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Minutes of Evidence
TAKEN BEFORE THE ECONOMIC AFFAIRS COMMITTEE
TUESDAY 12 OCTOBER 2010

Present Lord Best Lord MacGregor of Pulham Market (Chairman)
Lord Forsyth of Drumlean Lord Maclean of Rogart
Lord Hollick Lord Moonie
Lord Lawson of Blaby Lord Smith of Clifton
Lord Lipsey Lord Tugendhat

Memorandum by Professor Vivien Beattie: Glasgow University, Professor Stella Fearnley: Bournemouth University, and Tony Hines: Portsmouth University (ADT 1)

1. INTRODUCTION
1.1 We welcome the opportunity to submit evidence to the Committee on this very important subject.
1.2 We have ordered our comments into four main areas:
  — Key points from our submission.
  — Summaries of outputs from our research, particularly relating to the role of auditors, audit quality, auditor/client interactions, financial reporting and audit market concentration.
  — Specific responses to the 14 questions posed in the Call for Evidence.
  — A brief summary of regulatory changes in the UK since 2002, which impact on auditing, financial reporting and governance is included as Appendix 1 as this provides background to our comments.

2. KEY POINTS FROM OUR SUBMISSION

2.1. Audit Quality
Audit is a subset of financial reporting and in the UK context is already heavily regulated. Compliance with accounting and auditing standards is being achieved by a strong enforcement regime. Audit committees are viewed as having made a significant contribution to audit and financial reporting quality and the Financial Reporting Review Panel is believed to have to have similarly contributed to financial reporting quality. Achieving high levels of compliance may be viewed as good but our research also indicates that the audit process is becoming a compliance driven tick box regime, rather than one which considers the true and fair view, prudence (no longer part of the accounting model) and the economic substance of the financial statements.

We suggest that a stronger emphasis needs to be placed on the auditors’ overall view of financial statements in the context of substance over form, prudence and true and fair, rather than detailed compliance with the rules. We can see no case for further regulation of auditors under the existing UK regime.

We suggest that the audit report could be reconsidered so that the auditor comments on the relative reliability of different items on the balance sheet and also whether all the liabilities are properly disclosed.

2.2. The International Financial Reporting Standards (IFRS) accounting model
Our research highlights serious concerns about the quality of the IFRS accounting model expressed by expert preparers, including listed company audit partners. We suggest that, in the drive to converge accounting standards with the US and achieve global convergence of accounting standards, policy makers and standard setters lost sight of the underlying quality of the standards being promulgated by the International Accounting Standards Board (IASB). Our research contains many complaints about excessive complexity and counter intuitive outcomes. In the banking context, fair value accounting and changes to a less prudent loan loss provisioning model undoubtedly contributed to the economic crisis. IFRS related matters were considered by expert preparers to have undermined UK financial reporting integrity. Concerns have also been expressed about the ability of non-accountants on audit committees and company boards to understand the IFRS accounting model.
We do not believe that one set of global accounting standards is either achievable or desirable, as it allows the standard setter too much power and too little accountability. It is likely to be dominated by US interests under the current convergence objectives. We suggest that the UK should lead in recognising that global convergence is not achievable because of different cultures and legal frameworks and encourage other solutions, such as regional standard setting boards for the US, Europe and Asia. In the short term we suggest that the IASB concentrate on remedial action to the existing standards rather than promulgating any more.

We are disappointed that UK policy makers and the accountancy profession have supported an accounting model that was known to be flawed. It is inconceivable that UK standard setters and regulators could have been unaware of the concerns and the excessive costs associated with the introduction of IFRS in the UK. We suggest that IFRS itself should include requirements for substance over form, the true and fair override and prudence.

2.3. Competition and choice

We have no evidence of lack of competition—rather there is a limitation of choice. However companies themselves are reluctant to change auditors because of the cost of doing so. There are a number of ways choice could be increased but most of these would require a significant intervention and this would have to be justified to the companies. Market-based solutions would be better if this can be achieved. One interesting finding from our research is that a significant number of AIM companies are audited by non-Big Four firms and this could be built on for the main market which is dominated by the large firms.

However there remains a perception that audit firm size is a proxy for quality and smaller firms would have to show they can deliver the same quality in order to win the work.

3. Our Research into Auditing and Financial Reporting in the UK Regulatory Environment 2007–08

We carried out a major research study into the above areas in 2007–08. The research was funded by ICAEW Charitable Trusts and followed on from an earlier study carried out in the 1990s before the Enron scandal (Beattie, Fearnley and Brandt, 2001). The earlier study provided the basis for our evidence to the House of Commons Treasury Committee in 2002. The motivation for the 2007–08 research was to explore how the post Enron changes had affected the interactions between preparers and auditors of financial statements and their views on the effectiveness of the changes which had been introduced. The study comprised a survey and nine interview-based company case studies.

In June 2007 we surveyed finance directors (FDs), audit committee chairs (ACCs) and audit engagement partners (AEPs) from UK listed companies and obtained a total of 498 responses (149 FDs, 130 ACCs and 219 APs) representing an overall authoritative response rate of 37%. This is the first academic research project to survey all three parties simultaneously.

The survey responses were followed up with nine company case studies where all three parties were interviewed about how they interacted with each other on financial reporting and audit matters, and their views were also sought on the effectiveness of the regulatory framework.

4. Factors Affecting Audit Quality from Our Research

Respondents to our questionnaire were asked to grade 36 factors affecting audit quality on a scale of 1-7. Factors 1-3 undermined audit quality, 4 was neutral and 5-7 enhanced audit quality (Beattie, Fearnley and Hines, 2010).

4.1 Factors undermining audit quality

Factors considered to undermine audit quality were not related to the changes to the regulatory regime but to economic and competition issues, all of which had existed before the changes to the regime. These three factors are:

— Management time and costs in changing auditors.
— Budget pressures imposed by audit firms on staff.
— Not Big Four audit firm.

The response relating to not Big Four audit firm could be skewed as most of the respondents were either Big Four partners or were directors of companies audited by Big Four firms. Nevertheless, this confirms a widespread perception supported by many research studies that audit firm size is a proxy for audit quality.
4.2 Factors enhancing audit quality

15 factors were considered by respondents to enhance audit quality and of these five related to the enhanced role of the audit committee including the top two factors:

- Auditor required to communicate with the audit committee on all key issues associated with the audit and with ethical standards.
- One audit committee member has recent and relevant financial experience.

Four factors related to reputation damage for the firm/partner and the risk of regulatory action; three factors related to financial interests of the auditor and financial dependence of the audit firms on clients; three factors related to procedures within the firm to ensure quality; and Big Four audit firms were also considered to enhance audit quality. Again, the audit firm size responses may be skewed as most of the respondents were Big Four partners or Big Four clients.

4.3 How to improve audit quality

We also gave respondents the opportunity to make comments about how audit quality could be improved. From the wide range of comments 117 were critical of the regulatory regime claiming it is driven by rules and box ticking and expressed concerns that this is detrimental to audit quality. This was attributed to the complexity in IFRS, the changed auditing standards and the audit inspection regime. Some believe that true and fair has been undermined. Both auditors and directors believe that the system has become increasingly compliance driven and auditors are now spending time ensuring compliance with standards rather than engaging with the business. Some directors and auditors believe that the current restrictions on non-audit services in Ethical Standard 5 (Auditing Practices Board, 2004) mean that auditors have less understanding of the business as they are less engaged with it.

4.4 The auditor/client relationship

We also asked respondents if regulatory change had affected the nature of their relationship with their auditors/client. 267 respondents believed there was no change. 198 believed the relationship had changed and had become more formal, largely due to the increased focus on technical compliance and the move away from the business advisor role.

5. Financial Reporting Interactions From Our Research

Respondents reported a high level of financial reporting interactions mainly relating to ongoing problems with the changed accounting regime and other new requirements such as the Business Review although the new accounting regime dominates. The most frequently cited issues discussed and negotiated related to goodwill and fair values on acquisition, and there was little difference between the first and second years of the IFRS changeover (Beattie, Fearnley and Hines, 2008a). Thus the problems are of a continuing nature not just relating to the changeover. The 89 responses which came from directors and auditors in the financial sector showed a higher level of interaction in respect of financial instruments than the others. Not all companies are affected by the financial instrument standards. It is not possible from a survey to identify the precise nature of the interactions from survey responses.

6. The Impact of Recent and Forthcoming Changes to the Regulation of Financial Reporting and Auditing on the Overall Integrity of Financial Reporting

6.1 Factors improving financial reporting integrity

We asked respondents for views on the impact of 14 recent and forthcoming changes to the regulation of financial reporting and auditing on the overall integrity of financial reporting using the same ranking as for audit quality. None of the items listed received a mean score of 5 or above but the three highest ranking scores were:

- Financial Reporting Review Panel pro-actively reviewing published financial statements (4.94).
- Enhanced role for audit committees in overseeing external auditors (4.80).
- Introduction of regulation over the auditors of non-EU companies listed in the UK (4.76).

The bottom two items (ranked between 3 and 4) related to the introduction of IFRS with the lowest rank given to Impact of IFRS on the true and fair view (3.55).
6.2 Narrative comments

We received many comments from respondents on the above section of the survey. Many were critical of the impact of IFRS and fair value on the integrity of financial reporting (Beattie, Fearnley and Hines, 2008b; 2009a). They were also critical of the length and complexity of IFRS financial statements as well as some underlying principles. Apart from the IFRS factor, the main concerns, which also emerged from the audit quality comments, were the perceived move to a rules-based, prescriptive and compliance-driven framework where too much time was spent box ticking. Some commentators believed true and fair had been undermined by IFRS and others expressed concern about the possible downgrading of the stewardship objective of financial reporting under IFRS. Thus expert preparers did not believe that IFRS had improved UK financial reporting.

7. Research into Audit Market Concentration

7.1 Together and with others we have researched audit market concentration in the UK listed company sector for over 15 years (eg Abidin, Beattie and Goodacre, 2010; Beattie, Goodacre and Fearnley, 2003; and Beattie and Fearnley, 1994). The most recent study covers the period 1998–2003 and the entire population of domestic companies listed on the main or AIM markets (1386 companies in 2003). In 2003, the Big Four held 68% of this market (based on number of audits) and 96% (based on audit fees). The difference in concentration figures is due to the fact that the Big Four hold more of the large company audits which have higher associated audit fees.

7.2 PwC was market leader in 18 out of 34 sectors. In 20 sectors, the market leader had a share of over 50% (based on audit fees). In 11 sectors, a mid-tier firm held more that 2% of audit fees; in 2 sectors this was more than 5%.

7.3 The complex dynamic of changes in audit concentration is analysed to reveal four distinct reasons for change: companies leaving the public market; companies joining the public market; companies changing auditor from/to the Big Four; and (for the audit fee measure of concentration) audit fee changes. The 8% reduction in Big Four concentration over the period based on number of audits from 76% to 68% was mainly due to their relatively low (51%) share of joiners (mainly smaller AIM companies). The 1% increase in Big Four concentration over the period based on audit fees from 95% to 96% was mainly due to their lower share of leavers from the market. Overall, there are more smaller audit firms acting for the smaller companies in the AIM market.

7.4 Also evidence from our case study work (Beattie, Fearnley and Hines, 2011) indicates that smaller companies can prefer the more personalised attention they get from a smaller firm as they can be a more important client to that firm than if they were with a Big Four firm.

7.5 It was also suggested that once a company grows above a certain size or has international subsidiaries, the non-Big Four firms do not have such effective global networks.

8. Questions posed in the Call for Evidence:

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

Business has become more global and such businesses need the scope (and scale) of global audit firms. Firms have also merged over time to become more effective and profitable. There was no regulatory objection to previous mergers but the demise of Andersen was not anticipated. The drive for global accounting standards and the complexity of the standards themselves plays to the strengths of the larger firms and increases the barriers to entry to the global market for smaller firms.

Our studies into auditor changes in relation to changes in the population of listed companies reveal that, although almost half of new entrants to the market have a non-Big Four auditor, many change to a Big Four at a critical point in their growth, thereby maintaining concentration levels. New entrants to the market generally join the AIM market.

1 The Alternative Investment Market (AIM) is the London Stock Exchange market for smaller companies that wish to go public. The admission criteria are less onerous than for the main market.
2. **Does a lack of competition mean clients are charged excessive fees?**

Despite high levels of concentration, we have no evidence that the audit market is characterised by a lack of competition leading to excessive fees. The fundamental problem is lack of auditor choice. Recent fee rises can be attributed to the additional work required by IFRS. Fees, although often agreed initially between the FD and AEP, go to the audit committee for approval. There is some evidence from our case studies that ACCs are less concerned about fee levels than FDs as they want to ensure a proper audit is carried out.

3. **Does a narrow field of competition affect objectivity of advice provided?**

We do not believe so. The ethical standards for auditors and the enforcement of ethical standards and ISAs along with audit committee involvement offer a robust framework for preventing this.

4. **Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?**

As indicated above, any previous link that existed between these two issues has been broken by the strong enforcement within the regulatory regime.

5. **What is the role of auditors and should it be changed?**

We have already referred to auditing being a subset of financial reporting and therefore the quality of the accounting and auditing standards and the enforcement regime under which auditors are required to work will determine the quality of the final outcome.

The role of auditors in the UK was, under UK Generally Accepted Accounting Principles (GAAP), to provide independent assurance to shareholders that the accounts prepared by the board of directors comply with law and regulation and give a “true and fair view” of the company’s performance over a period and its financial position at the period end. The true and fair view override has effectively gone under IFRS (Nobes, 2009), to be replaced by “give a true and fair view, in accordance with IFRS as adopted by the European Union”. The true and fair view has to some extent been restored under the 2006 Companies Act but it is not yet clear whether this will make a significant difference. The principle of “substance over form”, part of UK GAAP (ASB, 1994) has gone from IFRS as has the principle of prudence. We argue (Beattie Fearnley & Hines, 2011) that the true and fair view override and the principles of substance over form and prudence should be brought into IFRS itself.

In the longer term a much wider review of the role of auditors in reporting to shareholders annually is needed given the changes in shareholder mix and behaviour and the interests of other stakeholders. We expressed our concerns about stock lending in our submission to the Treasury Committee (Beattie Fearnley and Hines (2009c))

6. **Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?**

A debate on auditor scepticism emerged in the UK in 2010 (FSA/FRC, 2010; APB, 2010). The specific issues where greater scepticism is called for in the AIU (2010) annual report are fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern. The appropriate current level of scepticism is considered to be an enquiring mind. We have no evidence from our research of a lack of scepticism. Even if there was, we would not characterise the problem as a lack of competition (a structural issue), rather the regulatory regime is the problem, ie the move towards a compliance driven tick box model of financial reporting and auditing, and the loss of substance over form, prudence and the undermining of true and fair.

7. **What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?**

Increasing regulation because of a financial scandal may help to prevent a repeat of the scandal which caused the increase in regulation. However ex post regulation is often driven by psychological biases such as the need to find a scapegoat (Hirshleifer, 2008), and generally fails to prevent another scandal with different attributes. This has recently manifested itself with the banking crisis following on so soon after the major changes to the regulatory regime post Enron and the search for scapegoats, including auditors.
Regulatory change is also costly and can have adverse unintended consequences. To repeat what we said in our submission to the UK Inquiry into the Banking Crisis (Beattie, Fearnley and Hines (2009d): “We suggest that, unless there is incontrovertible evidence of auditors failing to comply with law and regulation in their audits of the banks, there is no case for introducing more regulation into the audit process itself”.

Many concerns were expressed by our survey and interview respondents about the quality of IFRS and the IASB’s US convergence objectives. We believe that quality in accounting standards has been subordinated by the global ambitions of the standard setters (on which critical decision no public consultation was held). In our submission to the House of Commons Treasury Committee in 2008 (Beattie Fearnley and Hines, 2009c) we articulated our concerns about the accounting model, global convergence, and the governance of the IASB. Since this submission in 2008 our concerns about the feasibility of global convergence have increased rather than diminished and the problems of superimposing a US based accounting model on countries with different underlying legal regimes (5, 2006) are becoming more apparent. The full impact of the accounting deficiencies on the banking crisis are emerging, particularly the impact of mark to market accounting and the restricted loan loss provisions required by the IFRS accounting model.

Although auditors had no duty under IFRS to report on the lack of economic substance in bank accounts during the bubble, they must have noticed that the accounting model was producing dysfunctional results and that the structure of bank balance sheets was radically changing with the growth of derivative trading. Although the prudential supervision of banks is not the auditors’ responsibility, as the true experts in accounting, the accountancy profession would have greatly served the public interest by articulating in public their concerns about the accounting model.

There has been a disconnect between the views of the expert preparers applying the IFRS accounting model as reflected in our research findings and the UK public policy stance taken by accountancy professional bodies and the Financial Reporting Council, all of whom seem to have given primacy to US convergence and support of the IASB over concerns about the quality of the accounting model.

Going forward, we suggest that the UK should take the lead in publicly challenging the global convergence plans for accounting and recommend that the IASB abandons this scheme, and issues no more standards until it has cleared up the problems in the existing ones. We also suggest that the UK should lobby for reconsideration of standard setting. The IASB is trying to serve too many masters and subsequently serves none effectively.

One possibility would be to consider the establishment of regional boards such as US, EU and Asia and which would be more able to meet the needs of those they serve.

We also suggest consideration be given to changing the audit report to cover individual items on the balance sheet as opposed to a report on the financial statements as a whole. This would expose the degree of reliance a user could place on specific assets and liabilities whether on or off the balance sheet in order to expose problem valuations and off balance sheet liabilities. This would have exposed some of the problems about the reliability of some of the assets in the banks’ balance sheets.

If the audit product becomes a totally tick box compliance based activity then its own value to shareholders, other users and auditors themselves will be diminished. The question of audit purpose has already been raised by the House of Commons Treasury Committee.

8. How much information should bank auditors share with the supervisory authorities and vice versa?
Auditors should be required to communicate concerns on any issues concerning the stability of banks and the public interest to an independent regulatory body.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?
We do not believe that there is such a need. We believe the enforcement regime with regard to auditors is sufficiently strong. It is the accounting model which requires attention.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?
Concerns about non-audit service provision by the incumbent auditor have always been largely a perception problem, with no robust evidence that auditor independence is compromised (Beattie and Fearnley, 2002). We do not believe that significant conflicts remain following recent restrictions (Beattie, Fearnley and Hines, 2009b).
11. **Should more competition be introduced into auditing? If so, how?**

Although highly concentrated, the market appears to function in a competitive manner based on analysis using industrial economics. The problem lies in lack of choice. If it is considered to be in the public interest to reduce concentration, this could be achieved by: (a) breaking firms up; (b) restricting the number of main market listed company audits any one firm can undertake; (c) expanding the role of the soon to be defunct Audit Commission or the National Audit Office as a fifth big firm to engage with the private sector; (d) encouraging mergers between the larger non-Big Four firms; (e) insisting on joint audits for listed companies; (f) introducing compulsory audit firm rotation or tendering requiring regular tenders including non Big Four firms.

