objective as that of the shareholder, so the regulator need not rely, and certainly should not rely exclusively, on the published accounts in calculating capital requirements. We will consider ways in which the FSA might introduce such an element of prudence in the capital regime in our forthcoming report on public regulation.

Accounting standard setters need to better understand what prudential regulators are trying to achieve. Prudential regulators need to better understand how accounting standard setters are striving to meet the needs of investors. We note that the dialogue between the International Accounting Standards Board (IASB) and the regulatory community has improved over recent months and it was evident from a speech that the Chairman of the FSA delivered at ICAEW in January 2010 that the IASB is listening more carefully to its wider stakeholders. ICAEW will be considering how separate, tailored financial reports can meet the needs of users other than investors including regulators.

43. The existence of the European Commission's carve-out power seriously undermines the ability of the International Accounting Standards Board to project itself as a truly global setter of accounting standards, and indeed threatens the integrity of published accounts. Both are profoundly regrettable. Any threatened carve-out effectively presents the IASB with an invidious choice between losing the IASB's coverage of the European Union on the one hand, or acceding to the Commission's demands at the expense of a loss of credibility in other nations on the other. We are concerned that the IASB has already become tarnished by the accusation that it gave in too easily to the Commission's demands over fair value accounting, and by its suspension of its usual consultation process. We recommend that the Treasury consider the impact of the Commission's carve-out power on the prospects for the IASB's reputation and continuing work in establishing a global set of accounting standards.

If we are to avoid the possibility of a European carve-out being exercised it is essential that the IASB engage effectively with EU stakeholders particularly during the current period of political transition in Brussels. On 14 January 2010 ICAEW wrote a detailed letter to the Committee on the progress that has been made in this area since the beginning of 2009.

APPENDIX 2

INSOLVENCY-RELATED ISSUES

Insolvency has risen up the political agenda in recent months with the fallout from the economic crisis. There has also been understandable concern over the issue of pre-packs. We believe that the current regulatory regime for insolvency practitioners is broadly fit for purpose but that this sector needs to be more transparent about the ways in which it is held to account. The following explanation is intended to meet Committee concerns in this area.

Advising a Company in Financial Difficulty

In circumstances where a company is no longer able to pay its debts, the directors of that company are required to consider the interests of creditors over shareholders. In these circumstances, the directors should seek professional advice from a specialised Insolvency Practitioner (IP). Where this may result in insolvency proceedings, ICAEW, in conjunction with other insolvency regulators, has produced the Ethical Code for Insolvency Practitioners[5] (The Code) based on the Code of Ethics for Professional Accountants produced by the International Ethics Standards Board for Accountants (IESBA). This requires IPs to undertake ethical checks and impose safeguards in relation to any potential conflicts that could arise from advising the company concerned.

[5] Available from www.icaew.com/insolvency

Conflicts of Interest

The Ethical Code became effective from 1 January 2009, and applies to all IPs irrespective of their authorising body. The Code sets out five fundamental principles—integrity, objectivity, professional competence and due care, confidentiality and professional behaviour—with which the IP must always comply, and requires IPs to consider whether actions or relationships might constitute threats to those principles and, where these threats are significant, requires safeguards to be implemented.

When considering potential conflicts of interest, the most relevant principle in the Code is objectivity: "*An Insolvency Practitioner should not allow bias, conflict of interest or undue influence of others to override professional or business judgements*."

The Code includes examples of specific situations, for example, a practitioner should not accept an insolvency appointment where he or his firm have carried out audit-related work for the company within the previous three years. Where audit-related work has been carried out more than three years previously, a threat to compliance with the fundamental principles may still arise, but it is for the practitioner to consider whether such a threat can be eliminated or reduced to an acceptable level.

It is important to note that the Code applies to all professional work relating to an insolvency appointment and to any work that may lead to such an appointment.

Sanctions

Failures to comply with the Code, as well as breaches of any other legislative or regulatory requirements, can result in fines and restrictions on the appointments that can be taken. Where appropriate, the IP's licence can also be withdrawn. Ultimately, the IP can be referred to the disciplinary board of a Recognised Professional Body and their membership can be removed. Such breaches and failures can be identified either through the authorising bodies' monitoring visits to the IPs that they regulate, or as a result of a complaint made to the authorising body.

