Auditors: Market concentration and their role

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CONTENTS

Abstract  5
Chapter 1: Introduction  1  7
Chapter 2: Concentration in the audit market  11  9
  How the Big Four evolved  12  9
  The large-firm audit market in the United Kingdom  14  9
  Why did the Big Four become so dominant?  16  10
  Does market concentration limit competition and choice?  19  11
  What if Big Four became Big Three?  22  12
Chapter 3: Changes to the Legislative/Regulatory Framework  28  13
  Governing Audit  28  13
  What has been done to increase competition?  28  13
  Possible measures  36  14
  Should audit remain mandatory?  71  22
  Should auditors give broader assurance?  76  23
  Should auditors do less non-audit work and internal audit?  80  24
  Big Four to Big Three?  88  26
  Referral to the Office of Fair Trading  93  27
Chapter 4: The Legal/Regulatory Framework  99  29
  Current regulatory structure  99  29
  Changes to the regulatory structure  106  30
Chapter 5: The Impact of International Financial Reporting Standards (IFRS)  111  32
  Background  111  32
  IFRS and banks  114  32
Chapter 6: Bank audits and the financial crisis  134  38
  General  134  38
  Dialogue between bank auditors and supervisors  156  44
Chapter 7: Conclusions and Recommendations  168  47
Appendix 1: Economic Affairs Committee  52
Appendix 2: List of Witnesses  54
Appendix 3: List of measures raised in evidence to improve choice, competition and quality in the audit market  61
Appendix 4: Letter from Mr Andrew Bailey, Executive Director and Chief Cashier, Banking Services, Bank of England  66
Appendix 5: Supplementary memorandum by the Office of Fair Trading  68
Appendix 6: Letter from The Rt Hon Lord Tebbit CH  70
Appendix 7: Letter from The Lord Flight  71

References in footnotes to the Report are as follows:
Q refers to a question in oral evidence;
ADT 1 refers to written evidence as listed in Appendix 2
ABSTRACT

The Economic Affairs Committee’s inquiry into Auditors: market concentration and their role aimed to look into two main issues:

- the dominance of the Big Four and its effects on competition and choice; and
- whether traditional, statutory audit still meets today’s needs.

As the inquiry unfolded, the Committee also focussed on two other important issues:

- the effect on audit of the adoption of International Financial Reporting Standards (IFRS); and
- how banks were audited before and during the financial crisis and what changes there should be, including in auditors’ relationships with financial regulators.

This report addresses all of these issues.

Identification of the shortcomings of the large-firm audit market is easy enough. It is clearly an oligopoly with all the attendant concerns about competition, choice, quality and conflict of interest. It gave no warning of the banking crisis. The narrowness of the assurance it offers is much criticised. Its regulatory structure, in the UK and internationally, is complex and unclear.

Yet investors, regulators and commentators regard rigorous and reliable external audit as an essential underpinning of business and the capital markets which finance it, in Britain and elsewhere. The assurance offered by audit is especially needed in the case of banks, with their attendant risks and where loss of confidence can imperil the financial system. The importance of audit is recognised by the legal requirement that medium and large-company financial statements should be audited and by the size and prosperity of the audit business, which is dominated in Britain and globally by the Big Four: Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers.

The Big Four’s domination of the large firm audit market in the UK is almost complete: in 2010 they audited 99 of the FTSE 100 largest listed companies, which change auditors every 48 years on average. In bank audit in the UK there is only a Big Three, since Ernst & Young are not active. This report highlights the risk that one of the Big Four might leave the audit market, leading to an even greater and wholly unacceptable degree of concentration unless preventive action were taken.

The Committee’s concerns about the Big Four’s oligopoly of large firm audit were intensified by their failure to give warning of trouble in the run-up to the financial crash. Clearly bank auditors cannot express concerns openly about banks’ finances without undermining confidence and risking a run. But the Committee was highly critical of the fact that, as our evidence revealed, confidential dialogue between auditors and bank regulators had fallen away before the financial crisis so that there was no pooling of information or concerns which might have given warning
or allowed some action to mitigate the worst effects. This failure to maintain
dialogue seems to the Committee a dereliction of duty.

The Committee also heard evidence that audit standards had been lowered by the
adoption of International Financial Reporting Standards (IFRS). These became
mandatory for EU listed companies in 2005 and are intended to pave the way
towards common accounting standards around the world including the US. The
Committee heard that IFRS were more rules-based than previous national
standards and leave less scope for the auditor to exercise prudent judgment and as
necessary to override a box-ticking approach in order to reach a true and fair view
of a given financial statement.

The Committee considers that good audit is essential to business and finance. It
welcomes the Financial Reporting Council (FRC)’s efforts to improve competition
and choice in the audit market and to streamline the regulatory framework but
shares the FRC’s view that they have not led to any great improvement. The
Committee recommends several measures which should be of benefit in reducing
the dominance of the Big Four but concludes that these in themselves are unlikely
to be enough.

The Committee makes three main recommendations:

- first, a detailed investigation of the large-firm audit market by the Office of Fair
  Trading, with a view to an inquiry by the Competition Commission so that all
  the interrelated issues surrounding concentration, competition and choice can
  be thoroughly examined in depth and in the round. The Committee recognises
  that the global reach of the Big Four and of their clients goes beyond the scope
  of a national competition authority. But when London is both the incubator of
  at least some of the Big Four and one of the world’s leading financial centres, it
  seems right for the UK to take a lead;
- second, that prudence should be reasserted as the guiding principle of audit;
- third, the new framework of banking supervision should provide for bank audit
to contribute more to the transparency and stability of the financial system, in
  particular through two-way dialogue between auditors and supervisors about
  the financial health of banks.
Auditors: Market concentration and their role

CHAPTER 1: INTRODUCTION

1. In 1849 a Select Committee of the House of Lords inquired into *Audit of Railway Companies*. Its report is credited with helping establish the audit profession; certainly by 1872 the Great Western Railway had an external auditor (Mr Deloitte) and an audit committee.¹

2. Much has changed since then. Audit is long established as essential to the working of publicly-listed companies. Today’s investors confirm that it still provides indispensable assurance: “Audit and accountancy are absolutely fundamental to the integrity of our capital markets and the good governance of our companies.”²

3. Medium and large companies and banks are obliged by law to have their annual financial statements audited by qualified auditors. Financial statements are drawn up by companies' managements and directors. They are a snapshot of a company’s position at a given moment and of the results of operations over the past period. The auditor’s report and opinion are published with the financial statement and provide reasonable assurance that the company’s financial statements are true and fair and free from material misstatements.

4. Audits are usually carried out by accountancy firms. There are many in the United Kingdom and elsewhere. But large company audit is mostly in the hands of the “Big Four” international networks: Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers. Their dominance of the market raises concerns about competition and choice in the provision of a service their clients have no choice but to buy. Since most of the Big Four began here, and London is a leading financial centre, it is right for a British parliamentary Select Committee to look into these concerns, although measures proposed to address them need to take account of the global nature of the audit market.

5. Since statutory audit is concerned mainly with companies’ financial statements for the past period, it is largely backward-looking, though it includes a view that the company remains a going concern. This limitation is not always understood. Auditors’ endorsements of financial statements are

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¹ The Minute (quoted in Tricker, R I, (1978): *The Independent Director—The Role of the Audit Committee*, [Tolley], p56) read: *Report of the Audit Committee*

‘The auditors and Mr Deloitte attended the Committee and explained the various matters connected with the Finances and other departments of the railway, which explanations were highly satisfactory.’

‘The Committee consider the Auditors have performed their arduous duties with great care and intelligence and therefore confidently recommend that they be continued in office.

Benjamin Lancaster
Chairman
Paddington Station
22nd February, 1872’

² Q 404 (Mr David Pitt-Watson, Hermes Investments).
sometimes taken as forecasts of good financial health. Misunderstandings on these lines help form an “expectations gap”. Critics who do understand its role also question whether statutory audit meets all today’s needs and advocate more emphasis on the going concern statement, the forward-looking element in an audit report. We have heard other suggestions for widening its scope, usually at some cost.

6. Audit is shaped by the accounting standards underlying companies’ financial statements. In recent years, United Kingdom Generally Accepted Accounting Principles (UK GAAP) are being replaced by International Financial Reporting Standards (IFRS), which it is intended will be adopted globally and help encourage international trade and investment. But critics say IFRS is lowering the quality of audit by reducing scope for the exercise by auditors of prudence, scepticism and judgment in favour of a rules-based, box-ticking approach. They also question the ability of regulators to maintain standards.

7. Concerns about market concentration and about the scope, relevance, quality and regulation of traditional audit were exacerbated by the financial crisis of 2007–09 when bank audits were seen to fail to give warning of imminent collapse, and seem simply to have monitored compliance with the law rather than prudence. There is a striking contrast between the generally-recognised high quality of the Big Four’s audit work and their failure to spot systemic risk in banks. Questions have arisen in particular about communication between the auditors and regulators of banks.

8. All these concerns would become much more acute if for any reason the Big Four were reduced to a Big Three. As things stand, only three of the Big Four audit large banks in the UK; withdrawal from the audit market of one of the Big Four could in the worst case reduce the number of bank auditors to two.

9. In this report we examine and make recommendations on these complex and sometimes intractable issues, recognising that they are also being looked at by other bodies, national and international.

10. We are grateful to all our witnesses for their written and oral evidence to the inquiry.
CHAPTER 2: CONCENTRATION IN THE AUDIT MARKET

11. Concern about concentration of large-firm audit in the hands of the Big Four, and the impact on competition, choice, price and quality was our main motive in launching this inquiry.

How the Big Four evolved

12. It took about 150 years from the beginnings of modern audit in Britain around 1850 to the emergence of the Big Four. Some of the founders’ names, such as Deloitte, Price, Touche, Peat and Cooper, are still familiar. In the late nineteenth and early twentieth century, firms also grew in the United States and Europe. By the mid-twentieth century, there were large international groupings such as Deloitte, Haskins & Sells (UK/US, 1957), KMG (Netherlands/US/Germany, 1979) or Coopers & Lybrand (UK/US, 1957). But with many practitioners of various sizes and nationalities, including the international networks of the then Big Eight, the audit market still offered choice.

13. The pace of concentration quickened in the 1980s and 1990s. The first mega-merger was between KMG and Peat Marwick (1987). In 1989, Deloitte, Haskins & Sells and Touche Ross came together. The same year, Ernst & Whinney joined with Arthur Young. In 1998, Price Waterhouse and Coopers & Lybrand combined. Not all these mergers were tidy, since the international networks are federations of national partners, some of whom went their own ways, but the entities they led to—KPMG, Deloitte, Ernst & Young and PwC—together with Arthur Andersen became the Big Five which dominated the world market in large firm audit. The collapse of Arthur Andersen in 2002 after the Enron scandal, and the absorption of its audit business by the others, meant that the Big Five became the Big Four. Consolidation was not impeded by regulatory intervention.

The large-firm audit market in the United Kingdom

14. In 2010 the Big Four audited 99 of the FTSE 100 leading firms and around 240 of the next-biggest FTSE 250. They also had about 80% of the FTSE small capitalisation firm audits. In some important market segments the degree of concentration is even greater: for example, only three of the Big Four audit banks in the UK. The Big Four are all the stronger because the next tier of accounting/audit firms are so much smaller: the audit revenues of even the smallest of the Big Four are nearly three times those of the largest second-tier firm.

15. The audit of large firms, in the UK and internationally, is dominated by an oligopoly with all the dangers that go with that. The oligopoly’s power is underpinned by the fact that large firms are legally obliged to have their financial statements audited.

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3 ADT 24 (FRC).
4 FRC Professional Oversight Board, Key Facts & Trends in the accountancy profession, June 2010.
Why did the Big Four become so dominant?

16. Witnesses put forward various reasons for the high degree of concentration in the audit market: Professor Michael Power, London School of Economics, said: “There is an element of concentration which may have to do with natural forces of economies of scale.” Mr John Connolly, Senior Partner and Chief Executive, Deloitte, said: “The degree of concentration in the audit market has arisen as a direct result of market forces and, in particular, the demand from investors for audit quality as well as appropriate capability to undertake complex audits across the world.” Mr Philip Collins, Chairman of the Office of Fair Trading (OFT), acknowledging that the OFT had not held a detailed inquiry into the audit profession, said: “It is a market in which we have a keen interest but it is not a market in which we felt it appropriate, in the last seven or eight years, to conduct a detailed review because other things had been happening.”

17. We also heard that a Big Four firm was seen as the safe choice by audit clients. Professor Power said: “I think audit committees go by franchise value alone and do not analyse audit teams.” Mr Timothy Bush, Investment Management Association nominated representative on the Urgent Issues Task Force of the Accounting Standards Board, said “there is a regulatory sense that big is best” and Dr Gunnar Niels of Oxera spoke of “the reputational advantages of having a Big Four as your auditor”. Mr Jonathan Hayward, Director of Corporate Governance consultants Independent Audit, said: “No audit committee chairman of a FTSE property company … is particularly interested in changing to a medium-sized audit firm because there is lots of downside and no upside … in doing that.” In some cases reputational considerations have hardened into restrictive covenants or, as Ms Helen Brand, Chief Executive of the Association of Chartered Certified Accountants (ACCA) said: “Banks or organisations themselves are stipulating upfront that they will only employ a Big Four firm.”

18. A self-reinforcing cycle has helped to consolidate the dominance of the Big Four. Factors include:

   i. the internationalisation of business;
   ii. the scale of investment and capital required in an audit firm;
   iii. economies of scale in audit;
   iv. a semi-captive market;
   v. non-interventionist competition authorities;
   vi. the perception that big is best;
   vii. the reputational assurance of using Big Four auditors; and
   viii. the fall of Arthur Anderson.

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5 Q 6.
6 Q 235.
7 Q 174.
8 Q 8.
9 Q 84.
10 Q 80.
Does market concentration limit competition and choice?

19. We heard conflicting views about the effects of the Big Four’s domination of the market. Their own representatives argued that it was nevertheless competitive. Mr Ian Powell, Chairman and Senior Partner, PwC, said that the large firm audit market was “fiercely competitive” and that each tender was “ferociously fought” and that competition had affected prices.11 Mr John Griffith-Jones, Chairman, KPMG, acknowledging that FTSE 100 companies very rarely switched auditors, argued that continuity and a fresh approach could be achieved by the same audit firm through frequent rotation of audit staff when new audit teams could still draw on the firm’s corporate knowledge of the client.12 Mr Ashley Almanza, Chairman of The Hundred Group (of Finance Directors of FTSE 100 companies), and Chief Financial Officer of BG Group, said: “We’re content in general terms with the service provided and the competition that we observe in the market today.”13 He added: “Audit firms know that we have a choice and that very often is all you need to keep their pricing and the quality of their service honest.”14

20. Other witnesses thought the large firm audit market was not truly competitive and emphasised that tendering was rare: Mazars recalled research by Oxera published in 2006 by the FRC which indicated that “a FTSE 100 auditor can expect to remain in place, on average, for a period of 48 years”.15 Professor Vivien Beattie of the University of Glasgow said: “Concentration is sometimes even higher at sector level ... sometimes in some sectors one of the Big Four has more than 50% of the market.”16 Mr Collins said: “We think that the market, as currently structured, may not operate in a way that works well for users”.17 Baroness Hogg, Chairman of the Financial Reporting Council (FRC) said that, despite the efforts of its Market Participants’ Group “to explore ways of getting the market to work better ... concentration is as great as ever ... the time has come to consider more radical measures ... we would now urge consideration of further actions at national and G20 level.”18

21. Some institutional investors believe the market is not competitive. Mr Paul Lee, Director of Hermes Equity Ownership Services, said: “The major concern is the lack of competition”. Mr Guy Jubb, Head of Corporate Governance at Standard Life Investments, said: “It is not so much the competition issue but it is the lack of choice that is the area of particular concern ... we are no longer comfortable with relying on market forces to create the resolution ... there has to be some regulatory or governmental intervention.”19

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11 Q 242.
12 Q 244.
13 Q 292.
14 Q 305.
15 ADT 21.
16 Q 6.
17 Q 170.
18 Q 170.
19 Q 407.
What if Big Four became Big Three?

22. The market for large-firm audit could become even more concentrated if for any reason one of the Big Four withdrew. The demise of Arthur Andersen shows it could happen suddenly and unexpectedly. Legal liability is one area of risk: in the view of Professor Stella Fearnley, of the University of Bournemouth, “the risk obviously is a litigation risk.” Professor Power said: “I don’t think we can rule out dramatic loss of franchise value, shock events.”

23. Even witnesses comfortable with the present state of the market saw the prospect of a move from Big Four to Big Three as a step too far. Mr Almanza said: “Big Four to Three firms I think would be regarded by most large companies in the UK, certainly by our company, as an unwelcome change.” The Association of British Insurers (ABI) also suggested that the remaining Big Four might not in any event have the “necessary ... firepower to absorb a failed Big Four firm”.

24. The Big Four themselves oppose any further concentration. Mr Connolly said: “I would be uneasy about it going down to three.” Mr Griffith-Jones said: “We need a regulator to prevent it getting any more concentrated than it is at the moment.” Lord Myners thought that concentration might already have gone too far and that in the end, if other approaches did not work, “there should be some action to ‘trust bust’” because “everybody believes that it will be good to have more choice but nobody seems to be willing to be the first mover.”

25. The FRC is clear that a Big Three would not be acceptable. It emphasises “the need for a clear statement that the Government/competition authorities would break up a Big Three.