However, any major intervention would require legislation or at least regulatory change and a very careful cost benefit analysis. The international impact would be critical as market share varies between countries and the reaction of the auditee companies about enforced change could be very negative. Imposing significantly more cost and disruption on the corporate sector is unlikely to be welcomed given the concerns expressed by our survey respondents about the cost of auditor change.

The situation remains that audit firm size is viewed as a proxy for audit quality, thus a Big Four firm is a safe appointment for an audit committee to make.

12. **Should the role of internal auditors be enhanced and how should they interact with external auditors?**

No response offered—our studies do not address internal audit.

13. **Should the role of audit committees be enhanced?**

Their role already seems very well developed. We are not sure what form further enhancement would take. We have concerns that the complexity of IFRS may be damaging the effectiveness of the audit committee as only those members with an accounting qualification and recent experience of IFRS are able to engage effectively on accounting issues.

14. **Is the auditing profession well placed to promote improvement in corporate governance?**

Corporate governance is a matter for companies. We have no evidence that the current regime is not working. Going forward, auditors would always be able to contribute to suggestions for improvement.

*3 October 2010*

**References**


APPENDIX 1

REGULATORY CHANGES IN THE UK SINCE 2002

Because of the importance of the US capital markets to the UK economy, the UK regulatory framework was reviewed after the Enron collapse and the demise of the audit firm Andersen and but other changes not related to Enron were also introduced. The Enron scandal focussed on financial reporting and auditing problems and the changes therefore concentrate in these areas.

Key changes include:

— Revisions to the Combined Code for Corporate Governance (Financial Reporting Council (FRC), 2005) [renamed the UK Corporate Governance Code in 2010] which operates on a comply or explain basis. The role of the audit committee’s engagement with auditors was more clearly defined to include approval of fees and non-audit services and closer engagement with the audit process.

— The responsibility for setting auditing and ethical standards for auditors was transferred to the Financial Reporting Council (FRC). Since then the Auditing Practices Board (APB), a subsidiary body of the FRC, has adopted International Standards of Auditing (ISAs) ahead of any EU requirement to do so (but with limited changes to fit with UK law). ISA 260 (Auditing Practices Board, 2004) lays down the level of engagement auditors should have with company audit
committees; Ethical Standard 5 (APB, 2004) restricts the non-audit services that auditors can provide to the client companies.

— The Professional Oversight Board (POB) was established under the FRC to oversee the activities of the UK accountancy professional bodies and, via the Audit Inspection Unit (AIU) carry out independent inspections of public interest audits and firms. The AIU issues public reports on its inspections and, recently, individual reports on the major audit firms (those auditing more than 10 entities within the AIU’s scope, of which there are currently nine) have been published. In its most recent annual review, the AIU reveals that many audits require “significant improvement” and calls for greater scepticism (AIU, 2010).

— The Financial Reporting Review Panel (FRRP) changed its way of working to carry out pro-active compliance reviews of company financial statements. The FRRP previously been a predominantly reactive body;

— An EU Regulation in 2002 required all EU listed companies to prepare their group accounts under IFRS for December 2005 year ends onwards.

**Examination of Witnesses**

Witnesses: **Michael Power**, [Professor of Accounting, LSE]; **Vivien Beattie**, [Professor of Accounting, University of Glasgow]; and **Stella Fearnley**, [Professor of Accounting, Bournemouth University].

Q1 *The Chairman*: Good afternoon. I am sorry we have started a little bit late, but this is our first meeting since the recess and we had one or two matters to cover. Welcome to the Economic Affairs Committee. This is our first public meeting of the new Parliament and the first hearing in our inquiry into the issue of auditors: the market concentration and their role. There are just one or two formalities that I have to say at the beginning of this: copies are publicly available of Members of the Committee’s entries in the Register of Interest and of declarations of interest relevant to this inquiry. At this first session, each Member who feels that he has even a remote interest to declare will do so to get it on the record. Two Members of our Committee, Lord Currie and Baroness Kingsmill, are not taking part in this inquiry because they felt they were too conflicted. I welcome Professor Beattie, Professor Fearnley and Professor Power. We start our inquiry with an extremely well qualified group of witnesses. We are very grateful for the written evidence that you have given and for coming. I would be grateful if you would speak loud and clearly for the webcast and the shorthand writer. I know that Professor Power has to leave at 4.45 pm. Could I just say if, in answer to some of our questions, the first person who speaks in a sense speaks for you all, and if you do not wish to add to it, please feel free not to speak. Just come in if you have something fresh to say because we have a lot of material to get through. Would anyone like to make an opening statement? If so, could it please be brief? Professor Beattie.

**Professor Beattie**: Just to preface some of the remarks we might make later on, and to point out that, post Enron, what happened in the UK was there was a very strong enforcement regime put in place in relation to audit and accounting. In that situation, the quality of the outcome from the whole process very much depends on the quality of the accounting rules that are in place. When we came to 2005, under the EU, International Financial Accounting Standards were put in place and while they are often talked about as being quite principles-based, in fact there are quite a lot of de facto rules there because there’s a lot of detailed guidance. They are certainly more rules-based than UK accounting was, or UK GAAP still is. What we lost in that process of moving to IFRS for UK-listed companies was the true and fair view, the prudence principle and the principle of substance over form. The research that Stella and I, with a colleague, have carried out in the last two or three years into accounting and auditing—and I guess why we’re here today—has pointed up quite strong concern amongst expert preparers in the UK, by which I mean finance directors, audit committee chairs and auditors of listed companies. They are concerned about the accounting model; they are concerned that we have lost the true and fair view and these principles of substance over form and prudence, that we have moved to a compliance-driven tick box kind of process where judgment has been lost; they are concerned about the excessive length and complexity of financial statements nowadays; and are concerned that, under IFRS, there are a number of quite dysfunctional outcomes. Although it is not specific to the research we carried out, we are also aware there is quite a deep level of concern about the particular outcomes in the accounting model with respect to banks. Thank you.

Q2 *The Chairman*: Thank you. We will move straight on. The point you raised, which is also expressed in your written evidence, will be one that we will certainly be exploring as one of the issues in our session here today. Thank you for that. I am going to start with the first question and then move to my right. In doing so, I have to declare a past interest as a member of several audit committees and
chairman of one. I am currently chairman of three pension fund trustees which, of course, have auditors, and I am chairman—although I do not think this is quite so relevant in this context—of the House of Lords Audit Committee. The first question I wanted to ask you is: what, in your opinion, are the reasons why there has been, and continues to be, so much attention to the issue of audit market concentration and audit quality?

**Professor Beattie:** To some extent, it is because the audit product is unobservable and, in a sense, that makes it quite mysterious. The whole process of accounting and auditing is what underpins the capital markets, which is fundamental to the economy. So people have particular concern that the way in which we obtain trust in the information upon which the capital markets are based does have integrity and can be relied upon.

**Professor Power:** I would agree with that. There are a number of issues around the audit concentration question; one is a systemic issue, what would happen, what would be the nature of the market if a firm were to cease to exist and what that would mean for competition. A more serious issue is it is not a market at all, in the sense that there are not willing buyers in which one ordinarily thinks of markets. There are enforced buyers by statute and that also confuses the market analysis to a certain extent. Therefore there are issues of concentration and, descriptively, there is undoubtedly concentration amongst a small number of firms at the top end of this rather artificial market. Those issues become more poignant because the demand side is rather difficult to observe and perceive.

**Q3 The Chairman:** Do you think there would be a bigger problem if the Big Four became the Big Three?  
**Professor Fearnley:** There are conflicts of interest.

**The Chairman:** Please speak up a bit.

**Professor Fearnley:** Sorry. There are conflicts of interest within the big firms obviously for work they do for companies. Every firm has to have a bank, a banker of its own. So if there were three firms I think the conflicts of interest would be extremely problematic for auditors to be able to act for certain companies, particularly the large ones where—for the size of the organisation and, if they are international, for the scope of the organisation—the demand side do need to use one of the largest firms.

**Q4 The Chairman:** We will come on to possible solutions later but one last question from me. It really touches on what Professor Beattie said at the beginning. Do you think the audit of financial statements prepared under IFRS has negatively impacted audit quality?

**Professor Beattie:** To an extent, the accounting rules are very rigid and the auditing standards, which auditors are required to use, and the ethical guidance for auditors are very detailed now. I think that certainly does have an impact on the quality of the outcome, yes.

**Q5 Lord Lipsey:** Could I have a supplementary? You said it would be very serious if four became three. How great is the risk that four might become three?  
**Professor Fearnley:** I don’t think I can assess that risk. The risk obviously is a litigation risk. If one looks at what has happened since the collapse of Andersen, where people learnt a great deal from allowing that to happen, where an issue does come up in the firm they do try to handle it and try to deal with it in a better way than happened with Andersen. I would hope that the firms themselves would be able to manage the situation rather better than happened in the US.

**Professor Power:** I don’t think we can rule out dramatic loss of franchise value, shock events. There are plenty of examples of those in recent history so I think the risk is there.

**Q6 Lord Lawson of Blaby:** I would like to ask a string of interrelated questions but would be grateful if you would address all of them and not just one of them. They are all connected. Even with four, that is high degree of concentration and in some sectors—notably banking, which is particularly important, particularly sensitive, as we have learnt recently—the concentration is particularly marked. The first question: leaving aside whether it goes from four to three, are you concerned about the existing concentration and in what direction do you think we might move to allay that concern if you are concerned? The second one—I will confine myself to two aspects of this—I think relates to the question. These firms have accountancy and audit business but they also have business outside accountancy and audit of an advisory, consultancy nature and so on. Do you see any benefit from having a structural separation, so that accountancy firms have to stick to accountancy and audit and do not do this other work? You mentioned Andersen; of course Andersen did hive off their consultancy completely. I think there were concerns at the time about the mixture of the two. So if you could address those two questions I would be grateful.

**Professor Power:** I will start. I think the issue of whether concentration bothers us or not is the question of the source of the concentration. On the one hand, one can argue there are economies of scale that accrue to the large firms. They are able to muster technical expertise in very specific areas, as you have mentioned, Lord Lawson, the banking area in particular. In my experience, one of the things finance
directors are interested in is being able to compare themselves with a peer group of some kind and to know whether their accounting policies are more or less in line with what other people in the industry are doing. Some of the large firms are very well equipped to do that and to provide the technical support, and that is what they would say about the concentration anyway. So there is an element of concentration which may have to do with natural forces of economies of scale. Equally, I think there are some self-reinforcing myths about “big” being better quality that are shared, to a greater or lesser extent and more or less explicitly, by regulators, institutional investors and others. When I talk to the finance director of the board that I am on about using a non-Big Four auditor for the audit process he says, “Well, the market wouldn’t like it. The institutional investors would find that very odd”. Why? “Well they would”. So I think there are these sets of beliefs that circulate about “big” being equated with quality. No one wants to break rank and that is another source of, not so much concentration, as market freezing. So I think if you are going to dissect it in those two ways, you have two different kinds of diagnoses that point in different directions. For the other question, I for one am not in favour of structural separation for all the reasons, even though that is a bit countercultural at the moment. There are a lot of synergies and benefits between advisory work and auditing. I am sorry that so much attention has been given to this particular issue because it detracts from the really important issue, that of audit quality. The provision of other services is neither here nor there when it comes to the audit as audit.

Lord Lawson of Blaby: Do either of the other witnesses wish to add anything before I come back? Professor Beattie: I would simply say, yes, I would say I was worried about the level of audit concentration from a commonsense perspective. When you look at the structure, the fact that after the Big Four there is such an enormous gap before you get to any of what might be called the Group A or major firms means that, even if they were to combine together, it would hardly have a significant impact on the listed audit company market. There is an issue where concentration is sometimes even higher at sector level. I could certainly provide evidence if you split across, say, 34 sectors of industry a few years ago, exactly what the breakdown was for each of the Big Four and for each of the six next biggest audit firms and for the rest combined. It is quite scary how sometimes in some sectors one of the Big Four has more than 50% of the market, in terms of the audit fees they’re bringing in. It is important to understand how audit market concentration changes over time and the dynamics of that. What happens is that, as firms publicly join in the alternative investment market—initially many of them before they come on to the main market—and at that level of entry, if you like, to the market, almost 50% of these companies have a non-Big Four auditor. There are a lot of companies coming on to the AIM but at some particular point in their growth, either at that secondary market or in the main market, they seem to feel compelled to switch to a Big Four audit firm, either because they think the public perception demands that or some of the shareholders demand that, or the audit committee members and audit committee chair feel more safe if they have a Big Four auditor behind them. So it makes it very difficult I think—if you understand that structure of the market and the dynamics of change, how difficult a problem this is to try and change.

The Chairman: It would be helpful if you could let us have a note on the point you raised earlier about the research you did. Professor Beattie: I am happy to give information, yes.

Q7 Lord Lawson of Blaby: I have one supplementary. Professor Power pointed out that there are advantages in size as well as disadvantages. I think we are all well aware of that. The question is: where does the balance of advantage lie? That is what we as a committee have to decide first and then whether there is any remedy that we think is necessary. I had the impression from Professor Beattie that she was more concerned with the disadvantages and felt that there should be some movement, therefore, to deal with that. Is that correct?

Professor Beattie: I think I would say that is true, yes. It seems quite an extreme level of concentration in the market and not graduated at all, the four and then quite a big drop.

Professor Fearnley: Lord Lawson, I think the problem is that it is not an issue which is peculiar to the UK. The concentration is not like the supermarkets in the UK. This concentration is global. This is something the committee needs to consider when you consider what the solutions might be, because it is a much bigger issue than looking at a monopoly or looking at oligopoly just in the UK.

Q8 Lord Tugendhat: If I may just ask a supplementary, please. Professor Power emphasised the quality of the audit but, even among the Big Four, do you feel that they are able to provide a similar quality of audit to each of their customers in an area like banking? I remember years ago when I was chairman of Abbey National, we had Coopers and Lybrand as our auditors and we were the biggest banking relationship that Coopers and Lybrand had. They then merged and became PricewaterhouseCoopers, as a result of which we would have gone down to the third of their banking customers. So we put it out to tender. We went to...
Deloitte and we again became the biggest banking relationship, and it was understood that Deloitte would not take on another banking relationship without consulting us about the terms of it. We were very much concerned that if we were the number three at PricewaterhouseCoopers we would not have the best team. I think back on it and feel that we made the right decision. I cannot help feeling that when you have only four auditors, however big, it is very difficult for them to provide an equally good and thorough service to each of their relationships.

Professor Power: It is a very good point and this is digging below the surface, if you like, and looking at the kind of manpower model that different firms use and the particular forms of expertise that they deploy. Clearly, if somebody is working on a specific audit they are not working on another one so you are getting that kind of differentiation. Finance directors are quick to say they are not happy with audit teams and changes happen in that sense, but I think what your question is getting at—and I think it is a very intriguing one—is that you obviously were an informed purchaser of audit services. I am not sure that is the case any more. I think audit committees go by franchise value alone and do not analyse audit teams, and what is on offer and capabilities, in any more depth than that. I may be wrong on that but that is just an assumption. So one of the issues that your question surfaces—and I welcome it, and it is a very interesting dilemma because auditors have to be independent and have to comply with the rules but we are losing something along the way in the current regime that we have.

Q9 Lord Forsyth of Drumlean: In the investment banking world they say no CEO was ever fired for hiring Goldman Sachs as opposed to hiring somebody that nobody had heard of. Is not the problem that, in a culture where people are protecting their backs, it is the easy solution and the one for which you are not going to be criticised if things go wrong. So when you say they should be looking for quality, are they not also thinking about the extent of the risks that apply to them as directors and sitting on an audit committee, but especially if they are non-executive directors?

Professor Power: As a non-executive myself I can say absolutely that you take the easy route of equating large franchise value with quality because that is what you can defend ultimately. I suppose the purpose of this committee, and this whole area, is that we have to find some way of disturbing that.

Q10 Lord Forsyth of Drumlean: Is not the other problem that if you are dealing internationally and you say, “Well, we will get X to look at this”, and everybody knows that X is one of the Big Four, people will have a confidence in that because they know of it, whereas if it is Bloggs and Snooks, whom they have never heard of, it is more difficult?

Professor Power: Absolutely right, and the confidence may be justified as well in some circumstances.

Professor Fearnley: As the chair of an audit committee of a significant charity, we have just done audit tenders and we appointed the safest firm, which is what you do. Picking up what Lord Smith said if I may, Sorry, Lord Maclennan, I beg your pardon. The Chairman: Lord Tugendhat.

Professor Power: I think we have to make a distinction, when we are looking at audit, between the quality of the audit that is performed and the service quality that is provided to the client. The client does not always see the quality of the audit itself. Therefore, the client wants the service and they want things to happen as they do, but the quality of the audit is quite often unobservable to the client themselves. This is an issue for the firms that, if they do not deliver an audit in the right compliance mode, then they will have the audit inspection unit after them. So they have to go through all that. One of the issues that has come out from the research that Professor Beattie and I and another colleague have done is that they are complaining—both the firms and the companies—that it has become a very tick box activity, and the auditors are spending their time meeting the requirements of the inspections rather than meeting the requirements of their clients. There is also the other issue of the ethical standards prohibiting certain services. Some of the auditors have said to us that they no longer have access to the directors, chief executives or the chairman of the company because that is now against the ethical standards. So we have to look at how you achieve the balance between the proper role of the auditor and how the auditor can help the business. I think this is quite an interesting dilemma because auditors have to be independent and have to comply with the rules but we are losing something along the way in the current regime that we have.

The Chairman: I am sure we will come back to that in subsequent questions. Thank you.

Q11 Lord Best: I have to declare some interests: I am the chair of the audit committee of the Royal Society of Arts and I am the chairman and an ex-officio member of the audit committee—but I attend only one of its four meetings in order to get that little bit of distance—of the Hanover Housing Group. The first one uses Deloitte, the second one KPMG. So I declare those interests. Would it be fair to say that there really is not any great competition between the Big Four themselves in the audit market? I notice that the Office of Fair Trading in its submission to us says, “The OFT considers that competition in the market
for audit services in the UK may be limited", and I notice that of the FTSE 350 top companies only about 2.5% have changed their auditors in any one year. There is pretty good stagnation there. Do you agree that there is not much competition going on out there?

Professor Power: Yes, there are very few transactions and most of those probably take place because of mergers and aligning auditors in groups, and all that kind of stuff. I think it is well known that there are quite high switching costs for clients as well. So I think those two forces reinforce what you say.

Professor Beattie: I would take a different view. It is quite true that the rate of turnover is very low but I am not sure it is quite fair to deduce from that there is a lack of competition. I am relatively distant from seeing this first hand but from the case study evidence that we are getting, from talking to the finance directors, the audit committee chairs and the audit partners, reading that evidence it seemed quite clear to me that all parties felt that it was quite a competitive market, in the sense of if they did not satisfy the other party then there was always a threat and sanction that there would be some change. Often the change does not have to happen for the potential for change to make the market competitive.