Administration

The administration procedure was brought in to promote company rescue and, where it is considered the best way to serve the creditors, it will be recommended by IPs or other professional advisers. The purpose of administration[6] is to rescue the company as a going concern or to achieve better results for the creditors as a whole than would be likely if the company were wound up without administration. The proposed administrator may be selected by the directors but secured creditors must consent to the appointment. Mechanisms are also available for creditors to challenge the appointment. However, in many cases, creditors accept the IP put forward by the directors if the IP has been advising the company, as it helps the administration and is more cost-effective if the administrator has a knowledge and understanding of the business.

Pre-packaged Administrations

The interests of creditors are often best served where the business is sold as a going concern. In many instances, the adverse publicity associated with entering into administration will harm the goodwill of the business to such an extent that it precludes sale as going concern, and so the practice of "pre-pack" has developed. Pre-packs are not a new phenomenon and are not exclusive to administration. The Insolvency Service[7] has stated that it considers that pre-packs are a valuable tool for insolvency practitioners, and that a pre-pack can be the best way for an administrator to proceed.

It is in the nature of a pre-packaged sale in an administration that unsecured creditors are not given the opportunity to consider the sale of the business or assets before it takes place. It is important, therefore, that they are provided with a detailed explanation and justification of why a pre-packaged sale was undertaken, so that they can be satisfied that the administrator has acted with due regard for their interests.

To respond to this need, the authorising bodies issued Statement of Insolvency Practice 16—pre packaged sales in administrations[8] (SIP 16) in January 2009. The primary purpose of SIP 16 is to ensure that creditors are provided with the detailed and comprehensive explanation and justification of why a pre-packaged sale was undertaken. The SIP also requires practitioners to make clear disclosure about the nature and extent of their role and their relationship with the directors in the pre-appointment period.

The then Business and Enterprise Committee, in its April 2009 report on The Insolvency Service, stated that prompt, robust and effective action is needed to ensure that pre-pack administrations are transparent and free from abuse. The Committee subsequently welcomed the introduction of SIP 16 and The Insolvency Service's commitment to monitor its implementation.

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[6] Insolvency Act 1896, Schedule B1.
[7] Report on the first six months operation of SIP 16 http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/policychange/sip16-final.pdf
[8] Available from www.icaew.com/insolvency

R3, which represents IPs, conducted a survey in April 2009,[9] which indicated that the top four reasons for undertaking a pre-pack were:

— the sale needed to be fast;

— it was the best chance of saving the jobs of the workforce;

— it was the only alternative to liquidation; and

— the pre-pack would achieve a better return to creditors.

In 89 pre-pack case studies identified in the report, 5,478 jobs were at risk, but the pre-pack meant that 4,846 jobs (88%) were saved. It is also worth noting that pre-packs do not necessarily mean that the previous owner remains in charge—the survey responses noted that the business owner remained in charge in 59% of cases.

It is now a little over a year since SIP 16, came into force. Given that pre-packs remain high profile and elicit strong views both within and outside the insolvency profession, the authorising bodies will shortly be reviewing SIP16 to see whether it is achieving its purpose, and such review will seek the views of creditor groups and others affected by the insolvency process.

While pre-packs have attracted much media attention, it is important to remember that they represent a relatively low proportion of corporate insolvencies. In 2009, administrations represented only 16% of all corporate failures, of which the Insolvency Service estimated that around 25% were pre-packs. This means that only around 4% of all corporate failures in 2009 resulted in pre-packaged administrations.

Administration Fees

The complexity, size and risk of an administration are reflected in the fees charged by IPs. In most insolvency proceedings, the creditors collectively determine the bases of the IP's remuneration. Also, new insolvency rules[10] will come into effect from April 2010, which aim to make it easier for creditors to challenge IP fees that they think are excessive. The OFT launched a market study into corporate insolvency on 12 November 2009, which is also examining IP fees.

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[9] Available from www.bpf.org.uk/pdf/21405/R3 pre-pack survey May 2009.pdf

[10] New Insolvency Rules and revised SIP 9 Remuneration of insolvency office holders will be introduced in April 2010.

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