26. Most witnesses believe that the dominance of the Big Four limits competition and choice in the audit market. Ethically, audit firms are unable to accept work which would place them in conflict with other work for the same or other clients. This is a special problem in the UK banking sector, where only three of the Big Four are active. Banks’ choice of auditor is sometimes limited by the need to avoid using a firm engaged by another bank.

27. All witnesses fear the real possibility that one of the Big Four might withdraw leaving a Big Three (or even a Big Two, in the bank audit market). We agree. Loss of one of the Big Four would restrict competition and choice to an unacceptable extent. This is one reason for our recommendation of an Office of Fair Trading (OFT) investigation into the audit market.

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20 Q 5.  
21 Q 5.  
22 Q 292.  
23 ADT 42.  
24 Q 238.  
25 Q 236.  
26 Q 486.  
27 ADT 27.
CHAPTER 3: CHANGES TO THE LEGISLATIVE/REGULATORY FRAMEWORK GOVERNING AUDIT

What has been done to increase competition?

28. The dearth of competition in auditing is vividly illustrated by how rarely blue chip companies change auditors. A FTSE 100 auditor remains in place for about 48 years on average; for the FTSE 250 the average is 36 years. Nearly all these companies have Big Four auditors. For example, Barclays has used PwC or its predecessors since 1896, and since 1978 as sole auditor. These figures do not sit well with the view of the Big Four (paragraph 19 above) that the large firm audit market is highly competitive.

29. The Financial Reporting Council (FRC) created the Market Participants’ Group which issued 15 recommendations in 2007 aimed at reducing risk and bolstering competition in auditing. Amongst these were recommendations that audit committees explain their choice of auditor; that shareholders take a greater interest in audit selection; and that the FRC promote understanding of audit quality. It was hoped greater transparency and shareholder engagement would lead to more choice in the audit market.

30. The majority of these recommendations have been implemented but they lack teeth. Many recommendations are only guidance, which companies can all too easily ignore. For example, more than half of listed companies surveyed by the FRC ignored guidance that audit committees should provide information on frequency of audit tenders and on tenure of incumbent auditor. Even amongst those that sought to comply, the information was of little use in many cases. The FRC reported that “many ... failed to state exactly how long the relationship had lasted”, only saying the auditor had been in place “for many years” or “a number of years.”

31. Hence, as outlined in Chapter 2, the Big Four are as dominant as ever. Grant Thornton characterised the measures as “soft touch initiatives [that] have demonstrably not worked.” Even the FRC confessed to their “minimal impact on market concentration.”

32. The Institute of Chartered Accountants in England and Wales attempted to defend the measures, suggesting that more time was needed for some recommendations to take effect. But this was a minority view. Many witnesses argued that more action is needed to reduce market concentration. Mr Guy Jubb, Head of Corporate Governance at Standard Life Investments, said: “We are no longer comfortable with relying on market forces to create the resolution to this. We do believe that there has to be some regulatory or governmental intervention.” Baker Tilly argued: “It was commercially-led

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28 ADT 21 (Mazars).
29 Email from Barclays’ public affairs department, 11 March 2011.
32 ADT 20.
33 ADT 24.
34 ADT 6.
35 Q 407.
market mergers that caused the contraction and it will take positive discrimination in favour of potential competitors to now change it.”

Baroness Hogg, Chairman of the FRC, said: “The time has come to consider more radical measures”.

33. **Attempts to introduce greater competition into the audit market have so far failed.** Market concentration is as great as ever. The last set of recommendations from the Financial Reporting Council’s Market Participants Group in 2007 lacked teeth. It has had no effect in lessening the dominance of the Big Four.

34. Mr Edward Davey MP, Minister for Employment Relations, Consumer and Postal Affairs, at the Department for Business, Innovation and Skills, said of reducing market concentration: “There are some approaches that are quite regulatory, but we are not attracted to a very heavy-handed approach.” He “would put a lot more emphasis” on less heavy-handed measures to do with “transparency and disclosure” in areas such as how a company chooses an auditor and how long a firm has had an existing auditor.

35. **Measures envisaged by Mr Edward Davey MP, Minister at the Department for Business, Innovation and Skills, focus on transparency and disclosure.** These echo the approach of the FRC Market Participants Group—an approach that has palpably failed. We were disappointed that the Minister is not more ambitious. We would expect exactly the same result for the measures he advocated to our Committee as the FRC’s measures have had. It may be sensible to introduce these measures on their own merits. But they do not add up to a policy of creating greater competition and choice, of altering the current oligopolistic situation, or of addressing the risks of the Big Four coming down to a Big Three.

### Possible measures

36. We received many proposals for reducing market concentration. Witnesses’ more radical proposals included limiting the market share of the Big Four as measured by the number of appointments held over a five year period. A few witnesses said the authorities should consider breaking up the Big Four. The FRC said the Government and competition authorities should make clear that in the event of one of the Big Four collapsing, the Big Three would be broken up. Others suggested less radical measures such as joint audits and mandatory tendering of audit contracts to give non-Big Four firms more opportunities to compete. All proposals made to us are listed in Appendix 3. The main ones are discussed below:

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36 ADT 53.
37 Q 170.
38 Q 504.
39 ADT 20 (Grant Thornton), ADT 41 (Lord Sharman).
40 ADT 64 (Prof Kevin McMeeking), Q 111 (Dr Gunnar Niels).
41 ADT 27.
Joint audits

37. Joint audits—where two auditors sign off accounts—are required in France and, proponents argue, would give a foothold to non-Big Four auditors amongst large clients, if the requirement were specified appropriately.42

38. Mr David Herbinet, Partner at Mazars which has a strong presence in France, said joint audits could make changing auditors easier by offering some continuity: “What you can do with a joint audit is stagger the appointments whereby you can change one of the two without putting the whole audit at risk.”43 Joint audits were well suited to banks because of their systemic risks, complexity and “the inherent subjectivity in their financial statements.”44

39. But joint audits had plenty of critics. Mr Simon Michaels, Managing Partner at BDO, feared his firm would be “seen as being appointed as the poor relation of the Big Four to make up the numbers.”45 Professor Stella Fearnley, of the University of Bournemouth, added that a joint auditor could be another Big Four firm, so that market concentration would not be reduced.46 Mr Charles Tilley, Chief Executive of the Chartered Institute of Management Accountants (CIMA), warned joint audits created the “risk of things falling through the cracks ... it can become a bureaucratic nightmare”. Mr Iain McLaren, Senior Vice-President of the Institute of Chartered Accountants in Scotland (ICAS), and Mr Russell McBurnie, Finance Director of RSM Tenon, expressed similar views.47 Some French companies had told the FRC that joint audits were a “nightmare”, according to its Chief Executive, Mr Stephen Haddrill, because “auditors spend all their time passing the buck”. Other French companies said auditors worked well together with benefits from two sets of eyes. Mr Haddrill said: “The evidence we’ve seen in the UK has been that it’s been relatively inefficient in terms of the way the audit is conducted.”48

40. One suggested way to enhance competition would be to introduce mandatory joint audit where each audit firm signs off the audit report and opinion. The Committee is not convinced that this would deliver better accounts. It would certainly add bureaucracy and cost. It has only been applied in very few countries where the results do not amount to a resounding recommendation in their favour. But if it were promoted in the UK as a means to reduce market concentration, it should be on the basis that at least one joint auditor was a non-Big Four firm.

Regular mandatory tendering of audit contracts

41. As noted at paragraph 28, companies rarely change auditors. Many witnesses proposed mandatory tendering to give non-Big Four firms the opportunity to

42 ADT 21(Mazars).
43 Q 131.
44 ADT 21 (Mazars).
45 Q 134.
46 Q 20.
47 Q 77, Q 136.
48 Q 231.
compete, though some would exclude banks because of the specialist expertise required.

42. Other witnesses doubted that mandatory tendering, or the more radical suggestion of mandatory rotation after a fixed period, would work. Clients could simply switch Big Four auditors, with no effect on market concentration. Some expressed concerns that changes of auditors not only increased costs but reduced quality in the early years of a new audit. Mr Jonathan Hayward, director of corporate governance consultants Independent Audit, cited a study of the mandatory rotation regime in Italy which “concluded that the risks of audit failure in the early years, after a change, were greater than the risks of audit failure in the later years”.

43. Mr Paul Lee, Director of Hermes Equity Ownership Services, took the opposite view, arguing that audit quality improved as the new auditor put in more work. The Office of Fair Trading (OFT) thought that any negative fallout from changing auditors could be lessened by outgoing auditors providing incoming auditors with information in a standard format.

44. The very long tenure of auditors at large companies is evidence of the lack of competition and choice in the market for the provision of audit services. A regular tender, with a non Big Four auditor invited to participate, should promote greater competition to the benefit of both cost and quality. We recommend that FTSE 350 companies carry out a mandatory tender of their audit contract every 5 years. The Audit Committee should be required to include detailed reasons for their choice of auditors in their report to shareholders.

**Investor involvement in appointment of auditors**

45. Shareholders mostly approve the board’s recommendation on the appointment of auditors at annual general meetings with little or no discussion. Lord Myners said this was because investor apathy was endemic: “The average institutional investor has about as much interest in the companies in which it has invested its client’s funds, as somebody buying a betting ticket on a 2.30 horse at Plumpton. Passionately interested in what happens for the next three minutes, but not much interested in what happens to the horse thereafter.”

46. But a relatively small number of institutional investors play an active role in the companies where they hold shares. Mr Iain Richards, Head of Governance at Aviva Investors, defended his institution’s record. They did “vote against a notable number of [auditor] appointments”. But he added: “The difficulty is not enough of us do ... I think companies know that we are in such a small minority that they shrug their shoulders.” Lack of

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49 ADT 62 (Kingston Smith), ADT 26 (Office of Fair Trading), ADT 1 (Professor Beattie et al), Q 418 (Mr Paul Lee).
50 ADT 62 (Kingston Smith).
51 Q 418 (Mr Iain Richards), Q 420 (Mr Robert Talbut).
52 Q 329 (Mr Robin Freestone), Q 418 (Mr Iain Richards).
53 Q 418.
54 ADT 26.
55 Q 488.
56 Q 427.
information was also cited as a reason for not challenging auditor appointments. Mr Jubb suggested audit committees should discuss with principal shareholders every five years “the quality of service and other aspects surrounding the auditors.”

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47. Mazars suggested investor scrutiny might be strengthened by forming independent shareholder panels to choose the auditors. BDO recommended direct shareholder representation throughout the appointment and review process rather than only at the end. Mr Steve Maslin, Partner at Grant Thornton, would like the Financial Reporting Council “to convene a group of the UK’s largest institutional investors to get some focused action on the companies in which they invest—and that might be in the FTSE 250—to give a very strong signal to those companies to move more audits to firms outside of the Big Four.”

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48. There was wide support from witnesses for audit committee reporting to be more transparent about the rationale for audit tendering and audit choice decisions. There was also support for audit committees to report on significant financial reporting issues arising during the course of the audit, since the auditors’ report cannot be relied upon to do so. Mr Davey said: “Maybe there is a role for further development of the relatively new Stewardship Code in this area. Is there a role for the FRC’s guidance on audit committees to be looked at and possibly made mandatory?” We infer that, if audit committee guidance were to become mandatory, the Department for Business, Innovation and Skills might support audit committees themselves becoming mandatory for listed companies.

49. We recommend that:

i. audit committees should hold discussions with principal shareholders every five years;

ii. the published report of the audit committee should detail significant financial reporting issues raised during the course of the audit;

iii. they should also explain the basis of the decision on audit tendering and auditor choice; and

iv. the FRC’s UK Corporate Governance and Stewardship Codes should be amended accordingly.

50. Like the FRC’s Market Participants’ Group measures, the changes we recommend above should be marginally beneficial. But they would not deal with the fundamental issue of audit market concentration. Regrettably, with the notable exception of our investor witnesses, most shareholders appear to care little about a company’s choice of auditor. It seems improbable that this apathy will soon be remedied. So measures which rely on shareholder engagement to help lessen audit market concentration are unlikely to be effective.

57 Q 418 (Mr Robert Talbut), Q 433 (Mr Paul Lee).
58 Q 430.
59 ADT 21 (Mazars), ADT 19 (BDO).
60 Q 138.
61 Q 504.
Audit Commission

51. The FRC argued that Government plans to abolish the Audit Commission might offer the opportunity for one or more non-Big Four auditors to take on its work. As a standalone entity, the Audit Commission would be the fifth largest audit firm in the UK, representing about 10% of the market.\(^{52}\) Baroness Hogg said that if the Big Four picked up the work of the Audit Commission “that will be, at the very least, a big missed opportunity to increase the strength of work done by the non-Big Four firms.”\(^{53}\) Mr Maslin said that Grant Thornton “would be very enthusiastic under the right conditions to invest in taking a substantial part of the Audit Commission work.”\(^{54}\) If on the other hand the Audit Commission’s work went to the Big Four, market concentration would increase.

52. Preventing the Big Four from taking such work could however breach EU laws on public procurement. The FRC acknowledged that there were “practical difficulties that may need to be overcome to ensure the UK complies with European law relating to the procurement of public contracts but believe the prize of greater competition in the market makes this proposal worthy of further consideration.”\(^{55}\)

53. Baroness Hogg told us that the expected abolition of the Audit Commission would provide an opportunity to increase competition and choice in the audit market if it formed the basis of a substantial new competitor to the Big Four. We recommend that the Government should work to encourage the emergence of such a competitor.

Public sector work

54. BDO argued that for the types of projects where the Government tends to hire Big Four firms greater consideration should be given to smaller audit firms instead.\(^{56}\) Asked about the Government’s scope for ensuring more non-Big Four firms won public contracts, Mr Davey said: “In general, the Government is very keen at looking at how we procure goods and services and to see if that can be improved … We want to encourage a very competitive market for procurement of Government services including audit.”\(^{57}\)

55. The Government should make greater efforts, within EU procurement rules, to enable non-Big Four firms to win public sector work. This should include any work no longer undertaken by the Audit Commission.

Prevent companies restricting themselves to Big Four

56. Restrictive covenants where companies are required by shareholders or banks to use one of the Big Four auditors are a barrier to choice,\(^{58}\) as the Big Four plus BDO and Grant Thornton stated in a joint submission to the OECD:

\(^{52}\) ADT 24 (FRC), ADT 1 (Professor Beattie et al), Q 515 (Mr Richard Carter).
\(^{53}\) Q 192.
\(^{54}\) Q 139.
\(^{55}\) ADT 27.
\(^{56}\) ADT 19.
\(^{57}\) Q 506.
\(^{58}\) ADT 4 (ACCA), ADT 20 (Grant Thornton), ADT 62 (Kingston Smith).
“In certain countries including the USA, UK, Germany, Spain and Finland we have encountered clauses or requirements in contractual agreements between companies and their banks or underwriters that state that only the Big 4 audit firms can provide audit services to the company. [This] can distort the market for audit services by excluding certain audit firms from competing in this market.” Mr Scott Halliday, Managing Partner, Ernst & Young, said: “Removing the only Big Four clause from any banking agreements would be a positive step.”

57. Lord Sharman and Lord Smith of Kelvin doubted that restrictive covenants were common in the UK. The FRC nevertheless recommends “a greater level of dialogue between the British Bankers’ Association, lending institutions, audit firms and regulators to address the issue”. The OFT is considering the launch of a market study of restrictive bank covenants. We consider that the OFT should conduct a market study of restrictive bank covenants. This would form part of the wider inquiry into the audit market which we recommend later in this report.

Reform of the law on unlimited liability

58. Concerns about liability and insurance against claims for damages should a client collapse could deter non-Big Four accountants from auditing large listed companies. Auditors’ liability can be limited by contract so long as the cap is “fair and reasonable in all the circumstances” and the client consents. The Association of Chartered Certified Accountants (ACCA) argues that more needs to be done as listed companies rarely consent, mainly because US authorities view such agreements as direct threats to audit quality. ACCA believes Germany has less market concentration than Britain because of a long-standing cap on auditors’ liability.

59. But Mr Stephen Kingsley, Senior Managing Director at FTI Consulting, disagreed: “Lack of limitation clearly concentrates the mind.” He argued that unlimited liability, had not, of itself, caused the collapse of any major firm, not even Arthur Andersen. Mr Davey said the Government’s “conclusion is that we shouldn’t put a cap on [liability]. We have no plans to do so”. He added: “Liability does drive quality of audit, and there is quite strong evidence from the academics in this regard.”

60. Auditors’ unlimited liability needs to be investigated to determine whether it deters non-Big Four auditors from taking on large listed clients. This too could form part of an Office of Fair Trading (OFT) investigation into the audit market which we recommend later in the report.


70 Q 236.
71 ADT 71 (Lord Smith), ADT 41 (Lord Sharman).
72 ADT 27.
73 ADT 49.
74 ADT 4 (ACCA), ADT 53 (Baker Tilly), ADT 7 (ICAS), ADT 62 (Kingston Smith), ADT 69 (Professional & Business Services), ADT 41 (Lord Sharman).
75 ADT 13.
76 Q 550.
Change in ownership arrangements for auditors

61. The FRC believes that changes to the ownership rules—which are set at EU level and preclude non-auditors from holding more than 49% of the voting rights in an audit firm—would “make it easier for firms to invest to allow them to expand into the market for the audits of the largest companies.”

62. Surprisingly, BDO and Grant Thornton—the largest non-Big Four auditors—say they have no need for greater access to capital to expand. Grant Thornton said they would not need to raise additional capital to expand into audit of the FTSE 250 listed companies, now dominated by the Big Four. Mr Michaels of BDO declared: “Investment is not holding us back.”