Q12 Lord Best: Would it be fair to say that there are quite high switching costs and very little incentive to switch?

Professor Beattie: I would absolutely agree with that. There are very high switching costs but if the relationship is not working then there comes a point where that is worth taking on.

Q13 The Chairman: Is that not often achieved by changing the audit partner rather than changing the firm?

Professor Beattie: That can happen as well. Requests can be made and that can be done.

Q14 Lord Lipsey: It seems to me that there are two sets of factors leading to the concentration in this market. The real advantages the Big Four have, as a result of being so big, are global reach and a great variety of skills and the semi-psychological advantages they have that nobody gets sacked for hiring them and so on. Are the real advantages so great that it is a waste of time thinking you can break up this monopoly, because you would lose far too much, or are the psychological factors very important too and therefore there is a possibility of extending beyond the Big Four if we take the right regulatory measures?

Professor Beattie: I think you are absolutely right. There is both the perception problem and the reality problem. In thinking about the concept of audit quality—we have talked about audit firms size being very much seen as a mark of audit quality—the other mark that exists is indeed industry specialisation. Academic research will demonstrate that both of those are seen as marks of quality and, indeed, audit firms can potentially get a premium on audit fees if they have both larger size and industry specialisation. Ultimately that specialisation does exist at the people level, as Professor Power has said. It goes right down to the audit teams and the people in a particular industry will know all of this. Indeed when Andersen failed studies were undertaken to look at where the Andersen firms went, whether they chose to go with the firm that took over Andersen or whether they decided to follow the audit team if they went somewhere else. That is some of the reality of it. There is undoubtedly a big perception problem. A study which has just come out in America suggests that there seems to be a greater inclination of companies in America to move to what is called the second tier, and even the third tier. The study is monitoring the stock market reaction to these audit firm changes and finding that, whereas they thought they might be negative, they are becoming more positive. The study was suggesting there might be some hope for these kinds of market-led solutions to the problem of audit concentration; that is to say, trying in part to change the perceptions of people out there and make it acceptable to have a lower tier audit firm. But that is in the US. I have no sense of that in the UK at the moment.

Professor Fearnley: From our case study research, obviously we intentionally talked to companies that had a second tier auditor, and provided the companies did not get too big—and these were all main market listed companies—they preferred the second tier auditor. They thought they received a better personal service because they were more important to that firm than if they were a small listed company with a large firm; they felt that they were treated better. The very much came out that if we get beyond a certain size we will probably have to change, or if we become more international we will have to change, because we are not sure that this particular firm can provide us with that level of service that we will continue to need. The issue with the concentration is particularly with the largest firms with the big international reach. I do not think they have a choice, even if they wanted one.

Q15 Lord Lawson of Blaby: May I ask a question arising from that? Do you think there is a danger that if a very large company has a second or third tier auditor, and therefore that company’s business is hugely important to that particular auditing firm, that the auditing firm might not be as critical when criticism is warranted?
Professor Fearnley: There are ethical standards for auditors which prohibit them taking on a client above a certain size. I can’t remember the exact figure but I can provide you with that, Lord Lawson, if you would like to see it. There are restrictions that you cannot become too economically dependent upon one client. And one could say in some ways that actually prevents the growth of the smaller-tier firms into the market. But then the economic dependence is such a risk.

Professor Power: If I may, I think that’s a very important point, but I think it applies equally to the Big Four. I think the unit that we should think about in terms of independence—the relevant unit—is not the whole firm; it is the partner and his or her client bank. So if there is a partner with 12 clients, and the 12th one is absolutely massive, there is where your independence threat bites. That can be a small firm, a medium firm or a large firm. I think that some of these aggregated dependence levels for firms as a whole are not very meaningful in accessing that particular problem.

Q16 Lord Hollick: I was interested in your comments, Professor, about the greater readiness in the United States for companies to have second or third-tier auditing. Is there any evidence to suggest that the anxiety of large companies about moving from large audit firms to second-tier audit firms justified? Have they been punished by banks or the market for doing that? Is there any evidence that the next tier cannot provide the same level of audit support, particularly given your earlier remark that this has become increasingly a box-ticking exercise, rather than one where great judgment and expertise has to be applied?

Professor Beattie: There is a stream of research that will look at how the market responds to the announcement of an auditor change. In particular, you’d be interested in studies that look at changes from top tier to lower tier; and that normally would have negative market reaction. The investors don’t like that change to a small tier auditor. There is another stream of research that is particularly popular in the US academic world, which looks at what they call a proxy for audit quality, being the abnormal accruals of the company. It’s a bit of a red herring because audit quality is inherently unobservable. This is the problem for academics wanting to research this. So they come up with all sorts of ways of looking at it—looking at the qualified audit opinions and the incidence of those or abnormal accruals. I think it would be fair to sum up that body of knowledge as saying that it does seem to provide some evidence that the big firms seem to provide higher quality audit. But are they defined by that proxy, which I have reservations about. So it is a bit difficult to give a definitive answer.

Q17 Lord Tugendhat: Just following Lord Hollick’s point, we received a huge amount of submissions. I cannot remember which one I am about to quote, but one of them pointed out that the concentration is much the same in most of the large economies.

Professor Beattie: Yes.

Lord Tugendhat: But the outlier is France. In France I think the Big Four have only 61% of the market, whereas even in Italy they have a very high proportion. To what do you attribute this, and do you think that the 40% that are not done by the Big Four in France are any worse audited than the corresponding firms in the countries where the Big Four have such a large share?

Professor Beattie: I don’t know about the 60% to be honest. I’m not sure I can, off the top of my head, offer you an answer to that. I don’t know if any of my colleagues can.

Professor Power: There is more of a tradition of joint audits.

Lord Tugendhat: I am sorry?

Professor Power: There are more joint audits in France and that’s a very important feature of the audit landscape, which should be taken into account.

Q18 Lord Tugendhat: More choice?

Professor Power: Joint audit. So you have auditors from two different firms and they co-operate and divide up the work and liaise.

Q19 Lord Tugendhat: We used to have that here. Again thinking back, I was a director of NatWest in the 1980s and they had two of the biggest audit firms. I don’t know whether they had a better audit than having only one, but it was not uncommon here.

Professor Fearnley: I think that is pretty well gone from the UK now, but it has been a tradition in France, and that tradition continues.

Q20 The Chairman: Do you see advantages in that in helping the second-tier firms to have substantial clients in a bigger market?

Professor Fearnley: I think it is one of the possible ways of opening up the market to the second-tier firms, if they were to share an audit. But the other thing you have to bear in mind with the very large companies, if we went that way, is who would the joint auditor be, because it could just as easily be another of the Big Four firms. All these things need to be considered, but the likelihood is it could annoy the companies. Now, if you are worried about annoying the companies, that is another matter, because it would not be as efficient and it could cost more. I know there are various firms who think this would be a possible solution.
**Q21 Lord Hollick:** Is this just the French being French, or is it—

*Professor Fearnley:* Well, I think it is the French trying to stop oligopolies.

**Q22 Lord Smith of Clifton:** It would not be so efficient in one sense, and it anticipates a question coming on later. As for efficiency and having two people looking at it, it might lead to a greater degree of scepticism than if you have just one looking at it, and so it would be more efficient if that company was in trouble in some sort of way, like the banks were.

*Professor Fearnley:* I am not sure, Lord Smith, that it actually works like that. What they do is divide up the work between them.

**Lord Smith of Clifton:** A subcartel of a cartel.

*Professor Fearnley:* Yes; and of course if you have a very large firm and a very small one, the very large firm would probably do most of the work. Two eyes are always better than one. But you would have to talk to a French auditor to understand how it works in detail. I think that would be the best approach to it.

**The Chairman:** We must move on because I want to get some of the questions that impinge on the opening statement by Professor Beattie.

**Q23 Lord Moonie:** Chairman, can I also declare a general interest as chairman of an audit committee who uses the services of companies who have given us evidence and will be giving us evidence. I am trying to think very hard of what possible advantage I could get for myself out of that but I can’t really think of any. Never mind, the declaration is made. Can I ask you, on a slightly different tack, what would be the implications of the statutory requirement if an audit were dropped and assurance needs were left to the market? In other words, what is your view about liberalising the audit markets, so that all or most clients may choose whether or not they have an annual audit?

*Professor Power:* We have liberalised a bit of the market at the small end of things, and interestingly enough there are problems there of audit quality, and the POB has reported on that. At the top end of things, we obviously can’t know for sure. I think there would be, in the short run, quite a bit of uncertainty. Obviously as an academic it’s an idea that intrigues me because I don’t bear the costs of any change. But I think what we would see, if that were to happen—and it would be assuming issues of law and so on could be overcome—is a real demand would be visible for a more differentiated range of assurance services—to use a better word—focused on the kinds of things that investors might want. I think boards of directors would have to raise their game in thinking about audit. Investors would absolutely have to raise their game in thinking about audit. I actually think it is not insurmountable; there would be a kind of market solution. Instead of the black box of audit quality—this compliance product we’ve been talking about—I think there is the potential for a much more differentiated range of audits focused on different things at different prices. So there would be a spotlight on the board. I think the internal audit function would be drawn into the universe that we’re talking about much more, and I think it would be most interesting—in our sense of interesting. The barriers to that are that people think there are big changes to the law that would be needed and it’s just simply unthinkable for a whole range of institutions at the moment. But I think it should be talked about.

*Professor Beattie:* Before audit was required by law, voluntary audit—companies choosing to have an independent person audit the financial statements—was something that happened as a response to agency problems, so it was a way in which companies could signal their quality to say, “We’re very happy to have independent people audit voluntarily”. Evidence exists that there would still be quite a demand for audit and there would be a signalling process in place. But interestingly this was one question that we asked in the survey side of our research, where we put about 15 suggestions of proposed change in the area of audit and accounting. Of those 15, this was the idea that came right at the bottom in terms of the extent to which people thought it would improve financial reporting integrity. Indeed all three of the parties’ expert preparers thought it would moderately undermine financial reporting integrity were this to happen.

**Q24 Lord Lawson of Blaby:** May I ask just one supplementary? Of the companies that do not legally require an audit now, because they are SMEs—or whatever you like to call them—what proportion do in fact, despite that, have such a provision, and what proportion choose to avail themselves of this dispensation?

*Professor Beattie:* I don’t have that information to hand; I am sorry, Lord Lawson. I’m sure I could dig it out and provide it in due course, if that were helpful.

**Lord Lawson of Blaby:** Thank you very much; that would be helpful.

**Q25 Lord Forsyth of Drumlean:** We have pretty well explored a variety of the reasons why people might choose to have a Big Four firm but, looking at this objectively, are there really any circumstances where a client is effectively obliged to hire a Big Four firm?

*Professor Fearnley:* It’s a size issue, Lord Forsyth, and a specialist industry issue. But it is size and global reach.

**Q26 Lord Forsyth of Drumlean:** I do not know a great deal about the way that the Big Four organise themselves, but certainly when Arthur Andersen
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collapsed in a heap it turned out not to be one large
global organisation but a series of discrete
partnerships, and I suspect that is probably true of
the Big Four as well. Certainly also within their own
internal structure they tend to be centred around
particular partners. The smaller firms are involved in
networks with other firms around the world, so does
size really matter here?

Professor Fearnley: Certainly the evidence we’ve had
from our case studies is that the networks of the
smaller firms are not as strong and they don’t have an
office everywhere. Perhaps that is an exaggeration,
but the larger firms have a presence in many more
places in the world. Companies don’t like paying
huge travel costs. This may seem a very basic thing,
but they want a local auditor within reasonable reach
of having to do the work. And so I think it is quite
simply an issue of availability and an issue of
resourcing when the company gets very big. And if
you get into the banking sector and the oil and gas
sector there’s also a very important issue of specialist
knowledge. You couldn’t appoint an auditor who
didn’t have enough specialist knowledge in those
areas.

Q27 Lord Forsyth of Drumlean: Can you just help
me with that? When you say “specialist knowledge”
in the oil and gas sector, what kind of specialist
knowledge do you need to have in order to do the
audit? I am struggling to understand that. What
would you need to—

Professor Fearnley: The biggest criticism or the worst
criticism that a client can make of an auditor is that
they do not understand our business. And it is
important for an auditor to understand the way the
business works, because you’re not just ticking the
numbers that come out of it, you have to understand
where the numbers come from and how they work.
The more complex a business is and the more
complex the risks in that business are, the more you
need someone who can address those risks, because it
isn’t just sitting in a room checking numbers.

Q28 Lord Forsyth of Drumlean: Isn’t the other side
of that that if you have a small concentration of
people who are perhaps doing the big oil companies,
perhaps they won’t have the same degree of
scepticism that might be required?

Professor Fearnley: I think the scepticism issue has
been a little bit overplayed because, as Professor
Beattie and I have already said, what we have found
is we have a very compliance process-driven system
now, which has knocked quite a lot of scepticism out
of it. Providing they are complying with the system
then that has created a bit of a problem there, because
there is less focus on the output than there is on the
process of actually getting to it. So I think that is an
issue. But I don’t think there would necessarily be less
scepticism. I think there would be more understanding. If you look at different companies in
the same industry sector you do understand how
those companies work and the sort of things that
went wrong in company A that you can look out for
in company B. If it is a straightforward business it’s
not so difficult.

Q29 Lord Forsyth of Drumlean: It did not quite work
out with banking though, did it?

Professor Fearnley: Well, it was going wrong in all of
them, wasn’t it, I think was the problem?

The Chairman: That will lead us on to the next
question from Lord Hollick, because I think we are
now moving into some of the territory that you,
Professor Beattie, outlined in your opening remarks.

Q30 Lord Hollick: Moving on to the banking crisis,
do you think that the auditors—as they considered
making their going concern judgments before the
crisis—should have drawn attention to the systemic
risks that, with hindsight, became very clear?

Professor Fearnley: Do you want to do that one?

Professor Beattie: I can start. When you say, “Should
they have?” there is in one sense. What the auditors
will do today is very much they will do exactly as
required by the regulatory regime and that’s it. So
they don’t go, in any sense, an extra mile if they don’t
think it’s quite right. This is the problem with the true
and fair view and the substance over form concepts
going. We had them in UK accounting rules, but
they’re not embedded in IFRS rules. So to say,
“Should they have done so?”—well I’m not sure they
were required to do so under the accounting rules and
the regulatory regime. But of course then there’s a
secondary question, a normative question. Putting
aside the regulatory regime, should they have done so
from a public interest perspective? And I suppose it
would be easy for me, because I’m not in the
profession, to say yes. But we were struggling because
our hands were tied by this regulatory regime, which
had become so powerful and almost a crippling
judgment in a way. I don’t know if my colleagues
want to follow up.

Professor Fearnley: You see I think when you have a
very strong compliance enforcement regime—which
is a very good thing—everybody wants to keep out of
trouble. The way you keep out of trouble is to comply
with the rules. Besides which, you can’t get sued if
you’ve complied with the rules, and that is of course
very helpful as well. So I think this is the situation
that people have been in. This is what happened in
France with the Société Générale, where they
actually flouted the IFRS rules and they brought the
loss in in the year before they should have done—
according to the rules—and they were given a real
hammering. But my view is that if they had produced
their accounts without disclosing that loss everybody
would have fallen about laughing because they knew the loss was coming. But they were given such a hammering about that that I think everyone took fright and said, “Well if we’re all going to get really badly criticised for using the true and fair override, we won’t do it anymore. We’ll just comply with the rules”. And I think this is one of the unfortunate things about the situation that we’ve got ourselves into. We’d like to see things like prudence and substance over form coming back into the accounting regime and go back to the provisions in the Companies Act, which make it very clear that you adopt prudence and substance over form. But I think the problem is if you have mark to market you can’t have prudence.

Q31 Lord Hollick: You paint a rather alarming picture, if I may say, of auditors not applying common sense to a situation. The IFRS, as I understand it—or maybe I don’t understand it—still requires you to look at the going concern. And to establish whether or not a bank or a financial institution is a going concern you obviously have to look at both sides of its balance sheet, you have to look at the quality of its loans and you have to apply appropriate scepticism to the judgment measure to test it. Now none of those things are banned under IFRS, are they? Professor Fearnley: Certainly one of the problems with the banking crisis was that under IFRS the mechanism for providing for loan losses changed. And as a result the loan losses went down, because they were looking at incurred loss, ie make a provision if there’s evidence of a loss, rather than make a provision where there’s a risk in the portfolios. That made a very big difference because it freed up capital for the banks to lend more. If you’ll excuse me saying so, Chairman, if you let a bunch of little boys loose in the sweet shop without any supervision they’ll eat all the sweets. This is the sort of issue—that if you give people the opportunity to do these things through legitimate mechanisms in the accounting particularly, they will do it. I think what disappoints me about my own profession is that they didn’t stick their heads over the parapet and say not that we’re not doing the job properly but, “Hey, there’s something wrong here”. And to be honest the Financial Reporting Council didn’t either, because I think they were so obsessed with getting global accounting they lost sight of the quality of what was coming out, and I think this is a very significant issue.

Professor Power: I think you should also bear in mind the mechanisms for making a public statement in the area that you’re mentioning just didn’t exist. There’s an audit report. Qualifying the audit report of a bank is almost unthinkable, and there’s not much in between. There’s communicating with regulators, which is being addressed now, but there weren’t really the mechanisms. So even if there were concerns, and concerns were raised with management about the aggressive nature of the business model and the balance sheet gearing and so on, where do those concerns go? There were not institutionalised mechanisms. If you’re saying that some lone partner should have blown the whistle on Northern Rock, I think that is completely unrealistic. It just simply wasn’t their job as described by the system, as Vivien has said, and there weren’t the mechanisms to do so. So I think it wasn’t really the auditor’s job to spot what nobody else knew in the market.

Q32 The Chairman: If the auditor was concerned about that, isn’t it an issue that they should be drawing first of all to the attention of the audit committee and then to the board?

Professor Power: Absolutely, and that may have happened. I don’t know whether those conversations took place. But the mechanisms that might matter might be more of a public nature, or at least a line of supply to the regulator.

Q33 Lord Lawson of Blaby: Following on from what Lord MacGregor just said. Do you think this would be wholly improper? If they had identified that it was a problem but there was nothing within their statutory duties they could do about it—I do not know what the relationship is—might they have not said to the FSA, “There is a practice going on which I think you ought to look more closely at than you are at the present time”? Professor Power: There’s absolutely no way that—

Lord Lawson of Blaby: Did they say that?

Professor Power: Well I don’t know, but let’s think about how professional firms work. If I’m an audit partner of a bank I don’t just go directly to the FSA, I go through various hoops in my own firm to discuss the issues and it gets dealt with by the risk committee of the firm and that’s usually where it sits. So if there’s any contact with the regulator it is top of the firm to top of the regulator, rather than the individual partner. So I think it would be a very brave partner leading an assignment who would unilaterally take that kind of action, and indeed the mechanisms wouldn’t have been there.