63. The ABI argued that liberalising ownership rules could enable non-auditors to help recapitalise an audit firm on the brink of collapse.

64. The leading second-tier audit firms have told us that their scope for growth is not constrained by any problems of access to capital. So we see no immediate grounds to change the law to lift limits on shareholdings by non-auditors in audit firms, especially since such a change would carry the risk that auditors might become less independent. The OFT should also examine limits on share ownership as part of its investigation.

Risk committee adviser

65. In his review of corporate governance in UK banks and other financial industry entities, published in November 2009, Sir David Walker recommended that “the board of a FTSE 100-listed bank or life insurance company should establish a board risk committee separately from the audit committee. The board risk committee should have responsibility for oversight and advice to the board on the current risk exposures of the entity and future risk strategy, including strategy for capital and liquidity management, and the embedding and maintenance throughout the entity of a supportive culture in relation to the management of risk alongside...
established prescriptive rules and procedures.” It could be argued that such risk committees, composed largely of non-executive directors but with expert advice, might have prevented or at least mitigated some of the decisions taken by these institutions which led to the financial crisis.

66. The assessment of risk, whether by separate risk committees or as part of the audit committee, is becoming a more prominent feature of corporate governance not only in the banks and financial institutions but also in other major companies where appropriate. As the Walker report said: “This seems a welcome development in particular in the light of recent experience, much of which can be characterised as marking a failure by boards to identify and give appropriate weight to risks on which they had not previously focused.” The report also suggested the use of a “high-quality source of external advice.”

67. In its evidence to us, the FRC wished to encourage banks and other systemic institutions to use non-Big Four firms as a source of advice to these risk committees. The FRC argued that this would give such firms an exposure to large companies they might not otherwise have access to and might in time provide them with the opportunity to tender for the audits of some of these entities. Baroness Hogg argued that such risk committees—reporting to the board about the levels of risk facing different parts of the business and how these can be contained—should be advised by a firm other than the company’s auditors, and that such a measure might enable non-Big Four auditors to enter the big company market. Mr John Connolly, Senior Partner and Chief Executive, Deloitte said: “I think the concept of independent advisers advising risk committees is a good one. If that was adopted, I think that is a good change.” Mr John Griffith-Jones, Chairman, KPMG agreed that the auditor should not be the risk committee’s adviser but added that nonetheless “auditors have an important potential role to play around the risk area.” Lord Sharman said: “I have found ... that the appointment of an independent advisor to both the audit committee and the risk committee, separate from the external auditors, separate from the internal auditor, and separate from anybody else in the organisation ... is particularly helpful.” When asked, “How general is it?” he replied, “I suspect it’s not very common.”

68. Whether such risk assessment is done by a separate risk committee or as part of the audit committee work, we can see considerable benefits in expert external advice being increasingly used. It should not be provided by the firm’s own auditors. It will increasingly involve the use of specialist advice and experience quite distinct from that involved in audit work and could provide an opportunity for non-Big Four firms to build up such expertise and as an entree to FTSE 100 companies.

86 Q 194.
87 Q 246.
88 Q 256.
89 QQ 365–367.
69. We strongly support the development of separate risk committees in banks and major financial institutions. Other large companies should institute them where appropriate. Such committees will increasingly require specialist skills and external advice. This advice should not be provided by the firm which is the company’s auditor. Providing it could open opportunities for non-Big Four accountancy firms to enter the large company market in a way which they have found difficult to do.

70. We believe that every bank should have a properly constituted and effective Risk Committee of the Board. It should be one of the duties of the external auditor to ensure that this is done, by making clear that if it is not, the auditor will say so in a qualification to the accounts. This is best dealt with by rules made and guidance issued by the FRC rather than by being made a statutory requirement. Reference should however be made to it in legislation on the relationship between financial supervisors and auditors, to which we return later in the report.

Should audit remain mandatory?

71. Audits are mandatory for most companies except the smallest for which the burden and benefits are deemed disproportionate. There is a case for reduced mandatory audit requirements, while enabling companies to opt for more detailed audits to reassure investors. This could provide opportunities for non-Big Four auditors. The OFT said: “Reducing the requirements of statutory audit might stimulate switching to smaller auditors that are able to undertake a more limited audit. Doing this might also reduce auditor liability for errors and hence auditors’ risk of failure.”

72. Independent Audit argued for the removal of the requirement for an audit. It would then be for boards to take responsibility for their financial statements, perhaps also opting to have them audited. Mr Davey said: “The Government believes, there is a strong case for taking away the mandatory requirement for an audit from medium-sized companies.” If enacted, this change would apply to 32,385 companies. (A company is classified as medium-sized if it meets two out of the three criteria set by the EU: turnover between £6.5m and £25.9m; total assets from £3.26m to £12.9m; and 50 to 250 employees.)

73. However, most shareholders and lenders would insist on full audited accounts for listed companies. Professor Michael Power of the London School of Economics saw a more widespread removal of the requirement for audit as “just simply unthinkable for a whole range of institutions at the moment.” Investors also outlined the importance of audits. Mr David Pitt-Watson of Hermes said: “Audit and accountancy are absolutely fundamental to the integrity of our capital markets and the good governance of our

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90 ADT 26.
91 ADT 12.
92 Q 522.
93 Q 523.
95 Q 23.
companies.” Mr Richards of Aviva said: “The fact that we have an audit is valued by investors.”

74. We raised with witnesses the scope for financial statements insurance drawn to our attention by business consultants Z/Yen and also proposed by Professor Joshua Ronen of New York University’s Stern School of Business. One attraction of this is that it would create a parallel market to compete with the existing audit market that has proved resistant to widening choice. Under this system, companies could opt to seek insurance for their investors against losses caused by below par financial statements, as an alternative to the existing audit regime. The insurer would assess the company to determine the risk and then set a price for offering such insurance. It is hoped auditors would want to build a strong reputation to make sure that insurers hired them; and the interests of the insurers, who would want to pay out as few claims as possible would be aligned with shareholders. Mr John Connolly of Deloitte dismissed financial statements insurance as containing “a lot of very impractical features”. He suggested it would be costly and availability of insurance cover against audit failure would be limited. He said: “There is not enough insurance in the insurance market to cover the market capitalisation of a single FTSE 100 company, let alone the whole market, so I do not know why there is the view that this insurance would exist.”

75. In order to lower regulatory costs, there is a strong case for some reduction in the audit requirement on smaller companies. This is unlikely to reduce audit market concentration, since the audit requirement would remain in place for the large listed companies where the Big Four predominate.

Should auditors give broader assurance?

76. We heard much evidence that audits should change to be more useful to investors. The Institute of Chartered Accountants in Australia wanted ‘closer to the event’, more up-to-date assurance. ACCA argued for widening audit’s scope from financial statements to embrace risk management, corporate governance, and the business model. CIMA believe auditors should also offer some form of assurance on the narrative operating and financial review. Mr McLaren of ICAS said that assurance on these lines would be to a standard of ‘balanced and reasonable’ rather than ‘true and fair’. BDO saw a case for listed companies assurance, especially for large financial institutions, to extend to analyst briefings and other communications with investors.

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96 Q 404.
97 ADT 74.
99 Q 260.
100 ADT 23.
101 ADT 4.
102 ADT 5.
103 Q 69.
104 ADT 19.
77. Independent Audit argued for the rules and regulations concerning narrative statements, such as reviews of business operations in companies’ annual reports, to be further developed to close the “expectations gap” between what the general public want auditors to do and what they actually do in terms of providing assurance. Audits of narrative reports should give a qualitative commentary rather than a yes or no ‘binary’ opinion. But even Independent Audit warned that audit firms “are much less well-equipped to form a view on the subjective and sensitive topics that lie outside the financial statements.”

78. Mr Ashley Almanza, Chairman of The Hundred Group (of Finance Directors of FTSE 100 companies) and Chief Financial Officer of BG Group did not support any widening of auditors’ assurance because “whatever product they produced, would have to be so heavily qualified I query whether investors would get real value.”

79. Investors and others demand that audit should provide broader, more up-to-date, assurance on such matters as risk management, the firm’s business model and the business review. This additional assurance would help the audit to meet the current expectations of investors and the wider public. Any widening of auditors’ assurance would radically change their role. Again the OFT should address this issue as part of its broader review of the workings of the audit market.

Should auditors do less non-audit work and internal audit?

80. There has long been concern about conflict of interest if an external auditor also provides other services to the same client. Under the current rules certain work for an audit client is prohibited—anything that would involve auditing one’s own work, acting in a management capacity or acting as an advocate for an audit client. Some services such as advice on tax issues and acquisitions may only be provided by partners with no knowledge of their colleagues’ audit for the same client—the Chinese wall. But accountancy firms are generally free to offer consultancy services to their audit clients, although listed companies disclose in annual reports fees paid to auditors for consultancy work. Northern Rock was a case in point. In addition to auditing Northern Rock, PwC received some £700,000 in 2006 in consultancy income from Northern Rock. The House of Commons Treasury Select Committee referred to this as an apparent conflict of interest.

81. Earlier, in 2005, a former Chief Economist of PwC joined the Northern Rock Board as an independent director and the following year was appointed to its Audit Committee. She resigned from the committee after one meeting following concern expressed by PwC but rejoined early in 2007. Northern Rock and their auditors were subject to conflict of interest criteria in both the US and the UK. Although this arrangement does not seem to have breached the letter of US or UK criteria, PwC is to be commended for focusing on their substance rather than their form. We note however that compliance

105 ADT 12.
106 Q 322.
107 ADT 24 (FRC).
109 Northern Rock 2005 and 2006 annual reports.
with the UK’s Corporate Governance Code is at the discretion of companies, unenforced by regulation.

82. Professor Kevin McMeeking of Exeter University stated that prohibition of all consultancy advice to audit clients was “the only failsafe solution” to avoiding the potential for conflict.\(^{110}\)

83. Dr Sarah Blackburn of the Chartered Institute of Internal Auditors said “internal audit should not come from the external auditors of the company” and that “it’s useful to have more than one source of assurance and more than one point of view.”\(^{111}\)

84. Mr Timothy Bush, Investment Management Association nominated representative on the Urgent Issues Task Force of the Accounting Standards Board, raised concerns about companies receiving tax advice from their audit firm: “I would be concerned where there’s a skeleton in the cupboard that the auditor isn’t incentivised to uncover, and I think some tax planning can tie companies in knots for years, and if that is audited by the same firm that advised on the tax planning, then you’re going to have a real problem.”\(^{112}\)

85. Accountancy groups, unsurprisingly, believed the current rules require at most minor tinkering.\(^{113}\) They also saw benefits in staff acquiring wider experience. Mr Ian Powell, Chairman and Senior Partner, PwC said of auditors working in non-audit parts of the firm: “As they move back into audit practice, they are much better auditors because of the quality of the training and the experience that they’ve had.”\(^{114}\) Baker Tilly entered one proviso: if the client could create systemic risk to capital markets—such as a large bank—then auditors should face stricter rules in what non-audit services they could supply.\(^{115}\)

86. Accountancy groups saw no demand to prevent accountants from supplying other services to their audit clients.\(^{116}\) For smaller companies it may be cheaper to get non-audit advice from their auditors than from elsewhere.\(^{117}\) ACCA cited figures from listed company accounts showing that the ratio of non-audit to audit fees has fallen from 191% in 2002 to 71% in 2008\(^{118}\), still a high figure.

87. **We are not convinced that a complete ban on audit firms carrying out non-audit work for clients whose accounts they audit is justified. But we recommend that a firm’s external auditors should be banned from providing internal audit, tax advisory services and advice to the risk committee for that firm. We also recommend that the Office of Fair Trading should examine whether any other services should be banned from being carried out by a firm’s external auditors.**

\(^{110}\) ADT 64.
\(^{111}\) Q 380.
\(^{112}\) Q 100.
\(^{113}\) ADT 4 (ACCA), ADT 19 (BDO), ADT 53 (Baker Tilly), ADT 29 (Deloitte), ADT 6 (ICAEW), ADT 7 (ICAS), ADT 31 (KPMG), ADT 32 (PwC), ADT 69 (Professional & Business Services).
\(^{114}\) Q 250.
\(^{115}\) ADT 69.
\(^{116}\) ADT 6 (ICAEW).
\(^{117}\) ADT 4 (ACCA), Q 71 (Mr Iain McLaren and Mr Robert Hodgkinson).
\(^{118}\) ADT 4 (ACCA).
Big Four to Big Three?

88. As outlined in Chapter 2, there is always the possibility that for whatever reason one of the Big Four might leave the audit market. Mr Almanza said that going down to the Big Three would be “an unwelcome change”. The OFT said in such circumstances “existing competition problems in the market could be exacerbated”. Some companies, especially in riskier industries, might not be able to obtain audit services in the short term. This could trigger a loss of confidence in financial statements among investors.

89. Any move from the Big Four to a Big Three would create an unacceptable degree of market concentration. Choice and competition in the audit market would be seriously undermined.

90. Mr Almanza recommended that the authorities should have a contingency plan for the orderly transition of clients to another auditor if one of the Big Four collapsed. Mr Graham Roberts, Finance Director of British Land, writing in a personal capacity, argued that auditors should draw up ‘living wills’, similar to those proposed for banks, which would detail how a failing institution could be wound-up with the least possible disruption to the financial system. The FRC also advocates ‘living wills’: “These would set out how a firm would segregate, under regulatory supervision, how good and failing parts of the business will be separated and funded.”

91. By setting out an orderly process of dismantling, living wills should also help ensure that no audit firm was regarded as too big to fail. Even without living wills the FRC is keen to dispel any idea that the Big Four are too big to fail: “We would not moderate our actions to protect a firm from failure but it is of concern that some believe such a risk exists.” The FRC advocates a global contingency plan for a Big Four collapse by governments and regulators in the UK, EU and US, with two main strands:

- Conduct of audit work in the short term;
- Long term structure for the audit market.

The FRC recommends that in the first instance the Government should ask the Financial Stability Board—the global organisation that coordinates national financial authorities and standard setters—to examine the issues, “with a view to it being discussed at G20 level in due course”.

92. We recommend that the Government and regulators should promote the introduction of living wills for Big Four auditors. These would lay out all the information the authorities would need to separate the good from the failing parts of an audit firm so disruption to the financial system from a collapse would be minimised.

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119 Q 292.
120 ADT 26.
121 ADT 4 (ACCA), ADT 26 (OFT), ADT 24 (FRC).
122 Q 343.
123 ADT 38.
124 ADT 27.
125 ADT 24.
126 ADT 27.
Referral to the Office of Fair Trading

93. In 2002, when the large-firm audit market became concentrated in the hands of the Big Four following the collapse of Arthur Andersen, the OFT conducted a preliminary inquiry into whether to launch a full-scale competition investigation of audit. It decided not to do so, nor to refer the matter to the Competition Commission—usually the next stage in any full-scale competition investigation. The OFT explained its decision: “We have not found evidence to suggest that [audit] firms have acted to prevent, restrict or distort competition. Nor have we had complaints that they may be doing so.” The OFT considered that the time was not right for further investigation, while great changes were taking place in the audit market, and concluded: “Our approach is to keep the market under review and to examine any competition implications of regulatory proposals that may arise from current reviews of audit and accountancy services.”

94. The Big Four continue to strengthen their position by using their financial muscle to acquire significant parts of the home and international networks of next-tier firms. There have been several notable acquisitions in recent years in, for example, France and Brazil. These takeovers limit the scope for smaller competitors to develop international networks. The effect seems anti-competitive.

95. Lord Myners told us that if other measures to increase choice in the audit market did not work then as a last resort “one has to consider whether there should be an OFT reference and whether ... there should be some action to ‘trust bust’”.

96. Most other witnesses opposed breaking up the Big Four. ACCA said it could have unintended consequences such as one of the Big Four leaving the audit market altogether; it argued that as things stood there were enough reputational incentives for auditors to offer objective advice and maintain high standards. Independent Audit thought that any benefits would be uncertain, since market pressures for scale and consolidation were unlikely to abate. They also drew attention to the difficulty of breaking up the Big Four given their international networks beyond UK regulators’ reach. Yet the UK is a relatively important player in the audit world. Reforms in the UK might in the FRC’s view be “a catalyst for international developments and debate.”

97. The Committee believes radical approaches are needed to solve the many problems with the audit market. Any industry in which four firms share the total market (one with 40%, the others with around 20% each), has to be one where choice is clearly restricted. As Lord Sharman put it: “Anybody who chairs a major company, or sits as chairman of an audit committee of a

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129 Q 486.

130 ADT 4.

131 ADT 12.

132 ADT 24.

major company, cannot fail to be concerned about the lack of choice. It’s not
a lack of choice among four; quite often it comes down to the fact that you
only have two that you can possibly appoint.” Mr Philip Collins, Chairman
of the OFT, said: “We consider that the competition in the market for audit
services to large companies may be limited, as a result of barriers to entry and
expansion, switching costs and limited choice in firms. We observe low levels
of tendering and switching, high concentration and some evidence of high
fees. There may be other effects of a lack of competition, such as low quality
and lack of innovation … High concentration may also contribute to a risk of
systemic failure in the audit market. Barriers to entry might make it difficult
for mid-tier firms to step up to replace one of the Big Four firms if it were to
exit the market. Thus we think that the market, as currently structured, may
not operate in a way that works well for users.”

98. In this report we have recommended a number of measures to reduce
the dominance of the Big Four in the large firm audit market. But
within the time and the resources available to us, we have not been
able fully to address all the highly complex issues which may stem
from market concentration. These include:

i. lack of choice;

ii. higher fees than in a more competitive market;

iii. lower quality; and

iv. the huge risks involved if one of the Big Four left the audit
market.