Q34 Lord Forsyth of Drumlean: Are you hinting that this could be commercially damaging for the firm and, therefore, was not going to happen?

Professor Power: I beg your pardon.

Lord Forsyth of Drumlean: Are you hinting that because it might be commercially damaging for the firm’s relationship with their clients that it would not happen? Is that what you are implying?

Professor Power: That may be the case but I am thinking of the psychology of the lead partner on the particular assignment. They are required to take that
kind of matter through the, for want of a better term, bureaucracy of the firm and their risk management processes.

**Q35 Lord Tugendhat:** We all want to learn lessons from the crisis we have been through, so my question is not directed to the past. Would it be helpful for the future if, when the regulator has particular systemic concerns, or particular concerns about particular practices, it issued a public instruction, or a private instruction—I do not know which you would prefer—to the auditors to make inquiries along those particular lines and to satisfy themselves on the point about which the regulator has expressed concern?

**Professor Power:** The regulator has a lot on its mind at the moment, as you might imagine. I do not know, having people those lines of communication are beginning to free up in exactly the way that you are suggesting.

**Q36 The Chairman:** Forgive me, Lord Moonie, for a moment, but I know, Professor Power, you have to go very shortly and there is a question we wanted to ask you that I know you are particularly interested in, so can I just ask it? What in your view are the hallmarks of a profession, and do you think auditing measures up as a profession?

**Professor Power:** That is a very interesting question, Chairman. I will have to search around for a definition, but I think there would be a kind of consensus that it involves something like esoteric knowledge, which is hard won through an apprenticeship of some kind; some kind of natural monopoly, recognised and licensed by the state because of the nature of that knowledge and its public role; a degree of autonomy, whereby in return for state recognition professionals are allowed to control their own work and define this thing called “audit quality”; and backed up by a service ideal, which is to do with ethics and dependence. And I think all those four components more or less would characterise what we mean by “profession” today. Now, from the comments and the questions that we have made already, at least two of those components are looking pretty fragile as benchmarks of professionalism in the current world because, if you have a large firm that needs to make sure that there is consistency over the hundreds of audits that it runs on a yearly basis, then you need to run a machine and you need to bureaucratise the delivery of that audit in such a way that it is a standardised product. That is perhaps more remote from this professional ideal. So I think there are forces of standardisation around in the audit area that go against these professional characteristics, as I’ve described them. Now that’s not to say that it’s all gone and it’s all over but I always find it very striking that professional institutes play much less of a role these days than they did when I qualified. So I think the role of professional institutes has changed commensurate with the greater commercialisation and standardisation of the craft in this space.

**Q37 Lord Moonie:** Just talking about your professional institutes, it is even more the case in banking nowadays. There is a lack of standards that were applied when my brother, for example, qualified 40 years ago in what does apply today. On the question of risk—I am trying to tease it out; you have partly answered it, I think—how reasonable is it to expect an audit firm to be able to quantify risks which have not been adequately quantified, or not transparently enough quantified, by the companies concerned? This is not just a matter for financial services, where everybody has held up their hand and said, “We didn’t understand what was going on”. But in oil exploration and a whole host of specialised areas, how reasonable is it to expect that audit companies have this level of expertise?

**Professor Fearnley:** I think you have to draw the distinction between financial statement risk, which is what the auditors are about, and operational risk, which is what is within the organisation itself. Obviously, the auditors are responsible for looking at the financial statement risk and making sure that their opinion holds up against the risk of misstatement in the financial statements. But I think the operational risk is something that is up for grabs, as to who are the best people to be able to address that. I don’t think it’s necessarily the auditors; I think it depends on the nature of the business. If it’s a very complex business you could need specialist people to be able to understand what the risk of a blow-out in an oil company is, or what risk of a problem in a gas company is, or any of those sorts of risks. As we focus more on the risks within business, it’s down to the business to sort out how they deal with that in many ways.

**Q38 Lord Smith of Clifton:** Yes, turning from process and that sort of thing to the structural problems, which are almost explicit in our terms of reference, if it were decided that the Big Four market should return to, say, a Big Eight or even a Big 10, how might that be achieved or is that impossible?

**Professor Beattie:** There are a number of ways that that could be achieved and some of them we’ve touched on already. I feel qualified to comment on what some of the possibilities might be. Whether they’re practical or not, I would hesitate—as an academic, to be honest—to comment. At the moment, because of concerns, not so much about competition but about lack of choice in the audit
market, there was quite a lot of debate a few years ago and it was decided that we should start to see if market-led solutions would make a difference—for example, that being to try to address the perception problem, in particular, and encourage audit committee chairs to think about the possibility of taking a non-Big Four firm. That has been ongoing for some years and there have been regular reports from this group. To be honest, it doesn’t seem to be making a discernible difference. So that’s the easy approach. There are the radical ideas, by which I mean things like, “Let’s break up the Big Four”. Maybe that would be possible. I think you would have to ask the Big Four whether that would be possible.

**Lord Smith of Clifton:** We will.

**Professor Beattie:** I am sure you will. Forcing or inviting or encouraging the smaller firms to merge wouldn’t make a huge impact because they’re so far behind the Big Four. I don’t think the idea of joint audits is particularly a great idea. We had one case when we did a previous study in a different regulatory regime, and in that particular instance of a joint audit there was the big firm and then the little firm doing a little corner of the audit. That did not seem to be successful at all from what we saw. What other possibilities are there? I don’t think it’s a good idea, for example, to open up the audit market in the UK to non-EU audit firms, because I think there would be problems with culture clashes, certainly in the first while. There are a few other ideas. One might be to say—as I mentioned previously—that a lot of these smaller listed companies already have a non-Big Four firm, but at some point they jumped ship. If they could be encouraged, in a real sense, to stick with the non-Big Four firm you would get a more middle-of-the-road organic solution perhaps, because these non-Big Four audit firms could grow as their clients grew and became bigger. They could grow together potentially. But that is limiting the choice of those companies, potentially unreasonably, if they feel they want a Big Four firm.

**Lord Smith of Clifton:** It does raise the question, if the firm is going from AIM to FTSE and doing splendidly, on the chances of small second-tier or third-tier audit firms growing with them pari passu—you would have to start investing capital into the audit firms to enable them to do that.

**Professor Beattie:** Yes, and get the people.

**Q39 Lord Smith of Clifton:** Looking at that, is there any possibility of firms generally becoming less, as it were, a partnership and more floating as ordinary stock companies, so that some of these second or third-tier firms could acquire more capital in order to expand?

**Professor Fearnley:** I think there are one or two firms who have been listed; there’s Tenon. But one of the concerns I have about it is that that is putting market pressures on the performance of the firm itself. Therefore, there is an incentive to go for profit at the expense of performance, which of course is the very last thing we want to encourage with audit firms. Whatever solutions we look at I think there are very big risks. Of course if the firms were allowed to raise capital on the way, I am afraid it is the big firms that would raise the most, so they might finish up shutting all the others out anyway because you couldn’t say, “It’s only firm X or firm Y that can raise capital”. I would be uncomfortable with that. My feeling about this, which we know is a very difficult problem, is to ask the firms themselves to come up with proposed solutions—I can’t imagine they’d like it very much—because they’re the ones who would have the best idea of what could be done. If the Committee is minded to consider that there are not enough firms out there, then let’s see what they have to say.

**Q40 Lord Tugendhat:** Can I ask you about the tension between public service and profit maximisation? We are dealing with very responsible people in the big audit firms and very high ethical standards, but when you have eight players in a market then people don’t feel they have very special public service duties. When you are down to four fulfilling an absolutely vital function, there is a real element of public service about it and the whole edifice of trust in public accounts depends on a very small number of firms. Do you feel that in that situation, the balance between maximising their profits and their public service duty is more or less correct at the present time? How would you articulate this tension and where the balance lies?

**Professor Fearnley:** I think that’s a very difficult question to answer. If I can perhaps be a little unkind about my profession—which is fair enough I suppose—I think the accountancy profession, along with other professions, loses the plot from time to time and has to be pulled back from what it was doing before. We’ve seen this historically over excessive low balling, and of course this is why in the audit area it has gradually become more and more externally regulated, so that we can be sure that they don’t lose the plot. I think in the public interest areas now, with the regime we have, it would be quite difficult for the firms to lose the plot. The problem that we have of course is that the standard setters have lost the plot, so that is not very helpful to us in that sense. I believe now, if we didn’t have the problem with the underlying accounting standards, we would have a regime that is pretty good at keeping everything in order.
Q41 **The Chairman:** Do you want to elaborate on that point, because I think you touched on it earlier?  
**Professor Fearnley:** The standard setters losing the plot?  
**The Chairman:** Yes.  
**Professor Fearnley:** I think that when we went over to international financial reporting standards in 2005, the quality of what was delivered at that time was not good enough and I think it was rushed to get it into the EU by the deadline that the EU wanted. Certainly, from our research, we were astonished by the barrage of criticism that came from the preparers about the quality of these standards. The criticism wasn’t about it being a lot of work, because professions are used to work and finance directors are used to change; it was about some of the underlying principles, such as the removal of prudence and the effective loss of “true and fair”. These were the concerns that fed through and there were criticisms of the mark-to-market regime, although our work was not particularly focused on the banking sector. So we weren’t investigating the banking sector, but the criticisms were across the board. I think the problem you have is that the standards setter does not have the right degree of accountability, because if you have aspirations to be global, or you are global, then who are you accountable to? And the more people you’re accountable to, the less you’re accountable to any of them. This is the issue, and we don’t have a general election every five years for the standards setting board so we can kick them out if we don’t like what they’re doing. So it’s an extremely difficult situation. This is why we suggested, in our submission, that we should have maybe a European standard setter that had more direct accountability to the countries that it was serving. If we go with the US, we will finish up with US accounting and we will finish up subject to the vagaries of the US political system, which would be distinctly uncomfortable for us. So I think we’re getting to a point where I believe there are serious concerns about the accountability of the standard setter, and maybe we should have US GAAP, European GAAP, Asian GAAP, and just let people develop as they are. Before anybody starts to say, “We want it the same around the world”, there isn’t much else that’s the same around the world, so how do we think we can get accounting the same around the world? With technology as it is now, it’s not that difficult to change between one thing and another. You may not be aware, but there used to be a statement that you had to file in the US that showed the differences between US GAAP and UK GAAP, and that was jolly useful because it showed you where the bodies were buried. It was an extremely useful statement. It gave people the chance to compare: is this way of doing it better than that way? There is no one way of accounting for anything, and yet we are being told by these people, who I call dangling regulators—who in fact are sitting in a hot air balloon just off the east coast of the US—that they believe there is only one way. Well, of course, there is more than one way.

Q42 **Lord Tugendhat:** You touched earlier on the question of trust; the question of whether Chinese or Indian or other accountancy firms would come in and you said—if I understood you correctly—that it would not fly because it would not have the credibility. But when you mentioned the way in which the US insists on imposing its own standards in many areas, can one not imagine a situation—perhaps in the mining industry to begin with—where the Chinese would say that they don’t trust the accounts of BHP unless they can have Chinese auditors looking at them? And given the dependence of BHP on the Chinese market, it might be difficult for BHP to resist having a Chinese auditor alongside its regular western auditor. I wonder whether, given the growing power of China, the dependence on the Chinese market of a number of companies—I only pick mining as an obvious example—one couldn’t find the Chinese, in the first instance, insisting on some element of Chinese auditing of the accounts of companies that manufacture to a large degree within that market  
**Professor Fearnley:** If we get to the situation where an economy, such as the Chinese economy that is growing—as we know—very rapidly, makes those requests, I think those requests have to be considered at the time. As we are at the moment, I think that there are cultural issues. I think that is one of the cases for a joint audit because one obviously has to satisfy the regulator. Enforcement is national because we don’t have such things as global corporation laws or global laws, and I think it will be a long time—if ever—before we are able to achieve that. So I think one needs to look at degrees of co-operation that can be achieved, almost on an ad hoc basis, where these requests come in. This is one of the challenges: how do you make an international body accountable? Where is its residence? Who is the lead regulator? This was the problem we had with the Icelandic banks: who was the lead regulator? Going back a few years, this was the problem with BCCI. I think that is going to be a growing issue for us.

Q43 **Lord Lawson of Blaby:** I have, I must say, considerable sympathy with your magnificent outburst, Professor Fearnley.  
**Professor Fearnley:** Sorry, sir, it was a rant.  
**Lord Lawson of Blaby:** Yes, all right, your magnificent rant. I have considerable sympathy with it. On a matter of detail, because of your last point about the enforcement being national, which is an important point, I am slightly doubtful about your idea that a European GAAP is more sensible than a
UK GAAP, but leave that to one side. I would like to ask one specific point, which you have raised on two occasions now, and that is the malign effects of mark-to-market accounting. I address myself particularly to banking, where it is quite clear that mark-to-market accounting had a malign effect, both at the top of the cycle and at the very bottom; two different malign effects but in both cases. Yet mark to market accounting was brought in because of the unsatisfactory and rather creative character—or so it was felt—of the old fashioned, former form of accounting. So what is the solution? Can you tell us what you think should be done? It is a to start on this subject now so if we could have a note, Chairman, on mark to market accounting—what you think about it, what its effects are and what should be done about it—I think that will be extremely helpful.  

Professor Fearnley: Yes, of course, we will provide something of that nature for you. People have thrown away the idea of historical costs as being no use, but at least you know what someone paid for something. There are ways of disclosing or providing information about what is a realised gain and what isn’t. But one thing I would like to say to the Committee, which I think is a serious issue that’s slightly connected to the mark to market issue, is that we don’t have an adequate definition in this country of what is a distributable profit. Therefore, when dividends are being paid out, and particularly if they’re being paid out of unrealised gains in some way, it gets terribly messy. Could I ask your Lordships to get that looked at because it is an issue?  

Lord Lawson of Blaby: Absolutely. It is not just dividends; the bankers’ bonuses were paid out of completely fanciful paper profits as the result of a bubble, and there was never any real profit—or certainly not remotely on that scale—there at all, but the bonuses were real enough.  

Professor Fearnley: But if we get to the position of eroding the capital of the company—we don’t want to be there. Well of course we did, because the taxpayer had to cough up.  

The Chairman: Can we just let Professor Beattie comment on that.  
Professor Beattie: I think it’s a related idea here and it picks up something that was mentioned before. We talked about risk and financial statement risk and operational risk, and we’re very much focused on the accounting model for the financial statements. Perhaps some thought could be given to the fact that the annual report of companies is broader than just the financial statements and the notes to the accounts and increasingly what might be called the “front end” of the accounts. Particularly, there is a tension being placed on what is becoming semi-regulated, which is the management commentary or the business review, operating the financial review. We have different terms but, effectively, the same piece of narrative that sits at the front of the accounts is a kind of storyline for the financial statements. Traditionally, it has been almost non-existent; recently it’s growing and growing. And I think with the complexities of accounting nowadays, there is an increasing need for perhaps a piece of narrative that may be given some attention by the auditors. At the moment auditors are required to look at this storyline for consistency with the financial statements. It would be possible to give more attention to that part of the annual report of the company. That is where, perhaps, one could address some issues to do with what are the operational risks? Is there something in the financial statements that because of the accounting model is not telling us a very good story? I’m suggesting that we broaden it out a little bit to look beyond the financial statements to the complete report of the company.  

Q44 The Chairman: You have answered the question I was going to ask you. But can I touch on a small part of it? That would include, presumably, the audit of a client’s risk management, for example, and what was being done on the risk side, as well as corporate governance and as well as the front end of the annual report and accounts. Would this change the skills and the nature of the audit profession or do you think it would be capable of doing that?  

Professor Beattie: I think it would quite significantly change the skills required for the auditor and they may, indeed, need to bring additional expertise from not the traditional accounting route to do some of this. Professor Power mentioned that if we get away from the word “audit” and we think more of this word “assurance”, which is used to be inclusive of audit but potentially encapsulates other kinds of assurance, the auditor might decide it was possible to give assurance on the process by which information was created by management and say that that was reasonable. A much bigger task would be to ask the auditor to give assurance on the content of that information, and that would most definitely require quite a range of skills.  

Professor Fearnley: You need to be a little bit careful because if we are worried about the competition and choice and power of the audit firms, there is an issue of do you want to make them any more powerful and how is the best way to do it? There certainly needs to be more done but the real question is: who should do it?  

Q45 Lord Lipsey: This is a fascinating tack we are going down, but it almost suggests that the focus of our inquiry should not be too much on just the concentration into the Big Four, but into the rules that the Big Four and all the other accounting firms are employing. This might have a more revolutionary effect than simply trying to break that dominance of the Big Four. Is that a fair summary of your position?
Professor Fearnley: Audit is very old fashioned, in the sense that it goes back to company law when it was a very simple issue: the auditor reported to the shareholders at an annual general meeting and then the shareholders decided whether they were going to approve the accounts or kick the directors out. It doesn’t work like that anymore and I think a root and branch consideration of what the audit should be now. By the time you get to the issue of the annual report with the audit report on it, the only new information in there is what the directors get paid, because all that other information is now out in the market. I think we need to be thinking about whether we should just start from the first principles of looking how the market works now and what is the best way of providing third parties with assurance about it because there is so much stuff coming from on websites and everywhere. It’s not as it was when company law set the process up.

The Chairman: I think we are coming to the end, because we have had a long session, but there were a couple of questions that we wanted to ask you at the end. Lord Best, would you like to deal with the first one?

Q46 Lord Best: The first one is who, in fact in reality, does determine which firm of auditors is appointed? I don’t know if you have done any research on this. Is it management? Is it audit committees? Is it the board?

Professor Beattie: I think we would feel that we have done some work on this, some of it is going back to the mid-1990s, and the work from the 2007 and 2008 case studies tells a slightly different picture. So I think, whereas in the mid-1990s it was very much the finance director who was in the driving seat in all of this, and what recommendations they made to the board at the time would probably have been carried through. The shareholders would very seldom challenge that. One of the significant changes in the regulatory landscape is the rise in the role of the audit committee in companies, which we would see as a very strong positive in all of this. It makes the relationship in audit not so much just the finance director and the audit partner. They were the primary two people involved but we now have the third person, which is the audit committee chair, as a three-way thing, and in the background the audit committee. I think who determines which firm is appointed would probably be very much the audit committee chair with some consultation with the finance director. Would you agree?

Professor Fearnley: Yes, and certainly when I was involved in an audit appointment a couple of weeks ago, three of us listened to the presentations: myself, the chief executive and the finance director, and we agreed between them, and the audit committee had delegated to me the responsibility for agreeing who should be appointed. But it’s very much the audit committee chair engagement and the audit committee, so it isn’t just the executives now. Given that the auditor spends a lot of time with the executives, they have to get on with each other. If they don’t like the audit partner and they don’t think they can work with that person, then they won’t get appointed.