A thorough review of the issues in depth and in the round is overdue.
We recommend that the OFT should conduct such an investigation
into the audit market in the UK, with a view to a possible referral to
the Competition Commission. Its findings would need to take full
account of the international dimension, but the UK could give a lead
internationally by undertaking such a review.
CHAPTER 4: THE LEGAL/REGULATORY FRAMEWORK

Current regulatory structure

99. Accounting regulation is handled by a complex, multi-layered web of organisations. Frontline regulation is primarily handled by six professional bodies:

- Association of Chartered Certified Accountants (ACCA)
- Chartered Institute of Management Accountants (CIMA)
- Chartered Institute of Public Finance and Accountancy (CIPFA)
- Institute of Chartered Accountants in England and Wales (ICAEW)
- Institute of Chartered Accountants in Ireland (CAI)
- Institute of Chartered Accountants in Scotland (ICAS)

100. These bodies investigate complaints against their members and where necessary discipline them. Where complaints are upheld they can issue reprimands, fine the auditors (or their firm) or suspend their right to practise. They also promote the interests of their members including their monopoly rights to practise, licences to practise and continuing professional development.

101. Attempts by the professional bodies’ leaderships to effect mergers have been rejected each time by the members of at least one of the bodies involved. Mr Iain McLaren, Senior Vice-President of the Institute of Chartered Accountants in Scotland (ICAS) justified the fragmented set-up on the grounds that the organisations “compete vigorously” on training. He said: “No one in this day and age likes to have a sole supplier [and] what we hear from our members currently is that they would not welcome any consolidation.”

102. However in the 1980s unease about possible or actual conflict of interest while these professional bodies were in effect self-regulating trade associations led to the setting up in 1990 of the Financial Reporting Council (FRC) as the UK’s regulator responsible for promoting high quality corporate governance and financial statements. Its chairman and deputy chairman are appointed by the Secretary of State for Business, Innovation and Skills. There is extensive representation of the accountancy profession on the FRC. The professional bodies retained some disciplinary roles while the FRC oversees regulatory activities of the professional accountancy and actuarial bodies and operates independent disciplinary arrangements for the more serious, public interest cases.

103. The FRC also sets and/or adopts financial reporting and external auditing standards. In corporate governance, the FRC’s remit is largely limited to

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136 Q 51.

137 The FRC is not a costly quango to the public purse, with less than 10% of its £13m annual budget being funded by government, the rest being levies upon interested parties—see Financial Reporting Council, (December 2009): Draft Plan and Levy Proposals 2010/11, at http://www.frc.org.uk/images/uploaded/documents/Draft%20Plan%20and%20levy%20proposals%202010-11%20FINAL.pdf
drafting the UK Corporate Governance Code and Stewardship Code. It conducts very little monitoring and no enforcement of these pieces of discretionary guidance. Listed companies are however required to report on how they have applied the Corporate Governance Code in their annual report and accounts and, if necessary, explain which parts they have not complied with.

104. Their prominent role in the FRC, coupled with their professional bodies’ dual role as supervisors and trade associations, led the Committee to inquire if accountants and auditors—in particular the Big Four—are too influential over their own regulation, especially when nine of the fourteen members of the FRC’s Auditing Practices Board (APB)—which sets and/or adopts audit standards—are current or past members of Big Four firms. Although no current members of the Big Four firms are on the FRC’s main Board, past and former members are well represented on its other boards.

105. We asked if the supervisory and regulatory bodies had been captured by the profession. Mr Steve Cooper of the International Accounting Standards Board (IASB) said: “We are certainly not captured by the auditing profession. We obviously meet the auditors on a very regular basis. We meet with the technical partners. Clearly, they are the ones who have to interpret the standards that we issue and apply them in practice. It’s vital that we make sure that we meet them. We certainly don’t ignore their opinions. Their opinions are very, very important.” Mr Robert Hodgkinson, Executive Director of the ICAEW, dismissed the idea they were dominated by the Big Four.

Changes to the regulatory structure

106. The FRC is keen to gain more powers. It would firstly like to introduce an additional licence for auditors of listed companies. This would give the FRC the power to impose a range of sanctions against individual auditors which it currently cannot do. At present, the FRC’s only option is recommending the relevant professional body remove the licence of the entire audit firm—not just the individual auditor(s). Removing a firm’s licence is “a nuclear option”, according to FRC chief executive Stephen Haddrill. But even if the FRC recommends such a drastic step, it cannot enforce the action. Mr Haddrill said: “We would expect [the professional body] to enforce it but we don’t have that power.”

107. After gaining a licensing role the FRC wants “a wider range of sanctions to address shortcomings in audit quality and for use in disciplinary situations”. These would include being able to set conditions on how an erring audit firm does business in future and to set fines.

108. The FRC also wants more power to conduct preliminary investigations. Mr Haddrill said: “At the moment it’s quite difficult for us to conduct a comprehensive investigation into whether or not there has been an audit failure, if we don’t have some real hard evidence of that being available. We have very limited powers to call into account and to question directors, for

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138 Q 462.
139 Q 78.
140 Q 172.
141 ADT 24.
example, unless they happen to be accountants. So we find it quite hard to get a thorough review of whether something has gone wrong and would like our investigatory powers to be strengthened in that respect.”

109. The FRC argues for these changes on the grounds that too many audits seen by its Audit Inspection Unit (AIU)—which monitors the audits of all organisations in whose financial condition there is considered to be a major public interest—are substandard.

110. The regulation of accounting and auditing is fragmented and unwieldy with manifold overlapping organisations and functions. This is neither productive nor necessary. Other professions have only one regulator—medicine for example under the General Medical Council. The wider powers sought by the Financial Reporting Council would go some way to simplifying and streamlining matters for audit. But further impetus needs to be given to rationalisation and reform. We hope and expect that the profession will provide that impetus. In the absence of rapid progress, we recommend that the Government stand ready to impose a remedy.

142 Q 172.
143 ADT 24.
CHAPTER 5: THE IMPACT OF INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

Background

111. Accounting standards were not at first within our intended scope for this inquiry. But we included them after witnesses made trenchant criticisms of the effects on audit of the International Financial Reporting Standards (IFRS) adopted in recent years in the EU and the UK.

112. The previous British accounting standard was United Kingdom Generally Accepted Accounting Practices (UK GAAP). Audited financial statements were drawn up in accordance with it. Use of IFRS instead became mandatory for group accounts of EU listed companies from 2005. It has been the basis of large-company financial statements audited in the UK since then. The aim of IFRS is to achieve common reporting standards across the world with the aim of improving efficiency and liquidity in global financial markets and lowering the cost of capital. Although IFRS represent a convergence of standards with those of the US Financial Accounting Standards Board, which reflect a much more litigious culture, the US has still to decide if it will adopt IFRS.

113. Some witnesses argued forcefully that adoption of IFRS in the UK had led to lower standards of audit. The central criticism is that, because IFRS is more rule-based than UK GAAP, it leads auditors to place conformity with IFRS rules before traditional, sceptical reliance on “the true and fair view, the prudence principle and the principle of substance over form”.144 In short, a box-ticking approach is replacing the exercise of professional judgment which allowed the auditor’s view of what was true and fair to override form. In the words of Mr Iain Richards, Head of Governance at Aviva Investors: “The audit has become commoditised.”145 As Professor Stella Fearnley of the University of Bournemouth put it “the way you keep out of trouble is to comply with the rules”.146 Mr Stephen Kingsley, Senior Managing Director at FTI Consulting agreed: “‘Do these accounts make sense?’ That seems to have gone out of the window and been replaced by … ‘these accounts comply with accounting standards’”.147

IFRS and banks

114. Critics suggested that under IFRS bank financial statements in the UK and Ireland (a common accounting standards area) were prepared and audited according to laxer standards than before, especially as regards valuation of assets by mark to market, and made provision only for incurred and not expected losses, so that profits were overstated, leading to excessive distributions and in particular bonuses which would not have occurred under UK GAAP. Mr Timothy Bush, Investment Management Association nominated representative on the Urgent Issues Task Force of the Accounting Standards Board, argued that the relevant IFR standard, IAS39, is in conflict

144 Q 1(Professor Beattie).
145 Q 411.
146 Q 30.
147 Q 87.
with clause 19 of UK accounting rules under the Companies Act 2006 which requires accounts to be prepared prudently, and without crediting any unrealised profits, while recognising any contingent liabilities.\(^{148}\) Professor Fearnley saw IAS 39 as far less prudent than its equivalent under UK GAAP because it substituted neutrality for prudence.\(^{149}\)

115. Mr Richards suggested that IFRS contributed to pro-cyclicality in banks since mark to market tended to lead to greater volatility in reported results.\(^{150}\) In his view, IFRS were partly responsible for bank losses in the financial crisis: “In terms of the standards themselves, they obfuscate the separation of realised items from unrealised ones. There also appears to be some confusion, in practice at least, with other Companies Act provisions, such as in relation to distributable reserves and dividends. It would certainly be possible to characterise a significant proportion of bank capital raising and tax-payer funds as having been necessary to redress precisely the results of the problem created by both bonuses paid on unrealised profits (that disappeared) and imprudent dividend distributions. In terms of prudence the point should be obvious.”\(^{151}\)

116. Mr Bush went so far as to describe the bank crash in the UK and Ireland as “a crisis largely caused by accounting”\(^{152}\) and supplied a chart to illustrate his point.\(^{153}\) Mr Kingsley, though also a critic of IFRS, did not agree. While acknowledging that auditors might have done more, he saw banks’ managements as mainly responsible: “For some of our banking institutions, the size and complexity got away from the capability of the management process and systems to cope.”\(^{154}\) It is notable that the final report of the US National Commission on the Causes of the Financial and Economic Crisis in the US, Public Affairs (2011) says little about the role of auditors, although a minority dissenting report criticised the omission.\(^{155}\)

117. It seems clear that there were distortions in bank financial statements under previous accounting regimes before IFRS was mandatory. As Mr Martin Taylor last year told the Future of Banking Commission, in his time as CEO of Barclays [pre-1998], “the accounting standards require you to recognise [losses] only when they occur, and that means that banks have overstated profitability in the up phase of the cycle, and understated profitability in the down phase of the cycle.”\(^{156}\)

118. The Bank of England and FSA are concerned that under current accounting standards some bank assets, including complex financial instruments, are not valued in consistent and comparable manner. \textit{Especially important evidence was given to us by Mr Andrew Bailey, Chief Cashier at the Bank of England, about the Bank/FSA Working Group, which is to report by the end of June, and is

\(^{148}\) ADT 10.
\(^{149}\) ADT 2.
\(^{150}\) ADT 44.
\(^{151}\) ADT 44.
\(^{152}\) Q 87.
\(^{153}\) Q 88.
\(^{154}\) Q 87.
\(^{155}\) “The Commission majority did not discuss the significance of mark-to-market accounting in its report. This was a serious lapse, given the views of many that accounting policies played an important role in the financial crisis.” From dissenting report by Peter J Wallison.
\(^{156}\) The Future of Banking Commission report (2010), page 70.
“to consider enhanced disclosure requirements around the valuation of banks’ less liquid assets to enable users to compare financial instrument valuations between institutions ... Current financial statement disclosures around asset valuations, despite being compliant with accounting standards, are often not sufficiently granular or transparent in respect of the critical valuation assumptions, and sensitivities of those assumptions, to support users’ understanding and meaningful comparisons. It is arguable that this lack of transparency and comparability undermines the operation of market discipline and hinders the promotion of financial stability”.

119. Practitioners consider that differences between IFRS and UK GAAP are not significant. In the view of Ernst & Young and KPMG, the relevant standards, guidance and accounting by banks for loan loss provisions and fair value provisions were not significantly different under UK GAAP and IFRS. Both were based on the ‘incurred loss model’ (or ‘loan loss impairment’ model) which means that provisions for impairment were based on the prevailing conditions at a given time (the balance sheet date).

120. The Financial Reporting Council (FRC) denied that IFRS was inconsistent with the Companies Acts. “The FRC shares BIS’ view that … changes are not required to either IFRS or to the Companies Act 2006 in order to reduce any possibility of illegality … directors make … decisions [on distributions, etc] in the light of the company’s ‘realised profits’ as defined by section 853(4), Companies Act 2006. The method of calculating profits regarded as realised ‘in accordance with principles generally accepted at the time when the accounts are prepared’ is set out in ‘Guidance on the Determination of Realised Profits and Losses in the context of Distributions under the Companies Act 2010.”

121. Mr Steve Cooper of the International Accounting Standards Board (IASB), which sets IFRS standards, argued that IFRS gave due, though less, weight to prudence, to reach a more realistic view of profits: “Prudence does permeate accounting standards, revenue recognition, and all sorts of areas. We are careful to make sure that profits are only recognised when they really are profits. However, prudence acts two ways: if you understated things now, it gives an opportunity for companies to report a profit later; and at the very times that things are getting worse, if you are living off past fat and past unrealised profits, you can conceal the bad things that are coming later. So we do not want to create a bias within financial reporting that has that counterintuitive effect later on. We want things to be realistic, neutral, to faithfully reflect the economics of transactions.”

122. Mr Cooper also argued that auditors could still adopt a true and fair override: “There is a perception that ... IFRS do not have a true and fair basis, which ... is completely untrue ... the true and fair override is in IFRS ... in IAS 1 ... Paragraph 19 says that, in certain circumstances, it may be appropriate to depart from a specific set of rules if you need to do so in order

157 ADT 75.
158 ADT 35 (KPMG), ADT 34 (Ernst & Young).
160 Q 452.
to fairly present the information, fairly present the underlying economics of the business and the transactions entered into. So I do not believe there is any significant difference between the wording in international standards and what we have in UK accounting and UK legislation.” Mr Roger Marshall of the Accounting Standards Board (ASB) agreed: ASB had counsel’s opinion that “the requirement in IFRS to present fairly is not a different requirement to that of showing a true and fair view, but is a different articulation of the same concept.”

123. Other witnesses disagreed. In Mr Richards’s view: “IFRS has muddied the waters both as a result of how it has been implemented and its effects on accounts. Let me start with the observation that in practice critical concepts like prudence and accounting conservatism have been superseded in IFRS by process and compliance to standards. Aspects of the model seem more targeted at short-term trading (decision usefulness) rather than stewardship accountability. As a result concepts like the ‘true and fair view’ have been diluted and subordinated to that dynamic and other Companies Act accounting requirements have been obfuscated. Increasingly the True & Fair View has been characterised as being evidenced by compliance to the standards, particularly by standard setters.”

124. Mr Peter Wyman, formerly of PwC, recently said: “The rules allowed banks to pay dividends and bonuses out of unrealised profits—from profits that were anything but certain. The system is still in place now—we can’t tell if similar problems are building up because there is no requirement to separate realised from unrealised profits.” He added: “Significant further work is necessary before IFRS can be said to be totally fit for purpose.” Mr Cooper acknowledged that IFRS did not allow provision for expected losses: “It is very true that if you expect loans to go bad three years from now, the customer is currently paying and there is no indication that they are going to stop paying, but you just think that some … will go bad in three years … it wouldn’t be possible to provide now.” The IASB was developing a revised Standard (IFRS 9) intended to address concerns about expected but not incurred losses. It was not clear, however, when the new standards might be adopted.

125. Practitioners denied that IFRS had contributed to the banking crisis. Ernst & Young noted: “Some countries which do not use IFRS have experienced difficulties in their banking sector (e.g. USA). Equally other countries which use IFRS have not experienced difficulties in their banking sector (e.g. Australia). This provides additional support for the view that there is no causal link between adoption of IFRS and problems in the banking sector.”

126. Nevertheless, during the boom some banks clearly saw IFRS as inflating profits. Mr Adam Applegarth, then CEO of Northern Rock, told the Daily Telegraph in 2005 that moving to IFRS had introduced more volatility and led to “faintly insane” profits growth. Some regulators took precautions in

161 Q 450.
162 ADT 44.
164 QQ 452-454.
165 ADT 34.
spite of the EU requirement to move to IFRS. Lord Turner of Ecchinswell, Chairman of the Financial Services Authority, has drawn attention to the practice in Spain of “dynamic provisioning” or putting aside funds in good times to meet needs in bad\(^\text{167}\), not provided for by IFRS.

127. Professor Fearnley criticised IFRS standard setters as “dangling regulators” without clear lines of accountability.\(^\text{168}\) Mr Cooper defended the status of the IASB: “We are not tied to anyone. We are not representing anybody. We are not tied to any interested party. The whole idea is that we are appointed from a diverse range of geographical and business backgrounds, we are independent and take decisions in an independent transparent manner with appropriate, very public, due process.”\(^\text{169}\)

128. The Financial Secretary to the Treasury, Mr Mark Hoban MP, defended IFRS, provided that standards in its admittedly more prescriptive approach were steadily updated: “There was a shift between UK GAAP and IFRS, a move to a much more rules-based approach to accounting standards ... it is important those standards remain up-to-date and reflect current practice in capital markets, rather than what may have been the case in the past.”\(^\text{170}\)

129. Obvious benefits should flow from global adoption of common accounting standards for a global economy. But there is a corresponding risk that the lowest common denominator will prevail. So all concerned need to insist on the highest possible standards of rigour, clarity and quality of accounting and audit.

130. We accept that standards for use in many countries need clear rules which all can apply. It follows that IFRS is more rules-based than UK GAAP. But we are concerned by evidence that, by limiting auditors’ scope to exercise prudent judgment, IFRS is an inferior system which offers less assurance. IFRS also has specific defects, such as its inability to account for expected losses. The weaknesses of IFRS are especially serious in relation to bank audits.