Q47 Lord Forsyth of Drumlean: Just on that point. I am not very good at this, but if I am sitting on an audit committee and we are going to reappoint the auditors, I am very heavily influenced by what the management have to say. And although you may have a private meeting where you say to the auditors, “Is there anything you want to tell me?” or whatever, because you are not involved in the detail of the audit. And one of the worries that I find, sitting on an audit committee, is because you are influenced in that way. does it encourage the auditors to form a relationship with the management and, even though you have the audit committee, in practice you’re very much influenced by the management view. If I am the auditor wanting to get reappointed, I only need to suck up to them.

Professor Fearnley: I think that has always been the case that the auditor has to get on. But since we’ve had the changes with the audit committee more involved, and the increased enforcement, out of our case study research we haven’t found any evidence of auditors rolling over and going along with things that management wanted that they didn’t think were right. That still comes down to the individual audit partner. There is always going to be that type of situation. It’s better than it was because we found that when we did the study in the 1990s that there were real spats between the finance director and the audit partner, and the finance director would threaten the audit partner with a tender.

Professor Beattie: What seems to have happened is that the personal relationships, which did matter in the mid-1990s enormously, were very critical to the whole process. Because we’re now in this strong enforcement regime, strong ethical guidance, everybody is trying to just comply with the rules. It’s in everybody’s interests to comply with the rules and, in a sense, the personal relationships are far less important that they were so many years ago.

Q48 Lord Best: Is it regarded as good practice, perhaps promulgated by the professional institutes, that every so many years one goes out to tender? That would—I can tell—be much ignored, but is that not something that even the professional bodies regard as good practice?

Professor Fearnley: There’s no guideline on that at all. It’s entirely up to the company to decide whether it wishes to do that.
Professor Beattie: The audit committee is required each year to review the quality of the audit and ensure it’s satisfactory and review the selection of the firm and ensure it’s appropriate. I think it would feel if it had done that—and assured themselves on that front—it wouldn’t be necessary to periodically change auditors for the sake of it.

The Chairman: One last quick question and a quick answer.

Q49 Lord Lipsey: Magic wand: you can do one thing to increase competition in this industry. What would it be?

Professor Fearnley: I don’t have an answer to that I am afraid, Lord Lipsey, but my view would be—which I’ve mentioned before—to ask the firms because they would know better than we would what could be done.

Lord Lipsey: Yes, but they also have a huge vested interest against telling us.

Professor Fearnley: Indeed, but I am sure your Lordships would be able to get something out of them.

Lord Lipsey: We are not allowed to use rack and thumbscrews anymore, unfortunately.

The Chairman: I think the fact we have taken so long in this first session is a reflection of the excellent start you have given to us, even if you have left the last answer to us and not to you. So thank you very much indeed for coming. We are very grateful for your contribution. Thank you.

Professor Fearnley: Thank you for inviting us, Lord MacGregor.

Supplementary memorandum by Professor Stella Fearnley, Bournemouth University (ADT 51)

I am adding some additional comments to the evidence which I gave and also providing an update on the matters on which we were asked to provide further information.

1. Auditing as a Profession

I add an additional point to Professor Power’s evidence. Auditing itself is now subject to external independent oversight and discipline and therefore does not, on the face of it, meet the generally recognised criteria for a profession. However, all auditors have to be members of a recognised professional accountancy body to become auditors and therefore they have to adhere to that professional body’s code of conduct, which is wide ranging. Audit, because of its high public interest and the economic damage that failed audits can cause, has a further set of constraints. However, if an auditor were to be struck off or disciplined by his or her professional body for misconduct, then that person would be unable to carry out audits as not being a fit and proper person.

2. Economic Dependence

Ethical Standard 4 (revised) issued by the UK Auditing Practices Board addresses fee dependence in paragraphs 25 and 33. Para 25 requires that the auditor of a listed company cannot be auditor of that company if the total recurring fee, including non-audit services, exceeds 10% of total fee income or 10% of the income on which the partners remuneration is determined.

Para 33 requires that if the fee income as defined above exceeds 5%, the partner must inform the firm’s ethical partner and those charged with governance ie the audit committee, about the matter so, if necessary, additional safeguards can be introduced.

3. IFRS and Global Barriers to Entry to the Listed Company Audit Market

Below I refer to our submission to the Committee in paragraph 8 in response to question 1.

The drive for global accounting standards and the complexity of the standards themselves plays to the strengths of the larger firms and increases the barriers to entry to the global market for smaller firms.

In order to enter this market, smaller firms need an increased level of technical expertise which they may not have the critical mass to provide.

4. Number of Small Companies That Do Not Have Audits

I am currently investigating where this information can be obtained and will come back you on it.

5. Impact of Fair Value

I attach four documents about the impact of fair value which the Committee might find helpful:

— A speech and excellent slides presented by Lord Turner, the Chairman of the FSA in January 2010 in Chartered Accountant Hall about accounting and the economic crisis.2

2 Not published here.
— A paper issued by Ernst & Young in 2005 about fair values which highlights some of the problems before they actually happened and refers to the US influence on the standards. What this highlights is that the problems were well recognised before it all went wrong.

— A very short letter from a US Fund manager to the US Financial Accounting Standards Board about his views of their proposals to extend the use of fair value accounting.

6. Governance of the International Accounting Standards Board

I attach some comments I sent to the IASB about their governance consultation last year which highlight my concerns about their governance.

14 October 2010

Further supplementary memorandum by Professor Stella Fearnley, Bournemouth University (ADT 2)

HOW INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS) CHANGED ACCOUNTING FOR MARK TO MARKET AND LOAN LOSS PROVISIONS IN UK AND IRISH BANKS

Before the Change to IFRS

Before December 2005 all UK domestic company accounts were prepared under UK Generally Accepted Accounting Principles (UK GAAP). These standards are grounded by UK Company Law. The more recent standards issued under UK GAAP are called Financial Reporting Standards (FRSs), earlier ones are called Statements of Standard Accounting Practice (SSAPs).

UK Company Law requires accounts to:

— Be appropriately prudent.
— Justify asset values on the basis of the business being a demonstrable going concern.
— Observe substance over form.

Prudence is in the law to protect creditors and shareholders from abuse by directors by ensuring the maintenance of capital particularly in relation to paying out dividends (S 837 CA 1986). Under UK law, all companies, including subsidiaries of groups, must prepare and file their accounts on public record. Subsidiaries can have their own creditors and some have external shareholders. The holding company may also have its own creditors and the holding company's individual balance sheet is included in the group accounts as well as the consolidated balance sheet.

The underlying principle of prudence is that losses should be booked at the earliest opportunity and profits should not be recognised until earned, thus protecting capital for the common benefit of directors, shareholders and creditors. This is articulated twice in the law, in the accounting preparation rules (input rules), and then separately in the capital maintenance clauses, which instruct companies how to use the audited statutory accounts to pay dividends lawfully. In a group, dividends are paid up from subsidiary companies to the holding company, which then pays out to shareholders. Some other EU states also have capital maintenance regimes that are disconnected from audited published accounts (eg Germany).

Because of the increasingly specialist nature of banking business, a Statement of Recommended Practice (SORP) was issued by the British and Irish Bankers Association in the decade prior to 2005 and the introduction of IFRS. The SORP set out detailed accounting methods for banks which all banks were expected to follow. The SORP was entirely consistent with Company Law and set out how to account for mark to market and loan loss provisioning as follows:

— Dealing securities could be marked to market provided they were dealing positions of normal liquidity (ie near cash).
— Loan losses should be assessed so as to carry loans at no more than their ultimate realisable value, ie making provisions where defaults already existed and in addition where there was recognised credit risk, but no evidence of default, on all loan portfolios and especially higher risk loan portfolios.

Contingent liabilities had to be disclosed, and this process required the bank to assess the likelihood of a contingency materialising into true liability. This would cover such things as margin calls, which are cash outflows sensitive to asset prices going down.

3 Not published here.
4 Not published here.
5 Not published here.
The Introduction of IFRS in the EU

IFRS was brought into the EU by a 2002 EU Regulation with mandatory application to the group accounts of EU listed companies from and including December 2005 year ends. This Regulation in some aspects overrides UK Company Law, for example, the general presumption of prudence and substance over form. Accounts were deemed to be true and fair if they complied with IFRS. In English Common Law true and fair view is an objective which may change over time and is not capped at compliance. There has since been a change to reporting of true and fair but is too early to evaluate whether it has made any difference.

Just after the regulation was issued in 2002, the Enron scandal broke and the US standard setter, the Financial Accounting Standards Board (FASB) was heavily criticised. A member of the IASB was then appointed as chair of FASB. IASB then announced later in 2002, without public consultation, that it was going to converge its own standards with those of the US FASB. The IASB already had accounting standards in issue which had been inherited from its predecessor body. The IASB then had three years to prepare a suite of standards for Europe, and the IFRS standards were therefore open to the influence of US GAAP both by the convergence objective and the short time frame. US GAAP serves a different legal regime than the UK, for example: there is no federal company law and it varies from state to state; in some states auditors report to directors; it is much more difficult for shareholders to remove directors from office; and the litigation regime makes much easier for third parties to sue directors and auditors. US GAAP has become increasingly focussed on valuing companies at a moment in time, is getting increasingly less prudent and does not necessarily protect creditors or maintain capital. The litigation regime to an extent compensates for weaknesses in corporation law by making it easier for shareholders and creditors to recover their losses through litigation.

The EU Regulation left it to member states to decide whether to require other companies, including subsidiary accounts of listed groups, to apply IFRS. The UK government did not mandate IFRS for the accounts of any non-listed companies. This includes subsidiaries of listed companies reporting their group accounts under IFRS. France and Germany do not permit IFRS to be used by individual companies.

Many UK listed companies chose to retain UK GAAP in their subsidiary and holding company accounts and make the adjustments to IFRS at group consolidation level in preference to changing accounting systems throughout the group. This was considered to be simpler and also provided more certainty for continuing tax compliance and for paying dividends up to the holding company.

IFRS and UK Banks Subsidiaries

The IFRS standard (IAS 39) which mandates the accounting for securities dealing, accounting for financial instruments and loan loss provisioning is far less prudent than the banking SORP because IFRS did away with the principle of prudence, substituting neutrality, thus allowing upward valuations. IAS 39 differs from UK GAAP and the banking SORP as follows:

- It changed fair value accounting which had been restricted to market valuation of liquid dealing positions, thus allowing marking to market of not only large and illiquid positions, but allowing modelling of positions not traded at all;
  - It allowed profit taking on holding such assets that were going up in a rising market, which UK GAAP did not permit except for the most liquid positions traded at the margin.
  - It had an less prudent loan loss model “incurred loss”, which did not allow for risk sensitive loan provisioning where there was as yet no evidence of default, thus not taking account of inherent risk in a loan portfolio. This made subprime lending appear very profitable in the short run, given that a profit may be booked on charging the risk premium, but the cost of that risk was not booked.

In relation to the adoption of IAS 39 in UK banking sector, the UK Accounting Standards Board (ASB) substantially replicated this standard into UK GAAP as FRS 26. This change was motivated by the difficulties that banks would have experienced in trying to make all the IFRS changes needed at consolidation level because of the complexity of their accounting systems. Thus the banks in the UK and Ireland, whilst continuing to report under UK/Irish GAAP in their subsidiaries, were applying some of the requirements of the IAS 39 imprudent mark to market and loan loss provisioning model.

In order to accommodate this change, company law was changed to relax the accounting for certain types of financial transaction as, because it falls under UK GAAP, FRS 26 had to comply with company law. The changes allowed “fair value” (marking assets up) but still, supposedly, under the aegis of prudence.

The effect of this change for the accounting in the subsidiary companies of UK and Irish banks was that it allowed previously unrealised profits on more types of transaction (marking to market/model) to be booked. For example Collateralised Debt Obligations (CDOs), might contain good loans, as well as bad loans already
decaying, but the whole package was “insured”, so as to give a traded “value” that might be in excess of cost. 
Marking to market/model allowed profit taking whilst not booking losses. Company Law accounting rules do not allow the netting of assets/liabilities, and premature profit taking, and do not recognise insurance as an asset. Some CDO’s under pre-2005 UK GAAP would have shown losses and no profits at all. The CDO industry proliferated after 2005. Alongside banks that were using the imprudent provisioning model, CDO’s became depositories for increasingly riskier and potentially mispriced loans.

FRS 26 also changed the loan loss provisioning model removing the need for banks to provide prudently for expected future loan losses, only requiring provisions where there was already evidence of default as under IAS 39.

Thus for UK/Irish domiciled banking companies, profits, assets and capital, were inflated by:
- the mark to market/model regime to the extent it was less prudent than the BBA SORP;
- covering up realised losses within CDOs etc by mark to market/model gains; and
- reducing loan loss provisions under the incurred loss provisioning regime and, by increasing profits, increasing capital and therefore lending capacity.

It can be observed that the UK and Ireland, with the most comprehensive introduction of IFRS and IFRS style accounting in banking companies, have had the most non-investment bank collapses in the EU. There are now some concerns that FRS 26 does not match up with the UK capital maintenance rules and the requirement for prudence, which still applies under UK GAAP.

**The Impact of These Accounting Changes for Auditors**

As referred to in the submission to the Committee from Beattie, Fearney and Hines, the UK now has a very strong enforcement regime both for identifying non-compliance in financial reporting and auditing for listed and public interest companies. The Financial Reporting Review Panel (FRRP) reviews company accounts and raises queries with directors of companies about accounts where there may be non-compliance. In the case of the FRRP, research has shown that an FRRP adverse finding can rebound on an auditor who has signed off the accounts as being in order and damage a client relationship. It is not a career enhancing event for the audit partners involved and can also bring bad publicity for the firm.

The Audit Inspection Unit (AIU) inspects the audits of listed companies to ensure that the auditors are carrying out their work in accordance with Auditing and Ethical Standards are making sound judgments. As with the FRRP a poor inspection report for an audit partner is career damaging and brings public criticism for the firm.

In the UK now, the risk for an auditor of being caught out not complying with the accounting or auditing rules is high, and therefore there is a strong incentive to comply with the rules regardless of whether compliance produces optimal outcomes for shareholders and other users of accounts. The quality of the standards themselves becomes paramount. There is now considerable disquiet with the outcomes of the IFRS accounting model in the banking sector, where profits were inflated in the asset bubble because off the mark to market regime as described above, including the change to the loan loss provisions, which took no account of credit risk.

If an audit firms ensures that all their clients’ audited accounts comply with the accounting and auditing rules, they avoid costly encounters with regulators, which they cannot recover from clients and both reputation and litigation risk. The individual partner also avoids damaging his career and all parties avoid litigation.

The incentives for compliance are therefore very strong and there was little incentive in the system itself for auditors to do more than ensure compliance.

**The Promotion of IFRS in the UK**

Whilst other European countries such as France and Germany have been cautious in extending the application of IFRS beyond what was been mandated by the EU Regulation for 2005. The UK Accounting Standards Board has since 2004 been promoting IFRS adoption beyond what was mandated.

IFRS has been introduced into the AIM market and the UK Accounting Standards Board (ASB) has been steadily changing UK GAAP standards to make them compatible with the IFRS model. The is now consulting again on trying to get agreement to introduce a reduced form of IFRS for non-listed companies other than those defined by EU as small. Also a form of IFRS was introduced into central government accounting and NHS accounting for March 2010 year ends, at considerable cost in consultant fees, and will be introduced into local government and some other public bodies in 2011 again at considerable cost, and at a time when resources are under great pressure. It is not entirely clear whether the benefits to the public interest of these initiatives outweigh
the cost, particularly given the continuing major concerns about IFRS’s underlying principles and the complexity of the outputs.

The UK Accounting Standards Board seems to have been more determined and more willing than other European countries to give up control of its own accounting standards entirely to a body over which it has little, if any, control, and whose outputs remain of questionable quality.

A further issue is that HMRC has mandated that for March 2011, all UK companies should file accounts required for taxation purposes using single software package called XBRL, which has been developed in the US and requires specific accounting formats or taxonomies. XBRL has attributes of monopoly. XBRL is being promoted around the world as a mechanism for lodging accounts with securities regulators. The UK via HMRC is again in the forefront of adoption outside the US. This will add further cost to the UK corporate sector and more fees to consultants, again at a time where growth rather than unnecessary expense is needed.

2 November 2010

Supplementary memorandum by Professor Stella Fearnley, Professor Vivien Beattie and Tony Hines

RE: EVIDENCE GIVEN AT THE HEARING ON 25.01.2011

At the committee’s request we have reviewed the evidence relating to questions 540–547 given by Mark Hoban MP (MH), Ed Davey MP (ED) and Richard Carter (RC). The following issues were referred, to and we comment on each in turn based on our own research and also on publicly available sources.

1. Whether, since the introduction of IFRS in the UK for 2005 year ends, accounting and auditing has become more rules based than principles based;

2. Accounting measures economic value much more than historical cost;

3. IAS 39 the financial instruments standard is under revision;

4. The only IFRS standard which is significantly different from UK GAAP is IAS 39;

5. Accounts are not a substitute for prudential returns;

6. Asking auditors to change their traditional binary approach (to reporting) would create a lot of difficulties;

7. The losses sustained by the banks were greater than the bonuses and dividends paid out;

8. The position of the principle of prudence under IFRS.

1. **Whether, since the introduction of IFRS in the UK for 2005 year ends, accounting and auditing has become more rules based than principles based**

There is a difference of opinion between MH and ED on this matter. Our research with finance directors, audit committee chairs and audit partners of UK listed companies finds that these three preparer groups believe that accounting has become more rules based and auditing is more process driven than under UK GAAP and UK auditing standards. We attach chapter 14 of our forthcoming book which the Committee may find helpful.

2. **Accounting measures economic value much more than historical costs**

This statement by MH does not reflect what IAS 39 actually delivered in the crisis, as the economic value of the loans and financial instruments was grossly overstated. Therefore the accounting model, as applied in the crisis, could not be relied on to deliver economic value as it did not distinguish in all cases between price and value. It failed.

3. **IAS 39 the financial instruments standard is under revision**

This revision was referred to by all three witnesses. However we have two major concerns about the need for revision. First, the IASB has set itself up as a body fit to set accounting standards for the whole world and yet, within two years of its standards being adopted in the UK and the rest of the EU, the banking sector, which is at the heart of a capitalist society, was reporting grossly inflated profits in compliance with this new regime. Second, because of the convoluted process of agreeing change, which is inevitable with a body which purports to serve the world, it will be some years before IAS 39 is changed and adopted by the financial sector. This time delay was referred to by Steve Cooper, an IASB board member, in his evidence to the Committee on 18
January 2011. Some minor changes have already been made to IAS 39 but profits could continue to be misrepresented until all the changes are agreed and introduced.

Our view is that the IASB cannot be trusted to deliver high quality standards.