131. We recommend that the profession, regulators and the Government should all seek ways to defend and promote the exercise of auditors’ traditional, prudent scepticism. The Government should reassert the vital role of prudence in audit in the UK, whatever the accounting standard, and emphasise the importance of the going concern statement.

132. Achieving general agreement on IFRS could be a long and uncertain process. In the meantime, we recommend that the Government and regulators should not extend application of IFRS beyond the larger, listed companies where it is already mandatory. Continued use of UK GAAP should be permitted elsewhere, so that the basis of a functioning, alternative system remains in place in case IFRS do not meet their aims.\(^\text{170}\)

133. As it revises banking regulation, we recommend that the Government should have the importance of accounting standards at the forefront

\(^{167}\) Speech by Lord Turner at ICAEW, Banks are different: should accounting reflect that fact?, 21 January 2010.

\(^{168}\) Q 41.

\(^{169}\) Q 462.

\(^{170}\) Q 540.
of its mind. It should promote a prudent interpretation of IFRS as applied to banks. This would include sober valuation of complex financial instruments. At present IFRS permits recognition only of incurred losses, not expected losses. So it is essential that banks put aside reserves in good times to provide against downturns. This would have the incidental advantage of reducing the scope for banks to pay bonuses on the basis of profits struck without taking account of possible losses. We recognise that a fully satisfactory outcome depends on international negotiation and believe that the Government should give a lead.
CHAPTER 6: BANK AUDITS AND THE FINANCIAL CRISIS

General

134. During the course of our inquiry we have increasingly been led into issues that arise in their most acute form with the auditing of banks. Thus in the previous chapter, which exposes some of the shortcomings of IFRS, it is clear that these shortcomings are at their most serious in the case of the accounts of banks. There are at least two interconnected reasons for this.

135. First, an important part of the accountancy process is the correct valuation of assets. Indeed, a new process, customarily known as mark-to-market, under which assets are accounted for at market rather than book value, was introduced for just this reason. But the difficulty of correctly valuing the financial assets held by banks, particularly the highly complex and often somewhat artificially constructed financial instruments that have proliferated since the millennium, is of a wholly different order of magnitude from the difficulty of valuing the bulk of the assets held by the general run of companies. Moreover, in many cases and at many times the ‘market’ is a dangerously narrow one. Indeed, in many cases it is narrow to the point of non-existence, in which case the accepted practice is to use what is known as ‘mark-to-model’, valuing assets on the basis of financial models. This inevitably adds to the problems of complexity and an inadequate market the problem of the real-world (as opposed to mathematical) reliability of the model.

136. Second, given these complexities and uncertainties of valuation, it is all the more important that auditors should err on the side of prudence. Yet the evidence we have received has demonstrated that the advent of IFRS has led to a culture of box-ticking and ‘neutrality’ at the expense of prudence. This is particularly serious in the case of banks where, given their crucial importance to the health of the economy as a whole and the uniquely troubling consequences of a major bank failure, the necessity of erring on the side of prudence cannot be overstated.

137. But during the course of our inquiry we have found some other grave defects in the auditing of banks, unrelated to the advent of IFRS, and it is to these we now turn in this chapter.

138. The banking crisis of 2007–09 raised the question (among others) why there was so little warning that so many banks were in trouble and that the world’s financial system was at risk. The role of auditors in the crisis is naturally of most interest to this inquiry. We do not seek to apportion blame but to draw lessons, bearing in mind that, with hindsight, responsibility for the crisis and the lack of warning was shared by almost all the players in the system. As Lord Myners put it, “the financial crisis revealed the failure of just about everybody ... [but] the auditing profession, the accounting profession, cannot be excluded from those who must share responsibility and, more importantly, seek to learn lessons.”171

139. To learn the right lessons, it helps to know what happened. With audit, this is not easy. Although, in the words of Professor Vivien Beattie of Glasgow University, “accounting and auditing is what underpins the capital

171 Q 483.
markets,” the uninitiated cannot see it. Only the auditors themselves, and perhaps the client’s Audit Committee and the FRC’s Audit Inspection Unit (AIU) know just how thorough was a given audit and what it saw. Except in rare cases where the accounts are qualified, others make do with an anodyne assurance that the financial statements drawn up by the audited company are not misleading. As Professor Stella Fearnley of the University of Bournemouth said: “The quality of the audit is quite often unobservable to the client themselves.”

In the words of Mr Guy Jubb, Head of Corporate Governance at Standard Life Investments, “the output of the audit is the audit report and that is what we see. We have very little transparency currently as to what the actual audit process involves … audit reports … are very, very standardised in their content … are often … riddled with ‘get out of jail free’ clauses”.

Mr Jubb was nevertheless clear that “the reliability that we have to place upon audited financial information is the lifeblood of capital markets.”

140. **There is a particular—and particularly serious—problem with the auditing of banks which has to be faced.** An auditor who encounters a problem which might, in the ordinary course of events, justify a published qualification to the accounts, might understandably be reluctant to insist on this in the case of a bank. They might fear that to do so could cause a collapse of confidence and a run on the bank, to the detriment of the shareholders and, quite possibly, of the wider public interest. While this problem cannot be entirely avoided, we recommend in paragraphs 164, 165 and 167 how it can best be minimised.

141. We were especially interested in how the bank auditors had approached their tasks at the end of 2007, when as we now know the crisis was already under way, and at the end of 2008, when several banks were on their knees. We wished to know if they had seen signs of impending trouble in 2007 and, if so, what action they had taken. And for 2008, at the height of the crisis, with various banks needing state bailouts to survive, we wanted to know on what basis the auditors had signed off their financial statements, and opined that banks were still going concerns and we also wanted to know if they had had assurances of support from the Government. We questioned the senior partners in the UK of the Big Four (of which only three, Deloitte, KPMG and PwC, audit large British banks).

142. The Big Four expressed the general view that in auditing banks before and during the crisis they had carried out their duties properly. Mr John Connolly, Senior Partner and Chief Executive, Deloitte, denied there was a failure of audit. Mr John Griffith-Jones, Chairman, KPMG, recalled that the scope of statutory audit is limited: “The auditor’s primary role is to count the score at the end of the accounting period … not trying to forecast next year’s profits … not responsible … for making an assessment of the risk of the business … if you have a company that has leverage of 100 times and a company that has no leverage at all, the audit report is the same … It is the

172 Q 2.
173 Q 10.
174 QQ 405-406.
175 Q 405.
176 Q 263.
role of the auditors to point out weaknesses in controls.” Mr Ian Powell, Chairman and Senior Partner, PwC, agreed: “It’s not the job of the auditor presently to look at the business model of a business. That is the job of management.” He acknowledged however that in “undertaking an audit you do look at the market conditions that were extant at the time of signing off the audit.” We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may be that the Big Four carried out their duties properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so.

143. There is inevitably a connection between the assessment of the Big Four’s performance and the question, discussed earlier, of market concentration. The point is that, in the case of auditing, the benefits that might be expected from competition have to be weighed against the fact that oligopoly allows the existence of audit firms that have the size, strength and competence both to conduct the effective audit of large, highly complex, and often global banking groups, and to avoid being cowed by such clients. To the extent that the gain from oligopoly may appear in practice to have been somewhat disappointing, the case for more competition is enhanced.

144. We were told that in assessing whether to endorse a company as a going concern an auditor takes account of “the business’s projected net cash generation and its ability to obtain funding (regardless of the source ... or the circumstances in which the funding is required)” and that in banks, where financing is obtained mainly from deposits, and their retention depends on confidence, “going concern in a bank is therefore inextricably linked with a question of confidence. Whilst confidence is maintained the bank is a going concern; when confidence is lost then it is no longer a going concern.” We received evidence from the Big Four, for example at paragraph 149 below, which seemed to suggest that an auditor might properly regard a bank as a going concern even when a non-bank in a similar position might not be so regarded, since a bank that got into difficulties would be bailed out. It cannot (or at least should not) be taken for granted by auditors that banks in difficulties will be bailed out by the authorities and the taxpayers. We do not accept therefore that this should at any time be a decisive consideration in making the ‘going concern’ judgment.

145. It could be argued that, until 2006, confidence remained generally high in the British and global economy and financial system. The role of bank audits was not then in question. Even at Northern Rock, when PwC concluded its audit for 2006 in January 2007 the company “had a history of profitable operations and had a track record of ready access to funds ... none of the information available to us indicated anything that would constitute a ‘material uncertainty’ ... we concluded that in our opinion there were no matters relating to the going concern basis of accounting that were required to be reported to shareholders.” We find this complacency disturbing. In 2006 Northern Rock was already operating a dangerously risky business

177 Q 274.
178 Q 278.
179 Q 275.
180 ADT 35 (KPMG).
181 ADT 36.
model. The FSA said: “Northern Rock, relative to its peers, [had] a high public target for asset growth (15–25% year-on-year) and for profit growth; a low net interest margin; a low cost:income ratio; and relatively high reliance on wholesale funding and securitisation.” As a result of this business model it was able to increase its share of the UK mortgage market at an extraordinary rate. Northern Rock’s market share of net residential lending jumped from 11.2% in 2004 to 18.9% in the first half of 2007. We are astonished that PwC appeared not to recognize an amber light that flashed so brightly.

146. The Bank of England’s timeline of crisis events, annexed to its Financial Stability Report of June 2009, starts only in March 2007. It may be argued that it would have required unusual prescience on the part of auditors to spot trouble coming in banks’ financial statements for the year 2006, although this does not apply in the case of Northern Rock. It is true that, even if the auditors did have concerns, they were confronted with the problem referred to in paragraph 140 above. But we were provided with no evidence from the Big Four that they did, in fact, have any concerns.

147. A year later, as bank audits were prepared in late 2007, the writing was on the wall. Mr Powell said: “The closure of the wholesale markets in the second half of 2007 created real difficulty for many banks ... one of the key questions around the banks ... at the year-end 31 December 2007 was ... is there adequate liquidity or is there likely to be liquidity provided to these banks to survive” so that auditors could sign off a going-concern opinion. He added that PwC reported to the FSA on 11 September 2007 that they “had concerns about the going concern of Northern Rock” and “Northern Rock asked for emergency support from the Bank of England on 13 September and were granted that”. But since “other banks were all still funding themselves in the short-term wholesale markets at the end of 2007 and market conditions were still showing signs of easing when banks announced their results in February 2008 ... auditors ... had no reason to believe that a going concern qualification was appropriate with respect to the financial reports for the financial years ending 31 December 2007”. We do not accept this. A going concern qualification was clearly warranted in several cases, even if the auditors may understandably have been reluctant to make it for the reason referred to in paragraphs 140 and 144 above.

148. Other bank auditors also maintained that circumstances at the end of 2007 were not so difficult as to justify qualifying going concern opinions on banks. In KPMG’s view, there were “two key issues which had given cause for concern during the year—firstly in relation to lack of liquidity, particularly in respect of the securitisation markets, and secondly in relation to the valuation of securitised assets”. But “for the UK banking industry in general there was insufficient evidence to believe at that time that a material uncertainty in

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182 FSA Internal Audit Division, The supervision of Northern Rock: a lessons learned review, Executive Summary, para 15, March 2008.
183 Net residential lending refers to mortgages advanced in a given period minus redemptions.
184 Northern Rock 2007 interim results.
186 Q 266.
187 QQ 267-268.
188 ADT 36.
relation to going concern existed in this regard.” Deloitte’s view was similar and was reinforced by official intervention in the markets: “We did not have significant concerns about going concern for the majority of our clients. This assessment was reached after considering both the state of the banking market and the actions of the Treasury, the Bank of England and others following the collapse of Northern Rock ... nobody ... predicted the total market dislocation that would occur later in 2008.”

In late 2008 and early 2009, banks were audited during a general loss of confidence following the bankruptcy of Lehman Brothers. The Big Four auditors were in close touch with the authorities. Mr Scott Halliday, Managing Partner, Ernst & Young, said: “At the banking crisis, all four of us had meetings with the Bank of England around trying to improve the dialogue between the Bank of England and the firms.” Mr Connolly described the Big Four’s approach to the Chancellor of the Exchequer, which resulted in a meeting at the Treasury on 16 December 2008 with the then Financial Services Secretary, Lord Myners. “All four of the people here had detailed discussions, instigated by the Big Four, with Lord Myners because of the circumstances we were in. It was recognised that the banks would only be going concerns if there was support forthcoming ... it was a proper and appropriate act from the four firms to seek to understand the likelihood of support being forthcoming ... had we concluded ... that there was not going to be support, then a different audit opinion would have been given.” Lord Myners “provided evidence of the Government’s actions and the extent of their commitment which would support the management, directors and auditors in forming their view on going concern ... we also considered the evidence obtained by ... our banking clients [on] the recapitalisation scheme, the Bank of England’s Liquidity Scheme and the Treasury’s Credit Guarantee Scheme ... concluded that ... support ... would ... avoid ... significant uncertainty as to going concern.”

Lord Myners also gave us his account of the meeting described by Mr Connolly. To the best of his knowledge it was a unique event; there were no similar meetings in 2007 or 2009. Lord Myners reminded the auditors that the “Government were committed to taking whatever action they regarded as necessary to maintain financial stability” and said he would “like to maintain a regular dialogue with them on this issue relating to the preparation and completion of year-end accounts” but “they did not seek an additional meeting.” His subsequent letter in reply to Mr Griffith-Jones included the statement that the Government remained “committed to taking whatever action is necessary to maintain financial stability and to protect depositors and the taxpayer.” Lord Myners also told us that “with auditing

189 ADT 35.  
190 ADT 33.  
191 Q 256.  
192 Mr John Griffith-Jones’s letter to the Chancellor of 11 November 2008 - available at  
193 Q 263.  
194 Lord Myners’s reply of 17 December 2008 - available at  
195 ADT 33 (Deloitte).  
196 Q 473.  
197 Q 466.
and accounting for banks ... there has to be an underlying assumption of continued confidence.”

151. Lord Myners added that, around the time of his meetings with the Big Four auditors, he invited the chairs of audit companies of major banks to meetings, and was disappointed that they mostly showed only a “cloudy” grasp of valuation models of complex financial instruments. In defence of the audit chairs, it has to be said that very few in senior management positions in the major banks had more than a ‘cloudy’ grasp themselves of the mathematical models used to value the banks’ complex financial instruments. It is clear, moreover, that the models, whether grasped cloudily or not, gave a false sense of security to the banks. We are not clear, however, to what extent if at all the Big Four conducted an independent assessment of the reliability of these models.

152. Press reports of the time make clear that it was known publicly that a meeting between the Big Four auditors and the responsible Treasury Minister had taken place. Audited financial statements by banks for 2008 were issued at the usual time in early 2009. That of Royal Bank of Scotland included “extensive disclosure of the liquidity provided by central banks ... and support from the UK Government ... also a going concern statement which referred explicitly to the UK Government’s support.”

153. By the time banks were audited in late 2008, events had shattered confidence in most of them. Auditors and Ministers recognised that banks could be seen as going concerns only if continuing support by the Government was assured. They reached an understanding to enable auditors to sign off on banks’ financial statements—some of which acknowledged dependence on Government support.

154. We are concerned at a number of aspects of the above narrative. Not only were the contacts between the Big Four and the authorities few and far between, but they appear to have occurred very late in the day, in particular the meeting with Lord Myners in December 2008. Moreover Mr Halliday of Ernst & Young referred only to “meetings with the Bank of England around trying to improve the dialogue between the Bank of England and the firms,” despite the fact that the authority responsible for the supervision of the banks was, and had been since 1997, the Financial Services Authority.

155. Adequate and timely dialogue between bank auditors and supervisors is of the first importance. It is essential not only to enable the auditors to audit more effectively and the supervisors to supervise more effectively, but in particular to overcome the problem caused by the understandable reluctance of auditors to qualify banks’ accounts. It is to this we now turn.

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108 Q 467.
109 Q 478.
111 The Sunday Times, ‘Brown calls in UK’s top bank bosses’ by Iain Dey and David Smith, 11 January 2009.
112 ADT 33 (Deloitte).
113 Q 256.
Dialogue between bank auditors and supervisors

156. The importance of close dialogue between bank auditors and supervisors first came to the fore in the wake of the collapse of Johnson Matthey Bankers in 1984, which led to the Bank of England (at that time responsible for bank supervision in the UK, a responsibility which it lost to the Financial Services Authority in 1997 and which it is now about to resume) acquiring JMB and all its liabilities (for the sum of £1). It rapidly became clear both that the Bank had fallen down badly in the exercise of its supervisory responsibilities and that JMB’s auditors, Arthur Young, had also failed to do their job adequately.204

157. Accordingly, the Bank commenced legal action against the auditors for negligence which led Arthur Young to make a substantial payment to the Bank in an out-of-court settlement; and on the wider issue of bank supervision in general the Chancellor appointed a Committee of Inquiry, under the chairmanship of the Governor. The Committee’s report was published in June 1985 and, among other recommendations, proposed: “A mechanism should be established to enable a regular dialogue to take place between the supervisors and banks’ auditors. Existing confidentiality restraints on both parties should be removed … as soon as possible by legislation.”205 This duly appeared as one of the more significant proposals of the White Paper on Banking Supervision published in December 1985, and was translated into legislative form in the Banking Act of 1987.206

158. This overcame what had previously been seen as a practical impediment to regular and adequate dialogue, including the sharing of information, between bank auditors and supervisors, namely the concern of many auditors that this would breach their duty of confidentiality to their client. (It was also the case that the previous Government’s 1979 Banking Act, which the 1987 Act was to replace, appeared to prohibit the supervisor passing information to the auditors). The 1987 Act, among a number of other provisions, in the explicit interest of furthering a regular dialogue, established for the first time that a bank auditor who provided the supervisor with confidential information or opinions about a client for the purpose of better supervision would have full statutory protection against any action for breach of good faith or confidentiality. It also gave a reserve power to the Treasury to oblige the auditor to disclose such information, should this appear not to be occurring—if, for example, it was not required by the accountant’s professional body.207

159. The provisions of the 1987 Act explicitly concerned communication between the auditors and the Bank of England, which was then the supervisory authority. The transfer in 1997 of this responsibility from the Bank to the Financial Services Authority meant that the relevant provisions needed to be reenacted in the legislation implementing the transfer, so as to ensure the necessary dialogue between the auditors and the FSA.