4. THE ONLY IFRS STANDARD WHICH IS SIGNIFICANTLY DIFFERENT FROM UK GAAP IS IAS 39

Our research indicates that IFRS differed from UK GAAP much more widely in 2007-8 that ED suggests eg accounting for: intangible assets and goodwill; employee benefits; share based payments; deferred tax and segmental reporting. All of these topics were the subject of criticism from preparers. Also there was wide criticism of the complexity of the standards and length of disclosures required. Concerns were expressed that non-accountant board members had difficulty understanding their company’s accounts after the change to IFRS. The UK Accounting Standards Board has been changing UK GAAP to IFRS but originally major differences existed between the two.

5. ACCOUNTS ARE NOT A SUBSTITUTE FOR PRUDENTIAL RETURNS

We find this comment by MH disturbing. This is a view included in the IASB’s latest conceptual framework for the preparation of financial statements (IASB, 2010). This framework now claims that:

“the objectives of general purpose financial reporting and the objectives of financial regulation may not be consistent, hence regulators are not considered a primary user and general purpose financial reports are not directed to regulators and other parties.” [F OB10 and F BC.1.20–BC 1.23].

We are concerned that this statement implies that accounting information as mandated by the IASB is not for regulators. If accounts are claimed to be general purpose this makes no sense as the objectives of other users may also differ. We do not understand where regulators get their information from if it is not based on the audited accounts. Protection of capital is a primary issue for shareholders, regulators and other users of accounts.

Our view is that it is an attempt by the standard setters to deny their responsibility to regulators and to make their framework fit with what they are currently doing and wish to do going forward.

6. ASKING AUDITORS TO CHANGE THEIR TRADITIONAL BINARY APPROACH (TO REPORTING) WOULD CREATE A LOT OF DIFFICULTIES

We do not support this comment by ED. He does not explain what sort for difficulties would be encountered and it would be helpful to know. We can see no reason why the auditors should not provide more information about the quality of earnings. The more responsibility is passed on to the audit committee, the less valuable audit becomes. It should be borne in mind that although audit committees are usually composed of independent directors, they are still directors of a company under the UK unitary board model, thus they are not independent to the same extent as auditors are required to be.

Our view is that auditors do not wish to change their audit report and prefer further responsibility to be passed on to the audit committee, probably because of liability concerns. The audit committee, although making a valuable contribution to the integrity of financial reporting is not a substitute for the auditor. Auditing requirements are not subject to an EU regulation and could change under UK law and regulation.

7. THE LOSSES SUSTAINED BY THE BANKS WERE GREATER THAN THE BONUSES AND DIVIDENDS PAID OUT

RC made this point. Our view is that it would have been even more disturbing if the banks had paid out all their false profits in bonuses and dividends and added nothing to reserves. This comment does nothing to mitigate the effect of imprudent accounting.

8. THE POSITION OF THE PRINCIPLE OF PRUDENCE UNDER IFRS

There is some confusion about this issue. RC and ED refer to prudence. RD refers to the IFRS standards and ED refers to the IFRS Framework. These are different documents. The IAS Framework (for the preparation and presentation of financial statements (2001) which is currently applicable is subordinate to the standards themselves. Para 3 states that if there is a conflict between a standard and the Framework, the requirements of the standard prevail. The 2001 Framework sets out primary qualitative characteristics of financial statements and includes prudence as part of the qualitative characteristic of reliability. Other principal characteristics are: understandability; relevance; and comparability.
Prudence is defined as:

Assets or income are not overstated and liabilities or expenses are not understated.

A caveat continues:

“The exercise of prudence does not allow, for example, the creation of hidden reserves or excessive provisions, the deliberate understatement of assets or income or the deliberate overstatement of liabilities or expenses, and therefore, the financial statements would not be neutral and therefore not have the quality of reliability.” (para 37)

The other characteristics of reliability in the 2001 Framework are: faithful representation; substance over form; neutrality and completeness. IAS 39 as a standard would override prudence. Our view is that the prevention of hidden reserves or excessive provisions and the overstatement of liabilities or expenses is a matter for auditors not standard setters. Even if there was what is often referred to as “earnings management” in the banks, this would be preferable to the imprudent outcome of IAS 39.

The Committee may also wish to note that the IASB Framework has recently been revised (IASB, 2010) and both prudence and reliability are no longer in the Framework. The current primary characteristics are: relevance; faithful representation (with a subordinate quality of neutrality); comparability; verifiability; timeliness; and understandability.

Our view is that leaving prudence and reliability completely out of the current Framework takes away some the judgements that auditors may face and denies the principle of substance over form for shareholders and regulators. Faithful representation and verifiability are much easier to check. The new IASB framework is now the same as the US Framework and therefore is subject to greater influence relating to litigation defence. This again undermines the value of audit.

We hope these comments are helpful for the Committee.

3 February 2011
ABOUT ACCA
ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

We support our 140,000 members and 404,000 students in 170 countries, helping them to develop successful careers in accounting and business, based on the skills required by employers. We work through a network of 83 offices and centres and more than 8,000 Approved Employers worldwide, who provide high standards of employee learning and development. Through our public interest remit, we promote appropriate regulation of accounting and conduct relevant research to ensure accountancy continues to grow in reputation and influence.

“Audit and Society” is one of ACCA’s four thought leadership themes. We have run high-level roundtables around the world, from Poland to Singapore, in order to examine the role and the value of audit and to consider how it needs to evolve. We have a website containing summaries of these events and other materials relating to the role of audit which can be found here: http://www.accaglobal.com/af/audit

EXECUTIVE SUMMARY
ACCA agrees that the concentration of the largest audits in the world into the hands of four global providers has introduced a greater risk to the overall provision of audit and assurance services at the large end of the market.

ACCA believes that there is a risk that one of the Big Four accounting firms (“the Big Four”) could fail, and we are supportive of efforts to develop more competition in the market. If there were to be a failure of one of the Big Four, there would be serious repercussions for the capital markets, investor confidence and more widely.

We believe that there are two major considerations in this debate:

- a risk management issue, relating to dealing with the current consequences (real or potential) of there being only four suppliers serving, to a predominant extent, the large end of the market; and
- a competitiveness issue, ie whether shareholders would be better served, in terms of quality and value for money, through having a wider choice of auditor.

ACCA believes that a market with greater competition and choice would be in the public interest and would serve the interests of shareholders better. We are keen to see the Government foster opportunities which would enable other firms to “move into” the large-end audit and to ensure a level playing field. With this in mind, we believe that action to end restrictive covenants1 and to reform the law on liability should be considered as priorities. Should effective action on these issues be taken, we would expect those large audit firms outside the Big Four to respond and show an active interest in procuring listed company audit work.

Direct intervention in the market by, for example, forcing the firms to downsize or break up, would not in our view be appropriate. Such intervention could have unintended consequences (for example, forcing one of the large firms to pull out of audit altogether).

The failure risk aside, ACCA does not agree that the simple fact of there being only four major firms in the market is likely in itself to lead to threats to objectivity on the part of those firms’ audit work. The incentive for firms to offer a high standard of audit service is that their reputation and business could collapse very

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1 A restriction which prevents a company from using a firm other than one of the “Big Four” to provide audit and other services.
swiftly (as it did in the case of Arthur Andersen) following any allegation of deliberate collusion/falsifying or covering up the audit trail. Firms have every incentive to give the best advice they can. Furthermore, key principles such as objectivity, integrity and professional due care are enshrined in the ethical codes which professional accountants sign up to.

In terms of the debate on the future role of the auditor, ACCA is concerned that there continues to be an “expectation gap” between what the auditor is actually required to do and what many lay people, including shareholders and observers, think the auditor should do.

While we do not believe that the audit model is “broken”, we consider that the audit needs to evolve in scope so as to retain its value for shareholders, clients and other stakeholders alike. And as the audit role evolves, we need to look not just at cash flow and going concern but at how auditors can engage more with companies’ forward planning activities.

ACCA does not believe a separation of audit and non-audit services is either possible or desirable. There appears to be no discernible demand in the investment community for such a split, and we have seen no conclusive evidence that the current framework, with its independence safeguards and new ethical standards, is failing in practice. Furthermore, we believe that quality of services offered to businesses could suffer if artificially divided in this way, particularly at the smaller end of the market.

Responses to the Committee’s Questions

1. Why did auditing become so concentrated on four global firms?
Concentration in the market has been at this level for some years, and the market dominance of auditors PwC, Ernst & Young, KPMG and Deloitte, which audit most of the world’s biggest companies, is a matter of concern for regulators and politicians alike in the UK and more widely.

The group was the Big Eight until the 1980s. It became the Big Five following a series of mergers, prompted by the trend towards globalisation and the need for these large firms to be able to offer worldwide service. Each of what we currently know as the Big Four actually comprises a network of national firms which operate under a single umbrella, and which constitute a globally recognised brand.

The Big Five became the Big Four following the collapse of Arthur Andersen in 2002-03 in the aftermath of the Enron scandal.

It is unlikely that the Big Four will ever merge with each other due to competition law. But the impact of one, let alone more than one of the Big Four collapsing, or deciding to leave the audit market, would have serious repercussions for the capital markets, investor confidence and more widely. It would also mean that regulators would feel compelled to make exceptions to the current auditor independence rules.

Failure of one of the Big Four is certainly a risk. It is possible that this could be caused (as in the case of Enron) by a failure outside the UK. International dialogue is therefore necessary, as this is ultimately an internationally-interconnected issue.

ACCA supports the FRC’s efforts to develop more competition, including providing new guidance for companies’ audit committees and increasing the level of representation of non-Big Four firms on regulatory and professional bodies.

However, it should be acknowledged that there appears to be little appetite for change in the UK’s audit market, particularly from the shareholder community.

2. Do economies of scale make it too difficult for smaller firms to compete?

While smaller firms may have the capacity and ability to handle larger audits, they may not be given the opportunity to do so because banks invariably include requirements in lending agreements for listed companies to use one of the Big Four.

Large public companies also often have internal strictures, or “restrictive covenants” in place that state that only the Big Four audit firms are authorised to provide them with audit and other services. The result is that large companies (FTSE 350) often have little alternative but to use only the Big Four accounting firms and smaller companies are therefore locked out of the top-heavy market. Currently only one of the FTSE 100 companies is audited by a firm outside the Big Four.

There is no one, clear reason why shareholders put in place restrictions which only allow the appointment of certain firms—it is possible that it is a relic of past prudence. The concentration may be due to market misperceptions about audit firms’ capabilities, but there are also high barriers to market entry that make it difficult for smaller firms to challenge this status quo. Furthermore, there is much evidence to show that
companies change their auditors very rarely. Of those that do change audit firms, in most cases, they move from one of the Big Four to another rather than to a mid-tier or other audit firm.

Of course, there are also reputational issues, with many large companies viewing it as the safe choice to use one of the Big Four. The significant geographical coverage of the Big Four is also useful for global companies and is usually not paralleled by the mid-tier firms. However, a number of firms immediately outside the Big Four would argue they do have the capability and capacity to perform large-end audits.

The restrictive covenants that prevent companies from using other audit firms would become a serious problem if one of the Big Four were to collapse, as they would not then be able to use one of the mid-tier firms.

ACCA believes that a market with greater competition and choice would be in the public interest and would serve shareholders better.

There is a case to be argued around the “environment” in which the audit is provided. Government can promote the right conditions for business to flourish and this holds true for accountancy and audit. Opportunities should be fostered which would enable other firms to “move into” the large-end audit and to ensure a level playing field.

3. **Does a lack of competition mean clients are charged excessive fees?**

ACCA does not have sufficient evidence to comment on whether the fees charged by the Big Four are “excessive” in the context of the scale and complexity of the services provided, however, it is logical to conclude that insufficient competition may lead to higher fees being charged. On the other hand, as market leaders performing the largest audits, it is possible that the nature of the services being provided will lead to relatively higher fees.

ACCA believes, however, that price competition is a major factor in engendering auditor independence. Prior to the 1980s audit firms were not allowed to advertise their services and take part in bidding competitions for contracts. Competition between the accounting firms greatly increased when these restrictions were abolished, putting pressure on the audit firms to reduce their fees.

We also strongly believe that the fees charged for audit work must be at an appropriate level to properly reflect the work involved in carrying it out. Pressure to reduce fees may have the unwanted consequence of compromising the quality of an audit. We believe that quality must remain the fundamental driver of audit work. It would not be in the interests of audit quality or the public interest if firms were motivated to drive down their fees to a level which was not commensurate with the cost to them of carrying out the audit. We believe that company audit committees and shareholders must bear this in mind when considering the cost of the audit.

In saying this, however, we reaffirm our belief that the audit must seek to deliver value to shareholders, and that the profession should be prepared to articulate the value which is derived from audit services.

4. **Does a narrow field of competition affect objectivity of advice provided?**

It is possible that the relationship between auditors and companies can become too close and that this can impact objectivity. Enron is a case in point. Enron had a 12-year relationship with its auditor, Arthur Andersen. As Andersen did not want to jeopardise lucrative consulting as well as auditing fees, it was reluctant to call Enron to account over the use of misleading financial reporting and the creation of special entities to hide debt.

However, ACCA would not agree that the simple fact of there being only four major firms in the market is likely in itself to lead to threats to objectivity on the part of those firms’ audit work. Professional standards contain strong strictures on this point and consideration of a firm’s compliance with them is a key point of focus for regulators. The exposure of an audit firm to potentially ruinous damages claims for negligent work is also a strong motivating factor in encouraging audit firms to perform their work in accordance with applicable technical and ethical standards.

It is worth noting however, that the incentive for firms to offer a high standard of audit service, driven by public interest/ethical considerations, is that their reputation and business could collapse very swiftly (as it did with Arthur Andersen) if there was an allegation of deliberate collusion/falsifying or covering up the audit trail.
5. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

Even with a pool of only four big audit firms to choose from, companies can and do change their auditors if they are dissatisfied with the quality of service they are receiving. As regards “unwelcome” advice, the advice that an audit or professional services firm can be expected to give on business options should be the best advice the firm can give and should not be influenced by a calculation that the client has no choice but to accept it. As stated above, the consequences for a firm of auditors giving advice which is not in the client’s best interests are such that firms have every incentive to give the best advice they can.

In ACCA’s view, the buyers of professional services are sophisticated and frequently have a professional background themselves. They are in a prime position to understand the needs of their organisations and to commission services which best support their strategies and objectives. Starting from the user perspective, therefore, it should be considered to what extent buyers might prefer to achieve economies of scale and benefit from the enhanced business knowledge their incumbent auditors have of their companies, leading to the potential for superior solutions. External auditors should also engage more effectively with the internal audit function, which may bring issues of going concern to light more quickly. And as the audit role evolves, we need evidence that an audit or professional services firm can be expected to give on business options should be the best advice the firm can give and should not be influenced by a calculation that the client has no choice but to accept it.

To be clear, therefore, ACCA supports the benefits to be brought to business of wider market choice. But we also recognise that buyers and users of auditing and related services may prefer to use one supplier to bring particular benefits to their business, subject to proper considerations relating to independence and integrity.

6. What is the role of auditors and should it be changed?

This is a key question because there remains an “expectation gap” between what the auditor is actually required to do and what many lay people, including shareholders and observers, think the auditor should do. Many believe, for example, that the role of an auditor is to search for and detect all evidence of fraud and error contained in financial statements. There is also a lack of in-depth understanding among business owners, investors, managers, regulators and auditors themselves about the current role of audit and what it should be in the future. However, as famously stated in Re Kingston Cotton Mills in 1896, by LJ Lopes of the Appeal Court: the auditor is “a watchdog but not a bloodhound.”

Auditing is primarily focused on examining past events. The auditor’s role is to give an expert and independent opinion on whether companies’ financial statements give a true and fair view of their financial position at the balance sheet date and of their previous 12 months’ performance. The auditor has professional responsibilities under audit standards to look into the entity’s internal control systems and governance structures to the extent that they have a bearing on the integrity of the financial statements, and on the same basis must consider whether fraud or error has or might have affected the accounts. The auditor performs this function in order to report to shareholders on how the directors have performed their stewardship role.

While the auditor’s report is essentially retrospective in character, it should be noted that the financial statements themselves include assumptions about existing trends which are then often projected uncritically into the future. Examples of this include assessments of the outcomes of long-term contracts and work in progress; assessments of the useful economic life of key assets; provisions and contingencies; and assumptions about future trends in the macro economic environment. The financial statements are also required to be prepared on the assumption that the reporting entity will remain a going concern, and the auditor makes his own assessment of whether or not this is likely to be the case.

This issue of going concern often arises when companies collapse within a relatively short time of a clean audit report being written. The problem with going concern, from the auditor’s perspective, is that organisations do not neatly stop being going concerns in line with balance sheet dates or the dates accounts are signed. On the contrary, they can and do get into serious trouble very rapidly. It is important to remember that the going concern assessment and the auditor’s report are conducted at specific points in time, and cannot constitute a cast iron guarantee that the organisation will exist for the foreseeable future.

ACCA believes audit has a key role to play as a source of public confidence in the financial reporting supply chain. Audit instills discipline, financial rigour, better corporate governance and can deter fraud. It is part of the operating fabric of the economy, and the success of capital markets is dependant on there being a competitive and stable audit market. A strong audit function promotes trust and contributes to the working of efficient markets.

We do not believe the audit model is “broken” but believe that the audit needs to evolve so as to retain its value for shareholders, clients and other stakeholders alike. This should be achieved by extending the scope of the audit from simply giving an opinion on financial statements to addressing issues such as risk management, the effectiveness of corporate governance, and testing the assumptions underlying an organisation’s business model and its likely sustainability. External auditors should also engage more effectively with the internal audit function, which may bring issues of going concern to light more quickly. And as the audit role evolves, we need
to look not just at cash flow and going concern but at how auditors can engage more with companies’ forward planning activities.

It is true that sophisticated and complex business models in the largest global companies create challenges for auditors, and there is a consequential liability issue which must be addressed, but firms should see extension of the audit as an opportunity to enhance its value, rather than as a threat.

We also believe that the profession needs to embrace technological developments and reporting languages as a way of delivering the audit efficiently at both the large and smaller ends of the market, and to promote approaches that enable cost-effective delivery.

In the light of current and future developments in financial and non-financial reporting, therefore, ACCA is supportive of an evolution of the overall function of the external auditor; though it is reasonable to expect that such an evolution would need to be accompanied or preceded by an acceptable, fair and proportionate evolution of the applicable law on liability as stated above. ACCA believes that some form of liability reform needs urgently to be considered in the light of the very limited success of the reforms introduced by the Companies Act 2006.

7. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

Professional scepticism is a fundamental concept in audit, as demonstrated by the prominence given to it in auditing standards. It is also enshrined in the ACCA Rulebook, which sets out fundamental principles such as objectivity, integrity, and professional competence and due care. In the ACCA Rulebook, independence is described as: “The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, allowing an individual to act with integrity and exercise objectivity and professional scepticism”.