160. However, in practice the regular dialogue which had been working well following the passage of the 1987 Act appeared to fall into desuetude

204 Nigel Lawson (1993), The View from Number 11.
205 Report of the Committee set up to consider the system of banking supervision, June 1985.
206 Nigel Lawson (1993), The View from Number 11.
207 Nigel Lawson (1993), The View from Number 11; Banking Act (1987) Section 47.
following the 1997 transfer of supervisory responsibility from the Bank to the FSA. Of the three troubled banks which subsequently had to be bailed out by the taxpayer—Northern Rock, HBoS and the Royal Bank of Scotland—we were informed that in 2006 there was not a single meeting between the FSA and the external auditors of either Northern Rock (PwC) or HBoS (KPMG), and only one meeting between the auditor of RBS (Deloitte) and the FSA; and that in the whole of 2007 there was only one FSA/auditors meeting with each bank auditor. Even in 2008 there were only two meetings between the FSA and the auditors of Northern Rock and HBoS and none between the FSA and the auditors of RBS. As the FSA admitted to us, “the regular practice of auditor-supervisor meetings fell away gradually following the transition from the Bank of England to the FSA as banking supervisor.”

161. We are unclear at what level and at what depth these very few meetings took place. We regard the recent paucity of meetings between bank auditors and regulators, particularly in a period of looming financial crisis as a dereliction of duty by both auditors and regulators.

162. In its written evidence to us, the Bank of England acknowledged: “The working relationship between external auditors and the prudential supervisors had broken down in the period prior to the financial crisis. Prior to 2007, formal meetings between supervisors and external auditors no longer formed part of the routine supervisory framework and the informal channels of communication that existed when the Bank had responsibility for supervision had fallen away. The FSA had also in this period made much less frequent use of skilled persons’ reports as a routine supervisory tool [these had been another innovation of the 1987 Act]. The regular meetings that these had previously engendered helpfully reinforced the links between the auditor and supervisor. All [that is, the Bank and the FSA] agreed that the auditor has an important role to play in the regulatory framework and that an effective relationship between the two parties needed to be re-established.”

163. The way forward proposed by the Bank and the FSA was a code of practice for the relationship between the external auditor and the supervisor, and indeed a draft code with precisely this description was duly published by the FSA for ‘guidance consultation’ in February 2011.

164. We welcome the Code of Practice proposed by the Bank of England and the FSA for the relationship between the external auditor and the supervisor. But in the light of the regrettable backsliding of the years 1997–2007, and of the manifest importance of this issue, we believe that a Code of Practice does not go far enough. A statutory obligation is required.

165. This might take the form of a mandatory quarterly meeting, at the highest appropriate level, between the supervisory authority and the external auditor of each bank whose failure might, in the view of the supervisory authority, pose a systemic risk. There might be a further requirement for either side to initiate a meeting between the regular quarterly meetings should information come to light which might warrant such a meeting.

208 ADT 28.
209 ADT 75.
166. We therefore welcome the statement by Mr Mark Hoban MP, Financial Secretary to the Treasury, in his evidence to us that “if the Bank were to say that we need this [the requirement for adequate dialogue between auditors and supervisors] in the statute, then I would be happy to see that happen.”

We also note the statement by Mr Paul Lee, Director of Hermes Equity Ownership Services, speaking as a major bank shareholder, that despite the fact that the confidential information disclosed at private meetings between auditors and supervisors would not be available to shareholders, “we would not be concerned by such dialogue. We would welcome it.”

167. There was no single cause of the banking meltdown of 2008–09. First and foremost, the banks have themselves to blame. As our predecessor Committee found in its report on Banking Supervision and Regulation in 2009, the supervisory system put in place in 1997 proved unfit for purpose. But we conclude that the complacency of bank auditors was a significant contributory factor. Either they were culpably unaware of the mounting dangers, or, if they were aware of them, they equally culpably failed to alert the supervisory authority of their concerns. Our recommendations are designed to address these failings and thus make a repetition less likely.

210 Q 529.
211 Q 436.
CHAPTER 7: CONCLUSIONS AND RECOMMENDATIONS

168. The audit of large firms, in the UK and internationally, is dominated by an oligopoly with all the dangers that go with that. The oligopoly’s power is underpinned by the fact that large firms are legally obliged to have their financial statements audited. (para 15)

169. A self-reinforcing cycle has helped to consolidate the dominance of the Big Four. Factors include:
   i. the internationalisation of business;
   ii. the scale of investment and capital required in an audit firm;
   iii. economies of scale in audit;
   iv. a semi-captive market;
   v. non-interventionist competition authorities;
   vi. the perception that big is best;
   vii. the reputational assurance of using Big Four auditors; and
   viii. the fall of Arthur Anderson. (para 18)

170. Most witnesses believe that the dominance of the Big Four limits competition and choice in the audit market. Ethically, audit firms are unable to accept work which would place them in conflict with other work for the same or other clients. This is a special problem in the UK banking sector, where only three of the Big Four are active. Banks’ choice of auditor is sometimes limited by the need to avoid using a firm engaged by another bank. (para 26)

171. All witnesses fear the real possibility that one of the Big Four might withdraw leaving a Big Three (or even a Big Two, in the bank audit market). We agree. Loss of one of the Big Four would restrict competition and choice to an unacceptable extent. This is one reason for our recommendation of an Office of Fair Trading (OFT) investigation into the audit market. (para 27)

172. Attempts to introduce greater competition into the audit market have so far failed. Market concentration is as great as ever. The last set of recommendations from the Financial Reporting Council’s Market Participants Group in 2007 lacked teeth. It has had no effect in lessening the dominance of the Big Four. (para 33)

173. Measures envisaged by the Minister, Mr Edward Davey MP of the Department for Business, Innovation and Skills, focus on transparency and disclosure. These echo the approach of the FRC Market Participants Group—an approach that has palpably failed. We were disappointed that the Minister is not more ambitious. We would expect exactly the same result for the measures he advocated to our Committee as the FRC’s measures have had. It may be sensible to introduce these measures on their own merits. But they do not add up to a policy of creating greater competition and choice, of altering the current oligopolistic situation, or of addressing the risks of the Big Four coming down to a Big Three. (para 35)

174. One suggested way to enhance competition would be to introduce mandatory joint audit where each audit firm signs off the audit report and opinion. The Committee is not convinced that this would deliver better
accounts. It would certainly add bureaucracy and cost. It has only been applied in very few countries where the results do not amount to a resounding recommendation in their favour. But if it were promoted in the UK as a means to reduce market concentration, it should be on the basis that at least one joint auditor was a non-Big Four firm. (para 40)

175. The very long tenure of auditors at large companies is evidence of the lack of competition and choice in the market for the provision of audit services. A regular tender, with a non Big Four auditor invited to participate, should promote greater competition to the benefit of both cost and quality. We recommend that FTSE 350 companies carry out a mandatory tender of their audit contract every 5 years. The Audit Committee should be required to include detailed reasons for their choice of auditors in their report to shareholders. (para 44)

176. We recommend that:
   i. audit committees should hold discussions with principal shareholders every five years;
   ii. the published report of the audit committee should detail significant financial reporting issues raised during the course of the audit;
   iii. they should also explain the basis of the decision on audit tendering and auditor choice; and
   iv. the FRC’s UK Corporate Governance and Stewardship Codes should be amended accordingly. (para 49)

177. Like the FRC’s Market Participants’ Group measures, the changes we recommend above should be marginally beneficial. But they would not deal with the fundamental issue of audit market concentration. Regrettably, with the notable exception of our investor witnesses, most shareholders appear to care little about a company’s choice of auditor. It seems improbable that this apathy will soon be remedied. So measures which rely on shareholder engagement to help lessen audit market concentration are unlikely to be effective. (para 50)

178. Baroness Hogg told us that the expected abolition of the Audit Commission would provide an opportunity to increase competition and choice in the audit market if it formed the basis of a substantial new competitor to the Big Four. We recommend that the Government should work to encourage the emergence of such a competitor. (para 53)

179. The Government should make greater efforts, within EU procurement rules, to enable non-Big Four firms to win public sector work. This should include any work no longer undertaken by the Audit Commission. (para 55)

180. We consider that the OFT should conduct a market study of restrictive bank covenants. This would form part of the wider inquiry into the audit market which we recommend later in this report. (para 57)

181. Auditors’ unlimited liability needs to be investigated to determine whether it deters non-Big Four auditors from taking on large listed clients. This too could form part of an Office of Fair Trading (OFT) investigation into the audit market which we recommend later in the report. (para 60)

182. The leading second-tier audit firms have told us that their scope for growth is not constrained by any problems of access to capital. So we see no immediate grounds to change the law to lift limits on shareholdings by non-auditors in
audit firms, especially since such a change would carry the risk that auditors might become less independent. The OFT should also examine limits on share ownership as part of its investigation. (para 64)

183. We strongly support the development of separate risk committees in banks and major financial institutions. Other large companies should institute them where appropriate. Such committees will increasingly require specialist skills and external advice. This advice should not be provided by the firm which is the company’s auditor. Providing it could open opportunities for non-Big Four accountancy firms to enter the large company market in a way which they have found difficult to do. (para 69)

184. We believe that every bank should have a properly constituted and effective Risk Committee of the Board. It should be one of the duties of the external auditor to ensure that this is done, by making clear that if it is not, the auditor will say so in a qualification to the accounts. This is best dealt with by rules made and guidance issued by the FRC rather than by being made a statutory requirement. Reference should however be made to it in legislation on the relationship between financial supervisors and auditors, to which we return later in the report. (para 70)

185. In order to lower regulatory costs, there is a strong case for some reduction in the audit requirement on smaller companies. This is unlikely to reduce audit market concentration, since the audit requirement would remain in place for the large listed companies where the Big Four predominate. (para 75)

186. Investors and others demand that audit should provide broader, more up-to-date, assurance on such matters as risk management, the firm’s business model and the business review. This additional assurance would help the audit to meet the current expectations of investors and the wider public. Any widening of auditors’ assurance would radically change their role. Again the OFT should address this issue as part of its broader review of the workings of the audit market. (para 79)

187. We are not convinced that a complete ban on audit firms carrying out non-audit work for clients whose accounts they audit is justified. But we recommend that a firm’s external auditors should be banned from providing internal audit, tax advisory services and advice to the risk committee for that firm. We also recommend that the Office of Fair Trading should examine whether any other services should be banned from being carried out by a firm’s external auditors. (para 87)

188. Any move from the Big Four to a Big Three would create an unacceptable degree of market concentration. Choice and competition in the audit market would be seriously undermined. (para 89)

189. We recommend that the Government and regulators should promote the introduction of living wills for Big Four auditors. These would lay out all the information the authorities would need to separate the good from the failing parts of an audit firm so disruption to the financial system from a collapse would be minimised. (para 92)

190. In this report we have recommended a number of measures to reduce the dominance of the Big Four in the large firm audit market. But within the time and the resources available to us, we have not been able fully to address all the highly complex issues which may stem from market concentration. These include:
i. lack of choice;
ii. higher fees than in a more competitive market;
iii. lower quality; and
iv. the huge risks involved if one of the Big Four left the audit market.

A thorough review of the issues in depth and in the round is overdue. We recommend that the OFT should conduct such an investigation into the audit market in the UK, with a view to a possible referral to the Competition Commission. Its findings would need to take full account of the international dimension, but the UK could give a lead internationally by undertaking such a review. (para 98)

191. The regulation of accounting and auditing is fragmented and unwieldy with manifold overlapping organisations and functions. This is neither productive nor necessary. Other professions have only one regulator—medicine for example under the General Medical Council. The wider powers sought by the Financial Reporting Council would go some way to simplifying and streamlining matters for audit. But further impetus needs to be given to rationalisation and reform. We hope and expect that the profession will provide that impetus. In the absence of rapid progress, we recommend that the Government stand ready to impose a remedy. (para 110)

192. Obvious benefits should flow from global adoption of common accounting standards for a global economy. But there is a corresponding risk that the lowest common denominator will prevail. So all concerned need to insist on the highest possible standards of rigour, clarity and quality of accounting and audit. (para 129)

193. We accept that standards for use in many countries need clear rules which all can apply. It follows that IFRS is more rules-based than UK GAAP. But we are concerned by evidence that, by limiting auditors’ scope to exercise prudent judgment, IFRS is an inferior system which offers less assurance. IFRS also has specific defects, such as its inability to account for expected losses. The weaknesses of IFRS are especially serious in relation to bank audits. (para 130)

194. We recommend that the profession, regulators and the Government should all seek ways to defend and promote the exercise of auditors’ traditional, prudent scepticism. The Government should reassert the vital role of prudence in audit in the UK, whatever the accounting standard, and emphasise the importance of the going concern statement. (para 131)

195. Achieving general agreement on IFRS could be a long and uncertain process. In the meantime, we recommend that the Government and regulators should not extend application of IFRS beyond the larger, listed companies where it is already mandatory. Continued use of UK GAAP should be permitted elsewhere, so that the basis of a functioning, alternative system remains in place in case IFRS do not meet their aims. (para 132)

196. As it revises banking regulation, we recommend that the Government should have the importance of accounting standards at the forefront of its mind. It should promote a prudent interpretation of IFRS as applied to banks. This would include sober valuation of complex financial instruments. At present IFRS permits recognition only of incurred losses, not expected losses. So it is essential that banks put aside reserves in good times to provide against downturns. This would have the incidental advantage of reducing the scope for banks to pay bonuses on the basis of profits struck without taking account
of possible losses. We recognise that a fully satisfactory outcome depends on international negotiation and believe that the Government should give a lead. (para 133)

197. There is a particular—and particularly serious—problem with the auditing of banks which has to be faced. An auditor who encounters a problem which might, in the ordinary course of events, justify a published qualification to the accounts, might understandably be reluctant to insist on this in the case of a bank. They might fear that to do so could cause a collapse of confidence and a run on the bank, to the detriment of the shareholders and, quite possibly, of the wider public interest. While this problem cannot be entirely avoided, we recommend in paragraphs 164, 165 and 167 how it can best be minimised. (para 140)

198. We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may be that the Big Four carried out their duties properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so. (para 142)

199. It cannot (or at least should not) be taken for granted by auditors that banks in difficulties will be bailed out by the authorities and the taxpayers. We do not accept therefore that this should at any time be a decisive consideration in making the ‘going concern’ judgment. (para 144)

200. Adequate and timely dialogue between bank auditors and supervisors is of the first importance. It is essential not only to enable the auditors to audit more effectively and the supervisors to supervise more effectively, but in particular to overcome the problem caused by the understandable reluctance of auditors to qualify banks’ accounts. (para 155)

201. We regard the recent paucity of meetings between bank auditors and regulators, particularly in a period of looming financial crisis as a dereliction of duty by both auditors and regulators. (para 161)

202. We welcome the Code of Practice proposed by the Bank of England and the FSA for the relationship between the external auditor and the supervisor. But in the light of the regrettable backsliding of the years 1997–2007, and of the manifest importance of this issue, we believe that a Code of Practice does not go far enough. A statutory obligation is required. (para 164)

203. This might take the form of a mandatory quarterly meeting, at the highest appropriate level, between the supervisory authority and the external auditor of each bank whose failure might, in the view of the supervisory authority, pose a systemic risk. There might be a further requirement for either side to initiate a meeting between the regular quarterly meetings should information come to light which might warrant such a meeting. (para 165)

204. There was no single cause of the banking meltdown of 2008–09. First and foremost, the banks have themselves to blame. As our predecessor Committee found in its report on Banking Supervision and Regulation in 2009, the supervisory system put in place in 1997 proved unfit for purpose. But we conclude that the complacency of bank auditors was a significant contributory factor. Either they were culpably unaware of the mounting dangers, or, if they were aware of them, they equally culpably failed to alert the supervisory authority of their concerns. Our recommendations are designed to address these failings and thus make a repetition less likely. (para 167)
APPENDIX 1: ECONOMIC AFFAIRS COMMITTEE

The Members of the Committee that conducted this inquiry were:

Lord Best
Lord Currie of Marylebone*
Lord Forsyth of Drumlean
Lord Hollick
Baroness Kingsmill*
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord MacGregor of Pulham Market (Chairman)
Lord Mac荫nan of Rogart†
Lord Moonie
Lord Shipley†
Lord Smith of Clifton
Lord Tugendhat

*Lord Currie of Marylebone and Baroness Kingsmill did not take part in this inquiry.

† Lord Mac荫nan of Rogart and Lord Shipley were members of the Committee for only part of the duration of the inquiry.

Professor Andrew D Chambers, Professor of Corporate Governance at London South Bank University, was Specialist Adviser for this inquiry.

Declaration of Interests

The following interests were declared:

BEST, Lord

Chairman of the audit committee, Royal Society of Arts, previously audited by Deloitte, now by Haysmacintyre
Chairman of the Hanover Housing Group and member of the audit committee: external audit by KPMG, internal audit by BDO

FORSYTH OF DRUMLEAN, Lord

Director of companies, all listed in the in the Register of Members’ interests, all audited by members of the accountancy profession

HOLlick, Lord

Member of the audit committee of Diageo, audited by KPMG

LAWSON OF BLABY, Lord

Chairman of an unlisted company, listed in the Register of Members’ Interests, audited by Citroen Wells

LEVENE OF PORTSOken, Lord

Director of a number of companies, all listed in the Register of Members’ Interests, all audited by members of the accountancy profession

MACGREGOR OF PULHAM MARKET, Lord

Chairman, House of Lords Audit Committee
Chairman of three Pension Fund Trustees with auditors

MOONIE, Lord

Chairman of the audit committee of a company audited by BDO
SHIPLEY, Lord
Member of the audit Committee of One North East, the Regional Development Agency for the north-east. The auditors are KPMG and the National Audit Office.

TUGENDHAT, Lord
As Chairman of the Imperial College Healthcare NHS Trust, attends meetings of its audit committee

A full list of Members’ interests can be found in the Register of Lords’ Interests: http://www.parliament.uk/mps-lords-and-offices/standards-and-interests/register-of-lords-interests
APPENDIX 2: LIST OF WITNESSES

Oral Evidence

12 October 2010

Professor Michael Power, London School of Economics, Professor Vivien Beattie, University of Glasgow, and Professor Stella Fearnley, Bournemouth University

Written evidence, Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines (ADT 1)

Supplementary written evidence, Professor Stella Fearnley (ADT 51)

Further supplementary written evidence, Professor Stella Fearnley (ADT 2)

Further supplementary written evidence, Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines (ADT 3)

19 October 2010

Mr Charles Tilley, Chartered Institute of Management Accountants, Ms Helen Brand, Association of Chartered Certified Accountants, Mr Robert Hodgkinson, Institute of Chartered Accountants in England and Wales, and Mr Iain McLaren, Institute of Chartered Accountants of Scotland

Written evidence, Associated of Chartered Certified Accountants (ADT 4)

Written evidence, Chartered Institute of Management Accountants (ADT 5)

Written evidence, Institute of Chartered Accountants in England and Wales (ADT 6)

Written evidence, Institute of Chartered Accountants of Scotland (ADT 7)

Supplementary written evidence, Institute of Chartered Accountants in England and Wales (ADT 8)

Further supplementary written evidence, Mr Vernon Soare, Institute of Chartered Accountants in England and Wales (ADT 9)

26 October 2010

Mr Jonathan Hayward, Independent Audit Limited, Mr Stephen Kingsley, FTI Consulting, Dr Gunnar Niel, Oxera, and Mr Timothy Bush

Written evidence, Mr Timothy Bush (ADT 10)

Supplementary evidence, Mr Timothy Bush (ADT 11)

Written evidence, Independent Audit Limited (ADT 12)

Written evidence, Mr Stephen Kingsley (ADT 13)

Supplementary written evidence, Independent Audit Limited (ADT 14)

Supplementary written evidence, Mr Timothy Bush (ADT 15)

Further supplementary written evidence, Mr Timothy Bush (ADT 16)

Further supplementary written evidence, Mr Timothy Bush (ADT 16a)

Further supplementary written evidence, Mr Timothy Bush (ADT 17)

Further supplementary written evidence, Mr Timothy Bush (ADT 18)
2 November 2010

Mr David Herbinet, Mazars LLP, Mr Steve Maslin, Grant Thornton UK LLP, Mr Simon Michaels, BDO LLP, and Mr Russell McBurnie, RSM Tenon

Written evidence, BDO LLP (ADT 19)
Written evidence, Grant Thornton UK LLP (ADT 20)
Written evidence, Mazars LLP (ADT 21)
Supplementary written evidence, Grant Thornton UK LLP (ADT 22)
Supplementary written evidence, Mazars LLP (ADT 48)

Mr Lee White and Mr Andrew Stringer, Institute of Chartered Accountants in Australia

Written evidence (ADT 23)

9 November 2011

Mr Philip Collins and Mr David Stallibrass, Office of Fair Trading, Baroness Hogg and Mr Stephen Haddrill, Financial Reporting Council, Ms Sally Dewar and Mr Richard Thorpe, Financial Services Authority

Written evidence, Financial Reporting Council (ADT 24)
Written evidence, Financial Services Authority (ADT 25)
Written evidence, Office of Fair Trading (ADT 26)
Supplementary written evidence, Financial Reporting Council (ADT 27)
Supplementary written evidence, Financial Services Authority (ADT 28)
Supplementary written evidence, Office of Fair Trading (ADT 49)

23 November 2010

Mr Scott Halliday, Ernst & Young, Mr Ian Powell, PricewaterhouseCoopers, Mr John Griffith-Jones, KPMG, and Mr John Connolly, Deloitte

Written evidence, Deloitte (ADT 29)
Written evidence, Ernst & Young (ADT 30)
Written evidence, KPMG (ADT 31)
Written evidence, PricewaterhouseCoopers (ADT 32)
Supplementary written evidence, Deloitte (ADT 33)
Supplementary written evidence, Ernst & Young (ADT 34)
Supplementary written evidence, KPMG (ADT 35)
Supplementary written evidence, PricewaterhouseCoopers (ADT 36)

7 December 2010

Mr Ashley Almanza, The Hundred Group of Finance Directors and BG Group, Mr Robin Freestone, The Hundred Group of Finance Directors and Pearson Group, Mr Graham Roberts, British Land, and Mr Martin ten Brink, Royal Dutch Shell

Written evidence, The Hundred Group (ADT 37)
Written evidence, Mr Graham Roberts (ADT 38)
Written evidence, Royal Dutch Shell plc (ADT 39)
14 December 2010

*The Lord Sharman, Dr Ian Peters, and Dr Sarah Blackburn, Chartered Institute of Internal Auditors*

Written evidence, Chartered Institute of Internal Auditors (ADT 40)

Supplementary written evidence, Lord Sharman (ADT 41)

11 January 2011

*Mr David Pitt-Watson and Mr Paul Lee, Hermes, Mr Iain Richards, Aviva Investors, Mr Guy Jubb, Standard Life Investments and Mr Robert Talbut, the Royal London Asset Management and the Association of British Insurers*

Written evidence, Association of British Insurers (ADT 42)

Supplementary written evidence, Mr Paul Lee (ADT 43)

Supplementary written evidence, Mr Iain Richards (ADT 44)

Further supplementary written evidence, Mr Iain Richards (ADT 45)

Supplementary written evidence, Mr Guy Jubb (ADT 46)

18 January 2011

*Professor David Myddelton, Institute of Economic Affairs, Mr Steve Cooper, International Accounting Standards Board, and Mr Roger Marshall, Accounting Standards Board*

Supplementary written evidence, IASB / IFRS Foundation (ADT 50)

*The Lord Myners*

*Mr Paul Taylor, Fitch Ratings, Mr Alastair Wilson, Moody’s Ratings, and Mr Dominic Crawley, Standard & Poor’s*

25 January 2011

*Mr Mark Hoban MP, HM Treasury, Mr Edward Davey MP and Mr Richard Carter, Department for Business, Innovation and Skills*

Written evidence (ADT 47)

**Written Evidence**

Evidence marked * is associated with oral evidence and is printed. Other evidence is published online at [http://www.parliament.uk/holeconomicaffairs](http://www.parliament.uk/holeconomicaffairs) and available for inspection at the Parliamentary Archives (020 7219 5314).

**Numerical Order**

*Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines (ADT 1)*

*Professor Stella Fearnley (ADT 2)*

*Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines (ADT 3)*

*Association of Chartered Certified Accountants (ADT 4)*

*Chartered Institute of Management Accountants (ADT 5)*

*Institute of Chartered Accountants in England and Wales (ADT 6)*

*Institute of Chartered Accountants of Scotland (ADT 7)*

*Institute of Chartered Accountants in England and Wales (ADT 8)*
Mr Vernon Soare, Institute of Chartered Accountants in England and Wales (ADT 9)
Mr Timothy Bush (ADT 10)
Mr Timothy Bush (ADT 11)
Independent Audit Limited (ADT 12)
Mr Stephen Kingsley (ADT 13)
Independent Audit Limited (ADT 14)
Mr Timothy Bush (ADT 15)
Mr Timothy Bush (ADT 16)
Mr Timothy Bush (ADT 16a)
Mr Timothy Bush (ADT 17)
Mr Timothy Bush (ADT 18)
BDO LLP (ADT 19)
Grant Thornton UK LLP (ADT 20)
Mazars LLP (ADT 21)
Grant Thornton UK LLP (ADT 22)
Institute of Chartered Accountants in Australia (ADT 23)
Financial Reporting Council (ADT 24)
Financial Services Authority (ADT 25)
Office of Fair Trading (ADT 26)
Financial Reporting Council (ADT 27)
Financial Services Authority (ADT 28)
Deloitte (ADT 29)
Ernst & Young (ADT 30)
KPMG (ADT 31)
PricewaterhouseCoopers (ADT 32)
Deloitte (ADT 33)
Ernst & Young (ADT 34)
KPMG (ADT 35)
PricewaterhouseCoopers (ADT 36)
The Hundred Group (ADT 37)
Mr Graham Roberts (ADT 38)
Royal Dutch Shell plc (ADT 39)
Institute of Internal Auditors (ADT 40)
The Lord Sharman (ADT 41)
Association of British Insurers (ADT 42)
Mr Paul Lee, Hermes (ADT 43)
* Mr Iain Richards (ADT 44)
* Mr Iain Richards (ADT 45)
* Mr Guy Jubb (ADT 46)
* Department for Business, Innovation and Skills (ADT 47)
* Mazars LLP (ADT 48)
* Office of Fair Trading (ADT 49)
* IASB / IFRS Foundation (ADT 50)
* Professor Stella Fearnley (ADT 51)

Mr Duncan Alexander (ADT 52)
Baker Tilly UK Audit LLP (ADT 53)
Mr Laurence Longe, National Managing Partner, Baker Tilly UK Audit LLP (ADT 54)
Mr A St John Brown (ADT 55)
Mr Cormac Butler (ADT 56)
California Public Employees Retirement System (CalPERS) (ADT 57)
Corporate Value Associates (ADT 58)
Mr A F D Ferguson (ADT 59)
Mr Michael A. Hadfield (ADT 60)
International Audit and Assurance Standards Board (ADT 61)
Kingston Smith LLP (ADT 62)
Mr Keith Labbett (ADT 63)
Professor Kevin McMeeking (ADT 64)
Mr Cliff Moggs (ADT 65)
Mr P J Morgan (ADT 66)
Mr Bob Pigeon (ADT 67)
Professor Brenda Porter (ADT 68)
Sir Michael Snyder, Professional and Business Services Group (ADT 69)
The Lord Smith of Kelvin (ADT 70)
The Lord Smith of Kelvin (ADT 71)
UK Shareholders’ Association Ltd (ADT 72)
Mr James Wood (ADT 73)
Z/Yen Group Limited (ADT 74)
The Bank of England (ADT 75)
The Lord Flight (ADT 76)
The Rt Hon Lord Tebbit CH (ADT 77)

* Alphabetical Order

Mr Duncan Alexander (ADT 52)
Association of British Insurers (ADT 42)

Association of Chartered Certified Accountants (ADT 4)

Baker Tilly UK Audit LLP (ADT 53)

Mr Laurence Longe, National Managing Partner, Baker Tilly UK Audit LLP (ADT 54)

The Bank of England (ADT 75)

BDO LLP (ADT 19)

Professor Vivien Beattie, Professor Stella Fearnley and Tony Hines (ADT 1 and ADT 3)

Mr A St John Brown (ADT 55)

Mr Timothy Bush (ADT 10, ADT 11, ADT 15, ADT 16, ADT 16a, ADT 17 and ADT 18)

Mr Cormac Butler (ADT 56)

California Public Employees Retirement System (CalPERS) (ADT 57)

Chartered Institute of Management Accountants (ADT 5)

Corporate Value Associates (ADT 58)

Deloitte (ADT 29 and ADT 33)

Department for Business, Innovation and Skills (ADT 47)

Ernst & Young (ADT 30 and ADT 34)

Professor Stella Fearnley (ADT 2 and ADT 51)

Mr A F D Ferguson (ADT 59)

Financial Reporting Council (ADT 24 and ADT 27)

Financial Services Authority (ADT 25 and ADT 28)

The Lord Flight (ADT 76)

Grant Thornton UK LLP (ADT 20 and ADT 22)

Mr Michael A. Hadfield (ADT 60)

Mr Paul Lee (Hermes) (ADT 43)

The Hundred Group (ADT 37)

IASB / IFRS Foundation (ADT 50)

Independent Audit Limited (ADT 12 and ADT 14)

Institute of Chartered Accountants in Australia (ADT 23)

Institute of Chartered Accountants in England and Wales (ADT 6, ADT 8 and ADT 9)

Institute of Chartered Accountants of Scotland (ADT 7)

Institute of Internal Auditors (ADT 40)

International Audit and Assurance Standards Board (ADT 61)

Mr Guy Jubb (ADT 46)

Mr Stephen Kingsley (ADT 13)
Kingston Smith LLP (ADT 62)

* KPMG (ADT 31 and ADT 35)
  Mr Keith Labbett (ADT 63)

* Mazars LLP (ADT 21 and ADT 48)
  Professor Kevin McMeeking (ADT 64)
  Mr Cliff Moggs (ADT 65)
  Mr P J Morgan (ADT 66)

* Office of Fair Trading (ADT 26 and ADT 49)
  Mr Bob Pigeon (ADT 67)
  Professor Brenda Porter (ADT 68)

* PricewaterhouseCoopers (ADT 32 and ADT 36)
  Professional and Business Services Group (ADT 69)

* Mr Iain Richards (ADT 44 and ADT 45)

* Mr Graham Roberts (ADT 38)

* Royal Dutch Shell plc (ADT 39)

* The Lord Sharman (ADT 41)
  The Lord Smith of Kelvin (ADT 70, 71)
  The Rt Hon Lord Tebbit CH (ADT 77)
  UK Shareholders’ Association Ltd (ADT 72)
  Mr James Wood (ADT 73)
  Z/Yen Group Limited (ADT 74)
APPENDIX 3: LIST OF MEASURES RAISED IN EVIDENCE TO IMPROVE CHOICE, COMPETITION AND QUALITY IN THE AUDIT MARKET

We list below measures put forward during the Inquiry aimed at reducing market concentration and/or improving audit quality. They are grouped according to the body which would be mainly responsible for implementing them.

These proposed measures are listed fully irrespective of whether the Committee agrees with them. Many are discussed in our report and some are the basis of our recommendations. Others we have not pursued further.

Addressed to Government

1. Transform the Audit Commission into a large audit firm, in alliance with a non-Big 4 firm

If the existing Audit Commission were kept together as a standalone entity, it would be the fifth largest audit firm in the UK. A strategic alliance with another mid-tier firm would enable it to access the corporate market as well as the public sector.

2. Develop the National Audit Office’s private sector audit business

The size and credibility of the NAO, who are already empowered to tender for private sector audit business, in time could build another significant audit firm.

3. Remove the mandatory requirement for audit of mid-tier companies

Companies within the EC’s small companies regime currently do not have to have an audit, but audit has been described as the lifeblood of the capital markets and as especially important for large companies. Leaving it to market forces to determine whether mid-tier companies or unlisted companies would choose to have an audit would be likely to damage audit firms outside the Big 4 who need to develop in order to widen choice in the audit market.

4. Limit auditor liability

Although the 2006 Companies Act allows contractual limitation of audit liability to be negotiated, this is rarely done for large company audits. Proportionate liability would mean the size of the auditor’s potential liability would remain uncertain. A statutory cap on auditor liability would make it more attractive both for non-Big 4 firms to bid for large company audits and also for auditors to extend their audit assurance beyond the financial statements.

5. Change the ownership rules of auditing firms without risking audit quality

This would make it easier for firms to raise capital to expand into the market for the audits of the largest companies. The 8th EC Audit Directive limits external ownership to 49% and requires the majority of the management board of an audit firm to be approved EU auditors. Research indicates that the cost of capital in a partnership is considerably higher than in an external investment ownership model.
6. **Introduce an alternative auditor appointment process for large companies**

Auditors could be appointed by shareholder panels, by a regulator or by the audit committee (as in the US). A revised process could have the potential to address a number of concerns expressed to this Inquiry such as the concentration in the audit market, the infrequency with which auditors are currently changed and the perception that auditor choice is not currently sufficiently aligned to the interests of the shareholders to whom the auditors report.

7. **Introduce a financial statements insurance approach as an optional alternative to the present audit**

In view of the failure of past attempts to weaken concentration in the audit market, it has been suggested that a radical, innovative measure would be to introduce an alternative market to compete with the conventional audit market. Financial statements insurance would be such. Under the financial statements insurance approach (FSI), the audit committee (with the approval of its shareholders) could choose to approach an insurer to quote to cover the reliability of the statements which would otherwise be subject to a conventional audit. By arrangement, FSI could cover additional assertions made by management beyond those currently embraced by the conventional audit. As with other forms of insurance, the insurer would be likely to review the company and set conditions before providing the cover: this review might be done by the insurer’s staff or by a firm of accountants chosen from a panel approved by the FRC. The insurance premium and the limit of the cover would be published. Then the insurer would appoint an auditor, also from the approved list, whose scope of work would be determined by the degree of risk that the insurer was willing to bear. If the company failed this audit, it would have two options for the following year: first, to revert to a conventional audit; or to renegotiate the FSI cover. When a claim was made against an FSI policy—for example, after investors sought compensation for losses allegedly caused by relying on misleading financial statements—it would be assessed by an arbitration process.