It is therefore a matter of great concern that the joint FSA/FRC discussion paper published in June 2010\(^2\) raised concerns about this, stating that auditors showed a “worrying lack of scepticism” in some of their audits of financial institutions, and that they had focused too much on gathering and accepting evidence to support the assertions of institutions. These concerns are reiterated in the audit inspection reports on the Big Four firms published by the Professional Oversight Board in September 2010, which concluded that there was a lack of “sufficient professional scepticism in relation to key audit judgements”.

While ACCA has no evidence itself that professional scepticism has not been applied appropriately in the audit of banks, we believe that audit firms and the audit profession need to take the conclusions of the above report very seriously and to consider remedial steps as a matter of urgency.

8. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

A key point arising from this question is to ask whether the current role of auditors reporting on the company’s financial statements is still sufficient to meet stakeholders’ needs. Put simply, are auditors being directed by audit standards to look at the right things?

ACCA agrees that, in the light of the crisis, opportunities should be explored to add value to the role of the auditor. One option that we believe is especially worthy of consideration concerns the potential contribution that the auditor could make to the assessment of the risks inherent in the client company’s business model.

A company’s business review requires, amongst other things, a board to set out significant risks to the viability of their company’s business model. Northern Rock’s business model, for example, depended on being able to finance operations through access to wholesale money markets, and its stock rating assumed continuing growth of borrowing and lending. Without this access to markets the company could not have expanded and once this market closed it ceased to be viable. Ultimately, the bank’s business model was unsustainable and based on erroneous assumptions about the future of the economy.

ACCA believes therefore that auditors should be encouraged to engage more fully with the business model, which should be made accessible to them, allowing them to test its assumptions. To this end, we welcome the announcement by the Coalition Government in May 2010 that it will reintroduce the Operating and Financial Review (OFR). The aim of the OFR is to give a comprehensive and forward looking account of the business to shareholders “through the eyes of management or the board”. The process of drawing up such a review should be as informative to the board, particularly the non-executive directors, as it should be to shareholders.

The question then becomes whether the corporate reporting system as a whole needs an overhaul. As currently constituted, the audit is, to a degree, only as useful as the financial statements on which it reports. Many would argue therefore, that a move to embrace substantially more forward-looking, qualitative and non-financial data would improve its relevance. The role of audit and the nature of audit methodology would have to change accordingly.

Corporate governance is another area in which more expansive reporting would be useful. ACCA has also long argued that greater emphasis should be placed on principles in corporate governance (as opposed to specific compliance obligations), and it is encouraging to see that the FRC’s Corporate Governance Code is moving in this direction. Broadening the scope of audit/assurance and ensuring good governance, control and risk management (as set out in a series of reports produced by ACCA) could help reduce the risk of business failure. Prevention could also assist in ensuring the right conditions for a broader market.

ACCA would also like to see companies to provide more information in their annual reports about their business values and how they monitor that these values and standards are in place, because this goes to the heart of the board’s role and to the heart of governance. ACCA would like shareholders to insist that such information is provided and use it as a basis for engagement with the board. Few companies currently address ethics or values in their annual reports. Were they to do so, these should provide an insight into how boards set the company’s values and standards and how they ensure that these are reflected throughout the company.

Another potential innovation concerns management letters. At a roundtable event held by ACCA in Singapore with leading auditors, regulators, companies and investors, the point was also made that comments from auditors in the management letter should be reflected in the annual report. This, it was believed, would extend the welcome and increasing communication between auditors and non-executive directors on the audit committees to a wider audience of shareholders, and give investors more timely information that they require. It would be essential here, of course, that auditors did not then tone down the management letters.

One answer might be an extension of the current role of audit, at the larger end of the market, with formal inclusion of risk and internal controls.

9. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

The potential for conflicts of interest to exist has been acknowledged by the investor community, accounting and audit firms, professional bodies and regulators.

Some have advocated that in order for an auditor to remain strictly independent they should not be allowed by law to provide audit clients with any other advisory services.

The consensus so far, though, is that conflicts of interests can be managed through self-regulation and do not need to be regulated by statute. It should be noted that there have already been significant changes to the UK regulatory regime for non-audit services since the collapse of Enron. Requirements relating to auditor independence and the responsibilities of the various parties are now clearer, and there is greater transparency, for example:

- The UK Code on Corporate Governance now provides that the audit committee must play a key role in any decision to purchase non-audit services from the same firm as is carrying out the audit.
- The APB Ethical Standard 5 (ES 5) sets out detailed caveats for the provision of specific non-audit services, which amount to a de facto prohibition in many cases, particularly for listed entities. ES 5 has considerably strengthened auditor independence already and resulted in fewer non-audit services being provided. Figures quoted in Financial Director magazine, for example, showed a dramatic decline, since Enron, of the ratio of non-audit to audit fees in listed company accounts. From a peak of 191% in 2002, the figure steadily reduced to 71% in 2008. So it may be the case that extra regulations and new ethical standards issued by the audit profession since 2002, combined with market forces, have provided an answer to the “problem”.

ACCA does not believe though that the profession is complacent on this issue. The regulation of conflicts of interest is a key concern of the FRC, and in 2009 it initiated another review of whether the current rules on the provision of additional non-audit services are sufficient. As an interim measure the FRC wrote directly to major firms to suggest that they be “cautious” before entering into arrangements “which stretch the internal/external audit boundary”, not least because it could prove to be inconvenient and/or costly to change such arrangements should the outcome of the FRC’s work be that the Ethical Standards are changed in a way that affects the provision of such services.

While much attention in this debate focuses on listed companies, we should not forget the needs of SMEs, which can find it costly to use a separate supplier for the provision of non-audit services. Involvement in non-audit services can lead to better auditing of SMEs and should not be discouraged.
ACCA does not believe a complete separation of audit and non-audit services is either possible or desirable. Some services are closely related to audit while the extra insight of the incumbent audit firm brings quality and efficiency benefits that companies would not wish to lose. Both auditors and their clients have argued that the knowledge acquired during the audit process can allow other services to be provided less expensively.

Nor is there any visible demand in the investment community for such a split, and we have seen no evidence that the current framework, with its independence safeguards and new ethical standards, is failing in practice. We believe that quality of services offered to businesses could suffer if artificially divided in this way.

10. **Should more competition be introduced into auditing? If so, how?**

ACCA agrees with the 2009 OECD report³ that smaller audit firms are prevented from competing with the Big Four firms due to restrictions set by large public companies and are thus unable to enter or expand further into the audit market for quoted and larger companies.

While we do not suggest that concerns about liability are the biggest impediment to the involvement of mid-tier firms, the liability issue, and the related concern about the possibility of acquiring adequate insurance cover, are nevertheless important factors in their calculation of whether they could cope with listed company clients. The UK Government moved in 2006 to introduce contractual limitation of liability agreements, and while these appear to be working in some sectors, they are very difficult to adopt in the listed company sphere, not solely because of the problem of getting shareholders to agree to them but because of the adverse position of the US market authorities, which see agreements of this type as being direct threats to audit quality.

It is noteworthy that countries which have legislated for some form of statutory restriction of liability have succeeded in increasing the pool of audit firms operating in the listed sector. Germany is probably the best example. It has had a statutory limit on auditors’ liability since 1931: the current cap for the audit of listed companies is 4 million euros. While the top 20 companies are all audited by Big Four firms, there is significantly higher involvement of mid-tier firms among smaller listed companies—in all, 34% of all listed companies there are audited by firms outside the top 8 firms.

ACCA does not suggest that the imposition of a fixed monetary cap is the best solution to the problem of market concentration. But we believe that some reform of the current system, which leaves auditors of major companies exposed to very substantial claims for damages in some cases, must be seen as a necessary component of the response.

Furthermore, it would not in our view be appropriate to intervene directly in the market by, for example, forcing the firms to downsize or break up. We believe that the better solution would be to address the barriers to competition which currently exist and which act as a deterrence to the involvement of firms outside the Big Four.

11. **Should the role of internal auditors be enhanced and how should they interact with external auditors?**

Internal and external auditors have mutual interests regarding the effectiveness of internal financial controls. Both professions adhere to codes of ethics and professional standards set by their respective professional associations. There are, however, major differences with regard to their relationships to the organisation and to their scope of work and objectives. The two functions have distinct roles:

- **External Audit exists to provide assurance to the shareholders/stakeholders that the annual accounts are free from material error.** External auditors review and report on a number of matters, including the company’s financial statements, its reporting processes and the sufficiency of its internal controls.

- **Internal Audit exists to provide the board/management assurance that the internal controls to manage risks that threaten the organisation’s objectives are in place and working as intended.** Internal audit can provide the audit committee and management with an assessment of the internal controls in place with respect to the mitigation of risk, as well as the efficiency and effectiveness of the operations of the company.

The financial crisis and the increased focus on corporate governance have caused Internal Audit departments to consider their role and focus and how these should evolve. ACCA’s view is that the role of internal auditors is likely to grow in importance as companies seek to manage risk better. We further believe that:

- The internal and external auditors should meet periodically to discuss common interests; benefit from their complementary skills, areas of expertise, and perspectives; gain understanding of each other’s scope of work and methods; discuss audit coverage and scheduling to minimize redundancies; provide access to reports, programs and working papers; and jointly assess areas of risk.

— In fulfilling its oversight responsibilities for assurance, the board should require coordination of internal and external audit work to increase economy, efficiency, and effectiveness of the overall audit process.

— External auditors are party to a wealth of corporate information. They are currently required to pass on information to regulators where they consider that that information is relevant to the regulator’s functions. There is, potentially, scope for arrangements to be explored whereby auditors can, with due respect for their professional responsibilities, liaise further with regulators to ensure that relevant information is made available.

12. Should the role of audit committees be enhanced?

Yes. It is often stated that audit committee members have a part-time job with full-time responsibilities. The audit committee is critical to ensuring the organisation has strong and effective processes relating to independence, internal control, risk management, compliance, ethics, and financial disclosures.

Given the scale of the financial crisis, it is clear that many companies failed properly to assess and manage their risk. It is therefore clear that the oversight role of the audit committee will continue to expand and to grow in importance. Audit committees need to be independent and must review management decisions with healthy scepticism. This process necessarily includes a close analysis of the way companies assess and manage risk.

To fulfil its responsibilities, an audit committee should use all available tools, including the company’s internal audit function, external auditors, and, if necessary, the retention of outside counsel and advisors. Each of these tools serves a key function.

If and when the scope of the audit and/or the reporting framework is expanded, ACCA would expect the role of the audit committee too to change, especially if new areas of reporting are introduced. At this stage, however, we consider it more appropriate to take steps to encourage audit committees to fulfil their potential in the governance and reporting processes that currently exist. This means ensuring that knowledgeable and independent-minded individuals are appointed to audit committees and that they develop an aptitude for asking the right questions, both to their external auditor and their internal accounting staff. The FRC has published written guidance in this area and ACCA would like to see all listed companies implement this guidance in full.

13. Is the auditing profession well placed to promote improvement in corporate governance?

Yes. Auditors already play a part, albeit a limited one, in the monitoring of clients’ corporate governance arrangements. Under the UK Listing Rules, auditors are required to review specified parts of the company’s compliance statement (with the UK Corporate Governance Code) that are considered to be relevant to the financial statements. Under the UK Listing Rules, companies are now required to disclose prescribed information regarding their corporate governance arrangements, which must include details of their internal control and risk management systems as they relate to the financial reporting process. This information may be disclosed as part of the statutory directors report or in a free-standing statement. Either way, the company’s auditor is required by law to state in his audit report whether, in his/her opinion, that information is consistent with the financial statements. Where the information is not disclosed at all, the auditor must draw attention to that fact in his/her report.

Thus, while the auditor’s involvement in this area is currently limited, it is already recognised that the way that a company arranges its corporate governance systems has implications for the integrity of its financial reporting, and therefore for the role of the auditor. Given that the auditor has a professional and legal responsibility to understand a client company’s internal structures, and how they contribute to the integrity of its financial reporting processes, ACCA would agree that the auditor is well placed to assume a greater role in this area.

ACCA has done much work in the area of governance. In particular our policy paper Climbing Out of the Credit Crunch, examines five key areas: corporate governance, remuneration and incentives, risk identification and management, accounting and financial reporting and regulation—and recommends that accepted practices in all these areas need to change to avoid future failures.

ACCA was in fact one of the first organisations to point out that the 2007 banking crisis was to a great extent a corporate governance failure, and to assert that there is scope for audit to evolve and to enhance business confidence. These conclusions have now been widely accepted. All the banks that failed had complied with the letter of corporate governance requirements. But what they did not do, in many cases, was to show a genuine

4 http://www.accaglobal.com/pdfs/credit_crunch.pdf
commitment to the spirit of good governance. We believe that a greater commitment to behavioural issues, and to values and the principles of good governance, are needed if sustained improvements in governance are to be achieved. Merely expanding compliance requirements and tightening external regulation is not likely to be the long-term answer.

October 2010

**Letter from the Chartered Institute of Management Accountants (ADT 5)**

1. The Chartered Institute of Management Accountants (CIMA) is pleased to have the opportunity to present evidence to the Select Committee on Economic Affairs of the House of Lords in relation to its Call for Evidence on Auditors: Market concentration and their role. CIMA, founded in 1919, is the world’s leading and largest professional body of Management Accountants, with 172,000 members and students operating at the heart of business in 168 countries.

2. Although the CIMA qualification does not include auditing, our members have an active interest in the effectiveness of audit as a consumer. CIMA members occupy senior positions in many of the UK’s largest public and private organisations and have direct involvement in the selection of audit firms and the work of auditors though various FTSE 350 audit committees and boards. We have consulted with a number of these senior figures in the UK and we thank them for their invaluable input. Despite this, the views expressed in this evidence remain those of CIMA only.

3. Much has been said and written about the causes of the financial crisis and we believe that this is not a time for apportioning blame but rather for learning lessons that reduce the likelihood of an economic collapse of this magnitude reoccurring. It is the role of the board of an organisation to deliver effective, entrepreneurial and prudent management that can deliver long-term success. External reporting should allow judgements to be made by third parties on whether this is happening. It is the role of the audit report to express an opinion on whether the financial statements present a true and fair view of the organisation’s affairs. Investors and regulators should act in a manner that encourages organisations to act in their long-term best interests and in the case of public interest organisations in a manner consistent with the long-term public good.

4. We believe that there are several factors driving audit market concentration: complexity of accounting standards, the requirement for auditors with global reach, the reputational risk of choosing an auditor outside of the Big Four and the significant infrastructure investment required by a global audit firm. Despite the degree of concentration, the audit market remains competitive. However, any further reduction in the number of market participants would significantly impair competition.

5. In our opinion, the audit process delivers what is strictly required of it legally and by regulators—it tends to ensure compliance. There are a number of common misconceptions about audit: it is not designed to detect fraud; it is not designed or required to reveal that a company is undermining its own business model and it cannot vouch that every fact and figure in a set of annual accounts is correct.

6. At the present time the financial audit is focussed on the financial statements. We believe that this focus is unduly narrow. The front section of the Annual Report, the narrative Operating and Financial Review (OFR), provides the critical, forward-looking contextual information which is essential to a proper understanding of the financial statements. There are a number of initiatives underway which are seeking to improve narrative reporting and we believe it is important that consideration is also given to some form of audit assurance that covers the process of generating the OFR.

7. We are very concerned about the increasing reliance by auditors on the “management representation” letter. Where there is material uncertainty it is only right and proper that the auditor asks management to confirm the basis on which the financial statements have been prepared and for the auditor to make clear that they are relying on this statement. There is a risk that management representations are been relied upon in cases in which audit verification should be possible. Auditors have a critical role to challenge the board but we do believe that the management representation letter should also set out the steps taken by the auditors to verify the statements on which they have asked for management representation.

8. It is the purpose of good management information to equip boards to manage in an effective, entrepreneurial and prudent manner so as to deliver long-term success. We believe that the role of audit should be extended to specifically cover whether the information provided to boards is sufficient for the board to determine the business model and adequately assess associated risks.

9. There were many factors that led to the financial crisis of 2008. Predominantly, we believe, that the lightness of regulation and the pursuit of unsustainable business models by boards were the most significant factors leading to the crisis. We conclude that there was little more that audit, as currently designed, could have done to prevent the crisis.
10. The regulation of the large audit firms is now a global issue that requires international agreement for effective change. The difficulties that this produces should not be underestimated. However, the steps outlined above together with an open dialogue between banks, regulators and auditors should reduce the severity of future financial crises.

11. We attach responses to the detailed questions contained within the call for evidence and look forward to the opportunity to discuss these matters further with the Select Committee on 19 October.

RESPONSE TO DETAILED QUESTIONS

Q1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1. There appears to us to be several reasons why auditing has become so concentrated on four global firms:
   — Complexity of accounting standards.
   — Global reach.
   — Reputation.
   — Infrastructure investment.

2. International financial reporting standards (IFRS) are recognised as being complex. Proponents of IFRS cite the growing complexity in basic business transactions but nevertheless a significant amount of technical expertise is required by the audit firms to adequately advise their clients. The Big Four firms not only have more people in their technical departments but these staff are exposed to similar issues in the dealings with other multi-nationals. The prevalence of US GAAP and the need for advice from experts in this field also drive large companies towards a Big Four auditor.

3. Multi-nationals need access to high-quality local accounting advice and audit firms outside of the Big Four may find this difficult to provide across all necessary territories. Companies often find it easier to negotiate audit fees based on global coverage rather than adopt a piecemeal approach. Companies that operate around the world need an external auditor with similar coverage. It is vital that the auditor has a deep local presence and is not totally reliant on “head office” transfers for expertise. The clients who need coverage across the world are a relatively small in number so cannot support a large number of international audit firms; perhaps four or five.

4. Reputation, whether perceived or otherwise, is also an important driver. As the 2006 Oxera report (Competition and choice in the UK Audit Market) concluded, the Big Four benefit from the so-called “IBM effect” ie “nobody gets fired for buying IBM”. In addition to the ability to perform the technical audit and to provide global coverage, the Big Four are also regarded as being better able to offer value-added services on top of the audit and to provide insurance against catastrophic risks and other reputational risks.

5. As a result of the need to offer a global solution, the infrastructure requirements of a Big Four audit firm are significant different and more complex than those of a firm from the next tier. This gulf in the level of investment is difficult to bridge and represents a major barrier to market entry for the medium-sized audit firms.

Q2. Does a lack of competition mean clients are charged excessive fees?

6. The Oxera report did find some evidence that higher concentration led to higher audit fees, but it also noted that audit committees tended to focus on quality and reputation rather than price. It can also be difficult to separate the impact of concentration rather than cost increases due to other factors such as additional regulatory requirements.

7. On the other hand the greatest fees for auditors can come from non-audit services and there is a concern that some large company audits are done at a very low cost as opposed to being at an excessive cost as a form of “loss leader”. This causes concern as it is likely to lead to the audit firms seeking ways to cut costs and as such reduce the level of assurance that they provide.