8. **Lobby to ensure that measures taken by regulators of cross-border activities do not act as an effective barrier to using non-Big 4 audit firms**

Ideally proposed measures should always be tested against this requirement.

**Addressed to Competition Authorities**

9. **Place future limits on the market share of any audit firm**

The number of appointments held could be limited over a five year period, monitored by representatives of regulators and investors. Compel the Big 4 to give up some market share.

10. **Break up one or more of the Big 4**

The Big 4 are global networks of national partnerships as are several other non-Big 4 firms. In the absence of coordinated international action, unilateral action by the UK could be a catalyst for wider change.

11. **Eliminate covenants restricting choice of auditor**

It is uncertain the extent of these. We have been told that they may on occasion even stipulate which of the Big 4 must be used. A lighter touch to action by the competition authorities would be for a Code to be drawn up between the British Bankers’ Association, lending institutions, audit firms and regulators to address the issue.
12. **Indicate clearly government policy and plans in the event of a Big 4 network collapse**

This would need to cover how audit work is to be conducted in the short term and what long term structure is proposed for the audit market.

13. **Make a clear statement that the government/competition authorities would break up a Big 3, and how this would be done**

Choice is already grossly inadequate and it is generally accepted that the demise of one of the Big 4 from the audit market would create an intolerable situation.

14. **Coordinate with competition authorities, in the EC and US in particular, to indicate in advance of failure of a Big 4 how they would be likely to respond**

Cross-border contingency plans should be put in place to handle withdrawal from the market by one of the Big 4. To achieve this governments and competition authorities should engage first with the Financial Stability Board and then at G20 level to coordinate action that will lead to a plan being put in place. Arrangements would include developing a system to ring-fence healthy parts of a collapsing network.

**Addressed to Regulators**

15. **Board risk committees for financial institutions and large companies exposed to systemic risks should receive independent advice from a party other than the entity’s external auditors**

This advice need not require the same sort of global network as might the external audit, and could therefore be provided by a non-Big 4 firm, which may in time provide them with opportunities to tender for the audits of some of these entities.

16. **Require fair and regular public tendering of listed company audits**

Perhaps once every five years, with independent oversight to provide opportunities for firms to increase their market share. At least one non-Big 4 firm to be included in the tendering process.

17. **Achieve greater rotation of auditors**

Greater, even mandatory rotation of auditors of FTSE 350 companies.

18. **Require joint audits (as distinct from shared audits) of large companies or just large financial entities with one of the two firms being outside the Big 4 or outside the Big 4 + 2**

With a joint (as distinct from ‘shared’) audit, both audit firms provide the overall audit report and opinion. The audit work would be required to be shared equitably to encourage the smaller audit firm to grow. Joint audits may make it less likely that any auditor develops a too-trusting ‘cosy’ relationship with the client, but would add to total audit costs.

19. **Encourage greater use of shared audits by leading listed companies**

‘Shared’, as distinct from ‘joint’ audits make it harder to assign full responsibility for the audit report on a group’s results and arguably add to overall audit costs. A regulatory code of conduct could promote the use of non-Big 4 firms: this might be as auditors of subsidiaries within large, public groups.
20. **Restrict auditors of large companies from undertaking non-audit work for their audit clients**

The proportion of total fees earned for non-audit work has fallen over the past decade as sentiment has turned against using auditors for non-audit work. Nevertheless it can be convenient and cost-effective for clients to sometimes make modest use of their auditors in this way. Ethical standards for auditors are intended to address conflicts of interest: these standards could unequivocally bar auditors of large companies from providing tax advice and internal audit services of any sort to their audit clients, and limit the fee income from non-audit work to, say, 20% of total fee income from the client.

21. **Require fees for ‘audit related work’ and ‘extended audit work’ to be reported by audit firms separately from fees for audit work**

To discourage the apparent proportion of fees for work inessential to the audit from being understated.

22. **Limit the proportion of audit fees a firm can receive from a single client**

This would disadvantage small audit firms, and is already in place in the UK where total fees from a listed audit client, including audit of subsidiaries, should not regularly exceed 10% of annual fee income or 15% in the case of an unlisted client. There is a derogation for two years for unlisted entities if there are external quality control reviews but not for listed companies.

23. **Establish an early warning system of significant threats to the operations of a Big 4 firm**

We understand the FRC has agreed with the firms a protocol providing for the early warning of any significant threat to UK operations including—to the extent known—from overseas. An extension of this would be a contingency plan for the orderly transition of audit clients should a Big 4 firm exit the audit market for any reason.

24. **Require large audit firms to formulate ‘living wills’ under regulatory oversight**

Living wills for the largest audit firms would be intended to mitigate the risk of any exiting the audit market, and would set out how a firm would separate, under regulatory supervision, the good and failing parts of the business and would deal with funding issues.

25. **Establish a resolution regime for the orderly wind-up of a failing large audit firm**

The mechanism would need to be coordinated and agreed internationally.

26. **Incorporate into, as appropriate, the FRC’s Stewardship Code and into the FRC’s guidance for audit committees more on accounting and audit**

In particular that audit committees should report the rationale for audit tendering and auditor choice decisions, and the main issues the audit committee discussed with the auditors; and that investors should engage with their companies on these disclosures, as appropriate.
27. **Assess all regulatory changes to ensure where practical they pass the tests that they neither add to the burden of the profession nor impact negatively on choice in the audit market**

Because regulatory action should be in the public interest.

28. **Seek to reduce the complexity of financial reporting and auditing standards**

To better enable smaller audit firms to cope with the audits of large companies.

29. **Take measures to eliminate the perception and/or reality of regulatory capture by the auditing regulation**

This might entail a reduction in members of the accountancy profession who are members of regulatory boards, especially those who are or have been members of Big 4 firms or their antecedents; and making sure that chairs of regulatory boards meet generally accepted independence tests.

30. **Intervene in the FTSE 250 audit market to achieve wider audit firm participation**

If achieved, in the long term this would be likely to widen participation in the FTSE 100 audit market.

**Addressed to Professional Firms**

31. **Appeal to the Big 4 as professional entities to put the public interest first and voluntarily break up their firms to form a Big 6 or Big 8**

The quid pro quo for society ceding monopoly rights to practice and other privileges, is that professionals place the ideal of public service above other considerations. A clear ultimatum, time-defined, might be set for the Big 4’.

32. **Encourage increased investment by, or mergers of, non-Big 4 firms to create one or more larger ones**

Non-Big 4 firms argue that their access to additional capital to grow is not a problem, and it would be in the public interest for them to do so—especially to enhance their international networks.

**Addressed to Companies**

33. **Report transparently on the basis for choosing or retaining an audit firm**

Investors currently have little or no information on how an audit is awarded. The report on the audit committee would disclose when and how periodic formal evaluations of the external (and internal) auditors were undertaken and the key conclusions arising there from. Tendering or non-tendering decisions would be explained. The audit committee should hold discussions with principal shareholders every five years.

**Addressed to Investors**

34. **Find a way of ensuring that the largest institutional investors act together to influence large companies to consider non-Big 4 firms**

Investors told the Inquiry that they felt they were not influencing the choice of auditor sufficiently. The FRC could convene a group of large institutional investors to come up with audit market intervention initiatives.
APPENDIX 4: LETTER FROM MR ANDREW BAILEY, EXECUTIVE DIRECTOR AND CHIEF CASHIER, BANKING SERVICES, BANK OF ENGLAND (ADT 75)

At recent hearings of the House of Lords’ Select Committee on Economic Affairs into the role of auditors, a number of references have been made to the Working Group that the Bank and FSA established to consider the relationship between the external auditor and the prudential supervisor and wider accounting disclosure issues. I thought it would be helpful to provide you with some background to the Working Group and to let you know where its work currently stands.

The WG was established last September with the senior partners of the big six audit firms, the Bank of England, FSA, the Financial Reporting Council and the Institute of Chartered Accountants in England and Wales (ICAEW). The aim was to get the views of attendees on ways to improve the relationship and information flows between the audit profession and the prudential supervisors and to establish how publicly available information on firms could be made more useful to end-users, with a particular focus on disclosures around the valuation uncertainty of less liquid assets.

There was broad agreement at the meeting with the view that the working relationship between external auditor and the prudential supervisors had broken down in the period prior to the financial crises. Prior to 2007, formal meetings between supervisors and external auditors no longer formed part of the routine supervisory framework and the informal channels of communication that existed when the Bank had responsibility for supervision had fallen away. The FSA had also in this period made much less frequent use of skilled persons’ reports as a routine supervisory tool. The regular meetings that these had previously engendered helpfully reinforced the links between the auditor and supervisor. All agreed that the auditor has an important role to play in the regulatory framework and that an effective relationship between the two parties needed to be re-established. As part of their new intensive supervisory approach, the FSA had established regular meetings between the auditors and the supervisors; however, the working group agreed that it was important both to codify this new approach and to build on it further.

With this in mind, the Working Group has so far met on three occasions to consider how the relationship between supervisor and auditor could be improved in practical terms. It has met on three occasions since September and has drawn up a draft ‘Code of Practice’, which sets out principles that re-define the nature of the relationship between supervisor and auditor, the form and frequency that communication between the two parties should take, and the responsibilities and scope for sharing information between the two parties. The Code encourages both parties to foster an open, cooperative and constructive relationship to create a positive framework for effective input to the regulatory process. The intention is to agree the Code early this month and for it to be adopted by the FSA after a six week consultation period with affected firms.

The Working Group is now focussing on the second strand of its mandate. This is to consider enhanced disclosure requirements around the valuations of banks’ less liquid assets to enable users to compare financial instrument valuations between institutions. There is evidence to suggest that disparity exists in the valuations applied to similar financial instruments across firms, in part because complex/illiquid instruments are subject to valuation uncertainty. Current financial statement disclosures around asset valuations, despite being compliant with
accounting standards, are often not sufficiently granular or transparent in respect of the critical valuation assumptions, and sensitivities of those assumptions, to support users’ understanding and meaningful comparisons. It is arguable that this lack of transparency and comparability undermines the operation of market discipline and hinders the promotion of financial stability. The Working Group is therefore looking at ways to improve these disclosures to enable market participants to compare cross institutions on a common basis. It aims to conclude its discussions on these issues by end-June.

These initial objectives should be the start of a better understanding between supervisors and auditors.

8 February 2011
APPENDIX 5: SUPPLEMENTARY MEMORANDUM BY THE OFFICE OF FAIR TRADING (ADT 49)

This additional submission is made by the Office of Fair Trading (OFT), further to its submission of 24 September 2010 and its appearance before the Committee on 9 November 2010. The OFT is grateful to the Committee for this opportunity to give an update on its work in relation to the market for audit services.

The OFT gave oral evidence at a relatively early stage of the Committee’s evidence gathering. On 9 November, the OFT indicated that competition in the market for the provision of audit services to large companies in the UK may be limited. This additional submission gives an update on recent developments and a summary of the OFT’s thinking about ongoing and potential future work in relation to the audit market.

Since 9 November 2010, the OFT has submitted a response to the European Commission’s Green Paper on audit policy. The OFT has also liaised with other bodies, including the Financial Reporting Council and the Department of Business, Innovation and Skills (specifically on audit-related elements of the current joint HM Treasury and BIS-led Growth Review). During these bilateral discussions, the OFT has continued to suggest an exploration of the possibility of a reduced form of statutory audit (which might give greater scope for voluntary forms of assurance) and queried whether the current statutory audit framework is suitable for SMEs.

At European level, the OFT attended the Brussels audit conference on 10 February 2011. DG MARKT has received a very large number of submissions in reply to its Green Paper. The European Commission’s response to the consultation will, therefore, continue to take shape over the coming months, with further developments not now expected until the autumn.

In actively keeping the audit market under review, the OFT has also considered possible targeted interventions by the OFT itself against an over-arching principle of what the UK competition regime can effectively resolve, which will not duplicate existing efforts by others—what can be called a principle of ‘unilateral decidability’.

While the OFT wishes to remain actively engaged, it recognises that many possible issues related to audit market concentration cannot be resolved effectively by a UK competition authority acting alone. The regulatory and supranational character of many of the discrete issues in this market means that, although certain improvements might be sought through regulatory intervention or legislative change, such changes would likely need to be international in scope and application to be successful.

With these points in mind, the OFT is currently giving further consideration to more formal project work, such as a targeted Market Study, and is undertaking the initial steps in scoping such a potential study. At present, we consider that further examination of the existence and effect of bank covenants (which potentially limit companies’ auditor appointment choices) might be warranted. Where any other aspects of the audit market satisfy our principle of ‘unilateral decidability’, the scope of our potential study might be expanded as necessary. Any such work would be subject to Board approval.

212 Please note that throughout this document ‘audit’ refers to external audit only.
The OFT will continue, on other matters, to input into the debate around European regulation of statutory audit, including its form and framework. Further, the OFT remains alert to the potential issues regarding systemic risk posed by audit market concentration. The OFT has continued to push for consideration of this issue in international fora (principally the OECD). In particular, the OFT has sought to raise the issue of how merger regimes in different countries might react to a scenario involving the failure of a large audit firm and the disposal of its assets, given the prospect of a ‘four to three’ increase in concentration. In this context, the OFT will continue to work to promote such merger regime discussion and preparedness.

The OFT will update its website with further information on its work in the audit market as it becomes available.

The OFT would be happy to provide any further information that the Committee may find useful.

2 March 2011

\[213\text{ See: http://www.oft.gov.uk/OFTwork/markets-work/othermarketswork/accountancy-audit} \]
APPENDIX 6: LETTER FROM THE RT HON LORD TEBBIT CH
(ADT 77)

In response to the Call for Evidence in the matter of Auditors: Market concentration and their role, I would like to submit these few probably unoriginal thoughts.

I would say, however, that they date back to my experience as a non-executive director and member of audit committees in the 1990s and early 2000s in Sears Group, British Telecom and BET.

At that time I became concerned that in all three companies the audit fees were becoming a smaller amount than the fees from consultancy work, much of which was won because the auditors’ knowledge of the company enabled them to make better informed proposals for such work at lower prices than other would-be contractors.

That caused me to become of the opinion that the auditors were increasingly concerned not to irritate executive directors by making criticisms of accounting practices lest they might lose not only the audit contract, but the far more lucrative consultancy work.

My conclusion is that the answer to your Question 6 is self-obviously “No—auditors were not sufficiently sceptical in bank audits”. However, I do not think lack of competition was the cause—rather was it fear of losing consultancy income?

On Question 10, I think it might be prudent to limit consultancy income in relation to audit income of a client company.

6 January 2011
Economic Affairs Committee Report

IFRS

I have long been unhappy with IFRS accounting standards. I was one of the signatories with Jeremy Hosking and Timothy Bush to the Times letter of 23rd July 2010 and also wrote the attached\textsuperscript{214} piece for Conservative.Home which I believe Lord Lawson circulated to your Committee.

I am particularly concerned that IFRS is about to extend to the public sector as well as the insurance industry where in my judgement not only do the standards make Accounts difficult to understand but can also conflict with the fundamental principles of “true and fair”.

I also understand there has been some perceived inconsistency of evidence provided to your Committee, on the one hand provided by senior executives of major Life companies, together with Professor Stella Fearnley and Timothy Bush and, on the other hand, members of the Financial Reporting Council and the FSA. No doubt you and your Committee have formed your own views here.

I would make the point that there are substantial professional and individual vested interests and reputations going back some time, involved here.

I am concerned in particular as regards the legal advice provided to the FRC, on the basis of which I understand it is standard practice for the FRC to respond to letters to Ministers at the BIS.

I observe that both the Bank of England and members of the auditing profession such as Peter Wyman (although himself closely involved with the implementation of IFRS) provide a more independent assessment of the damaging impact of IFRS.

My belief is that, particularly with regard to banks, a major purpose of Accounts is to discharge the solvency obligations of directors and auditors to report the true capital position. When Runs on banks occur, it is largely because markets have spotted that particular banks are potentially insolvent. In the recent banking crisis, I believe there is little doubt that markets spotted that for certain banks IFRS “marked to market” standards had served to overstate capital resources in buoyant times; as subsequently they served to understate capital in difficult times.

My objections to IFRS are, however, wider than that I believe they were a contributor to the banking crisis; as referred to in my attached article, I have always felt that requiring the accounting treatment relating to the granting of options to be booked through the Profit & Loss Account both obscures the real trading position of the particular business and also fails to advise shareholders of the impact of actual or potential dilution. I also consider the requirement to discount pension fund liabilities at a rate of interest measured by prime bond yields overstates effective liabilities and has been a major contributor to the demise of final salary schemes. Liabilities should surely be discounted at the anticipated “blended” rate of return on the pension fund investment portfolio.

Finally, I make the comment from my career background in the investment management industry, that invariably, analysts go through the exercise of adjusting

\textsuperscript{214} Not printed here.
the IFRS statutory accounts to screen out the distortions resulting from “marked to market”, the treatment of options and IFRS 17 in order to arrive at an understanding of the performance of particular businesses.

Going back nearly 10 years I felt that IFRS was introduced “by command” and without adequate political and commercial debate. The impact has been demonstrably damaging, particularly in its contribution to the banking crisis.

22 February 2011