8. On the whole we believe that the audit market remains competitive although any further reductions in the number of global firms would be harmful to competition and undesirable. Whilst there are some limits on the alternative audit firms that an organisation could use, (due to independence, involvement with competitors), we believe that most companies would have a choice of capable firms should they decide to conduct a competitive audit tender process.
Q3. Does a narrow field of competition affect objectivity of advice provided?

9. From our experience, objectivity of advice is not impaired by the narrow field of competition for auditors. The larger audit firms generally have strong risk management and agreed global interpretations of accounting and reporting requirements that are not dictated by the wishes of any individual groups.

10. The fact that the audit firms also provide non-audit services is not, in itself, necessarily a conflict of interest in our view. The use of auditors for non-audit work should only take place in limited circumstances and under close scrutiny of senior management and the Audit Committee where their prior experience of our business means they are best placed to deliver the services required.

11. From a commercial point of view, as the revenue from an organisation being audited becomes more significant to an audit firm, the greater the potential risk of the objectivity of advice being affected. Although, we do not have any evidence that this conflict has affected any audit reports we believe that it is essential that market regulators continue to monitor and review this aspect.

Response to detailed questions

Q4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

12. This may well be the case but in our opinion, for the reasons given in response to Q3, we would conclude that auditors provide unbiased and professional advice even if this is not welcome by clients.

Q5. What is the role of auditors and should it be changed?

13. The efficient allocation of capital is fundamental to the capitalist economic model. Financial audit is an important element in this allocation process. But it is only one part and there is a limit to what should be expected from an audit. The scope of the audit—what it does, what it can do and what it is not meant to do—seems to be greatly misunderstood by the general public, investors and others. An audit is not designed to detect fraud, although it often does, nor is it designed to identify poor business models or management teams. Its purpose is to allow the audit firm to express an opinion on the truth and fairness of the financial statements published by the audited organisation. This is not an exact science; it is a process, governed by auditing guidelines and standards, which provides the audit firm with the information needed to form a view on the accounts prepared by the management team and approved by the directors.

14. That is not to say that the audit process could not be improved. The International Federation of Accountants (IFAC) have for some time been investigating the elements of the business reporting system. As well as considering corporate governance, financial reporting and the usefulness of financial reports, IFAC also investigated the audit of financial reports. The basis of the project was a global research study, in which 74 IFAC member bodies from 59 different countries and jurisdictions, including all major economies, participated. The results from the study were published in February 2009 IFAC in an Information Paper entitled “Developments in the Financial Reporting Supply Chain—Results from a Global Study among IFAC Member Bodies” (available from http://web.ifac.org/publications/ifac-policy-position-papers-reports-and-comment-letters/reports-1)

15. The study built upon previous work by the IFAC team which had identified a number of recommendations with regard to the audit of financial reports, these were:

— Continue to focus on independence, objectivity and integrity for auditors
— Converge to one set of global, principles-based auditing standards
— Ensure consistent use of auditing standards and safeguarding of quality within audit firms
— Improve auditors’ communication, both with the client and with external stakeholders
— Consider limited/proportionate liability for auditors
— Remove barriers that limit choice of auditor

16. The study found that the extent to which their earlier recommendations had been addressed varied from country to country. Of all the recommendations with regard to the audit of financial reports, most progress was reported on the continued focus on independence, objectivity, and integrity for auditors, closely followed by further convergence to one set of global, principles-based auditing standards and a more consistent use of auditing standards and quality control within audit firms.

17. Attempts to change the regulation of audit firms are difficult to implement due to the international nature of their operations which often means that cross-border agreement is necessary for any change to be effective.
18. Returning to a UK context, the Financial Reporting Council (FRC) earlier this year published its fifth progress report on the implementation of the recommendations of the Market Participants Group (MPG) and on other UK and international developments relevant to choice in the audit market. (http://www.frc.org.uk/press/pub2288.html)

19. CIMA, in our response to the fifth progress report, made substantive comment on 15 of the recommendations made by the MPG, which we regard as the most important.

— The FRC should promote wider understanding of the possible effects on audit choice of changes to audit firm ownership rules, subject to there being sufficient safeguards to protect auditor independence and audit quality.

— Audit firms should disclose the financial results of their work on statutory audits and directly related services on a comparable basis.

— Regulatory organisations should encourage appropriate participation on standard setting bodies and committees by individuals from different sizes of audit firms.

— The auditing profession should establish mechanisms to improve access by the incoming auditor to information relevant to the audit held by the outgoing auditor.

— The FRC should provide independent guidance for audit committees and other market participants on considerations relevant to the use of firms from more than one audit network.

— The FRC should amend the section of the Smith Guidance dealing with communications with shareholders to include a requirement for the provision of information relevant to the auditor re-selection process.

— Investor groups, corporate representatives and the FRC should promote good practices for shareholder engagement on auditor appointment and re-appointments.

— Regulators should develop protocols for a more consistent response to audit firm issues based on their seriousness.

— Every firm that audits public interest entities should comply with the provisions of the Combined Code on Corporate Governance with appropriate adaptations or give a considered explanation if it departs from the Code provisions.

20. Although the FRC should be commended for the openness of its reporting of progress on implementation of the recommendations of the MPG, it is disappointing to see that progress on only one of the recommendations listed above can be categorised as even “Moderate” whereas four rank as “Limited” and four as “None”. Progress in this respect is determined by the degree of impact on the associated risks. Whilst it is clear that the FRC has undertaken a considerable amount of work and that the benefit of some of its changes has yet to influence the progress measurement metric, CIMA calls on all market participants to redouble efforts to act upon all 15 recommendations in as timely a manner as possible.

21. The audit as currently designed focuses on the financial statements and in particular on the historic financial position of an organisation at a point in time. Income or net profit for the period in question is largely determined by the difference between the opening and closing audited balance sheets. This, undoubtedly, an important building block for an efficient allocation of capital but is only one element of the system.

22. CIMA believes that it is the role of the Board to deliver effective, entrepreneurial and prudent management that can deliver long-term success. Internal reporting should ensure that Boards are provided with the information set needed to operate in this way. We believe that there may be a role here for auditors to comment on whether the board is provided with sufficient information to be able to determine the business model and assess the associated risks.

23. Audited external reports should allow judgements to be made by third parties on whether this is happening; and investors and regulators should act in a manner that encourages this type of business approach.
24. We firmly believe that the top slice of information regularly reported to boards should form the basis for narrative reporting that supplies the necessary contextual information, including environmental and risk information, needed to help explain the financial position, performance and prospects of an organisation through its annual report and accounts.

25. Such narrative reporting is typically featured in the front section of annual reports. The effectiveness and completeness of this type of reporting varies considerably from company to company and, although there is a legal underpinning of minimum content through the Business Review legislation, we believe that there is scope to increase the mandatory requirements in this area. The Department for Business, Innovation and Skills (BIS) is currently consulting on a mandatory Operating and Financial Review (OFR). The OFR requirements specify the type of information that should be provided in the narrative section of an annual report. At this point in time the Accounting Standards Board has published voluntary guidance on the OFR and we intend to support the BIS proposal to make this guidance compulsory and to extend its provisions in the area of social and environmental disclosures.

26. There is a role here for the audit profession to provide some form of assurance over the disclosures in an OFR. We accept that the level of rigour applied to the audit of financial statements is not applicable to the “audit” of information in an OFR as it is more subjective and opinion based but nevertheless the audit profession should be challenged to offer an opinion on the contents of the OFR. We accept that this might raise substantial liability issues for auditors which may not be resolvable especially as liability protection would need to be global in nature. In which case we would like the audit profession to consider what assurance could be given over the process within the organisation used to generate the narrative report and its compliance with OFR requirements / guidelines.

27. In summary, we believe that the role of audit is largely undertaken with a high degree of professional competence by highly trained individuals. A number of recommendations have already been made that would enhance the audit function and we have highlighted those areas that we feel should be concentrated on to ensure that progress to date is turned into effective change. We believe that there is a need for consideration of a system of assurance from independent auditors on the OFR which would require an extension to the scope of the audit, recognising that this might require some form of liability protection for auditors.

28. We recognise that audit is only one part of the mechanism for efficient market allocation of capital and emphasise the integral part that effective narrative reporting, such as the OFR, should play in this allocation. CIMA has a history of making positive contributions in this area. Together with PricewaterhouseCoopers (PwC) and Radley Yeldar, we established the Report Leadership initiative in 2005, with the aim of challenge thinking on corporate reporting. Through a number of publications the group presented simple, practical, yet effective, ways to improve narrative and financial reporting. Further work is still planned for this group. In addition, we have recently joined with PwC and the think-tank Tomorrow’s Company to investigate the cultural and behavioural barriers to the effective development of corporate reporting which, we anticipate, will provide some interesting results.

Q6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

29. Much has been written and said about the role of the various market participants in the economic collapse. Overall, we believe the issue was an over-lightness of regulation rather than a failure of audit. As Mervyn King, governor of the Bank of England, speaking at the Trades Union Congress on 15 September said “Before the crisis, steady growth with low inflation and high employment was in our grasp. We let it slip—we, that is, in the financial sector and as policy-makers”

30. The overreliance in the financial sector on regulatory regimes, centred on the minimum capital requirements under Basel and the risk weightings applied to loan books, particularly in relation to property lending and especially because they were often based on short term loan loss experience models which only captured activity during the unusually prolonged upside of the economic cycle.

Q7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

31. It is not the auditor’s role to question strategy and to the extent that the banking crisis was caused by unsustainable business models then there was little more the auditor could have done. However, we do believe that there is a risk that the sheer complexity of accounting rules and liability concerns may have led to a reduction in the level of professional scepticism applied to the audit of financial statements to be replaced too
often by a tick-box mentality. This view is supported in the FSA and FRC joint discussion paper “Enhancing the auditor’s contribution to prudential regulation” in which questioned whether auditors “paid adequate attention to indicators of management bias” and told auditors to “challenge management more.”

Q8. How much information should bank auditors share with the supervisory authorities and vice versa?
32. The primary responsibility of an auditor is to the shareholders of the company being audited and satisfying this responsibility is unlikely to require significant exchange of information with the supervisory authorities. However, the audit of certain organisations, which would include banks, might well be regarded as of general public interest. We support an open dialogue between banks, their auditors and the Bank of England which may require auditors to share information relating to financial stability with the supervisory authority. If auditors’ responsibilities were increased in this way then the issue of legal liability to shareholders for equity losses arising as a result of disclosure to supervisory authorities would need to be addressed.

Q9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?
33. We have no evidence that advice to clients is not objective even if that advice is likely to be unwelcome. There possibly needs to be a strengthening of the relationship between the auditors and the audit committee and Chairman, for example through regular private sessions with the audit committee and/or Chairman.

Q10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?
34. We have no evidence that such conflicts do arise. However, to the extent that they might then the systems in place to maintain the quality of audit, including the work of the Audit Inspection Unit of the FRC, need to be maintained.

Q11. Should more competition be introduced into auditing? If so, how?
35. The capitalist market model depends upon healthy competition and it is difficult not to agree that more competition would be a good thing. However, it is not easy to see how this might be achieved.
36. If one believes that company boards act in the best interests of their company then the fact that all of the largest UK companies are audited by firms from the Big Four tells us that they are unwilling to move towards the next level of audit firms and, as such, are likely to be sceptical about moving to a new entrant to the market especially if that entrant came about artificially.

Q12. Should the role of internal auditors be enhanced and how should they interact with external auditors?
37. Internal and external audit are distinct but complementary to each other and CIMA believes that both are extremely important. Good internal audit, which could be outsourced to an external audit firm, might have helped during the recent economic crisis because it would have reported on the adequacy of internal controls and risk issues— but if a bank was pursuing an unsustainable business model, it is not clear how much influence they could have had.
38. There are valuable synergies to be gained from a strong relationship between internal and external auditors such as reliance by external auditors on internal audit transaction testing.

Q13. Should the role of audit committees be enhanced?
39. The UK Corporate Governance Code is comprehensive in terms of the role of the audit committee. It is notable that the recent review of the code did not result in enhancements to the audit committee role; but the new code has a heightened focus on the whole board’s responsibility for risk.
40. The audit committee should adequately discharge its responsibilities in a professional and challenging manner but this should not reduce the sense of responsibility of the whole board to the entire published corporate report.

Q14. Is the auditing profession well placed to promote improvement in corporate governance?
41. The auditing profession is well placed to provide advice on how governance might be improved. However, it remains the responsibility of the Board to ensure adequate corporate governance based upon the FRC’s UK Corporate Governance Code. The FRC and its subsidiary bodies have an important role to play in monitoring company reports and in our opinion this process appears fit for purpose.

September 2010
Memorandum by the Institute of Chartered Accountants in England and Wales (ADT 6)

INTRODUCTION
The Institute of Chartered Accountants in England and Wales (ICAEW) welcomes the opportunity to submit evidence in response to this House of Lords Economic Affairs Committee inquiry. ICAEW is committed to working with Government and regulators as well as wider market participants in order to help maintain economic confidence. Our 134,000 members work across every sector of the economy leading and advising organisations of all sizes. They include auditors, executive and non-executive directors, investors, regulators and wider market participants. By drawing on their collective expertise we are well placed to comment on the issues raised by the Committee.

BACKGROUND
While it will take a number of years before the causes of the financial crisis are fully understood, evidence to date indicates that it was caused by a combination of sub-prime lending and a dramatic fall in property prices in the US. The collapse in confidence across capital markets that followed was fuelled by doubts about the viability of financial institutions holding significant assets that depended directly or indirectly on property lending or wholesale market funding.

Concerns about the relative strength of the capital base of these institutions led to a meltdown in the liquidity available to them, which cumulatively resulted in a sharp contraction of funds available to the banking system generally and the ability of banks to provide credit to consumers and businesses. As financial institutions have come under pressure from regulators to restore capital ratios to prudent levels this has continued to limit the amount of lending that is taking place, resulting in a significant decline in economic activity.

The speed at which all this happened was dramatic. A number of well known financial institutions were swept away, amalgamated or nationalised. Governments across the world were forced to underwrite failing industry sectors at a cost of many billions. Orthodoxies that governed economic behaviour over the previous decade were thrown into question. The real economy is only beginning to move from recession to fragile recovery.

In these circumstances it is right that our financial systems be scrutinised. All market participants need to think hard about the lessons of the past two years and be prepared to take the necessary steps to ensure that the risk of this happening again is mitigated.

The audit profession, which plays an integral part in the effective operation of capital markets and the wider economy, is no exception.

The past 24 months have tested auditing reforms adopted in the UK after Enron as well as the work undertaken through avenues such as the Audit Quality Forum. The evidence to date suggests that in the main, auditors have been performing an important role with diligence in the face of challenging economic circumstances and that recent reforms are holding up well.

Part of the auditors’ contribution has been to challenge asset valuations, which has contributed to companies having to revalue their assets, in certain cases requiring a considerable reduction in values in order to give a true and fair view in accordance with the relevant financial reporting framework. These revaluations have contributed to the falling financial performance of banks, reductions in share price and criticism of their directors in general meetings of shareholders as well as the media.

However, over the past 18 months ICAEW has been examining what lessons can be learnt from the crisis and how audit needs to evolve to meet changing market expectations. Our Financial Services Faculty has led on this work. Key recommendations are included in the report “Audit of banks: lessons from the crisis” which we have appended to this submission. In particular, we believe that improvements can be made in terms of the way risk is reported by banks. We also think there is a need for better dialogue between auditors and bank supervisors. To this end and at the request of the Bank of England we are participating in a Working Group to look at the flow of critical information on banks between the regulator and auditors.

This House of Lords Committee inquiry is a timely and important contribution to the current debate. It builds on the Committee’s June 2009 report into Banking Supervision and Regulation to which ICAEW also submitted evidence.

Three key points inform our written submission:

— This has not been an audit driven crisis and UK audit quality remains world leading.
— The audit profession, along with other market participants, must nonetheless reflect on what lessons can be learned from what has happened over the past two years.
This has been a global crisis and reform proposals must therefore be capable of implementation across markets.

UK audit firms belong to international networks and audit UK businesses that are international in their operations. We urge the Committee to ensure that hasty responses to the current crisis at the national level do not inadvertently sow the seeds of a future crisis.

ICAEW has been invited to give oral evidence to the Committee in October when we will be happy to expand on any of the points set out in this submission.

Responses to Specific Terms of Reference

Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1. The current concentration of firms providing audit services to the listed company sector has largely been driven by the behaviour and economic choices of these companies as well as the growth strategies of these firms.

2. When the audit committee of a listed company looks to appoint an auditor, what drives this choice is the need to ensure that the firm has the necessary breadth and depth of expertise. Those who appoint auditors should not be motivated by the need to ensure diversity in the audit market but the need to ensure auditors do the best job for their shareholders. From the perspective of the individuals who make these appointments there are incentives to gravitate towards an internationally recognised brand with the global reach that this brings.

3. While greater choice across the FTSE audit market is clearly something we would welcome what matters ultimately is that audit quality remains high.

4. This issue of market concentration has been looked at by the UK Government and the European Commission both of whom commissioned independent research in this area. It was also examined by the Audit Quality Forum, whose work fed into a two year project undertaken by the Market Participants Group (MPG) of the Financial Reporting Council. The MPG identified a range of long-term, market driven steps that could be taken to increase competition and choice which are now being implemented. It is too early to assess the impact of these measures (the Audit Firm Governance Code for example was only introduced earlier this year) and they should be kept under close review. It is also worth noting that the European Commission is likely to revisit the issue in its forthcoming Green Paper on audit.

5. Economies of scale certainly create barriers to entry. The Oxera report made the point that “any new entrant would need to overcome perception barriers and demonstrate sector-specific skills, international coverage and high quality staff to win audits”. This is not easy given the difference in size between the four largest firms and other major international networks. Other barriers also exist. For example, the European Union’s Directive on statutory audit sets certain minimum control requirements for audit firms. These may prevent external capital providers funding a smaller firm as it seeks to become larger.

6. It is also important to remember that the current situation has arisen through market demand with the largest firms growing their audit services to meet the global needs of their clients. In many ways this process has been a success story for the UK economy as the UK arms of the dozen or so largest international network firms as well as many of the mid-tier practices have been at the forefront of driving quality, innovation and capability in this industry sector.

Does a lack of competition mean clients are charged excessive fees?

7. No. We are not aware of any evidence to support a claim that audit clients are charged excessive fees. While there are relatively few firms currently serving the listed company sector those that serve the market compete fiercely with each other on price as well as other differentiators. Competitive tendering or the threat of it across this sector ensures the firms are kept on their toes.

Does a narrow field of competition affect objectivity of advice provided?

8. No. In our view the competitive structure of the current audit market does not have a significant bearing on auditor objectivity. Of far greater significance is the investment in training and development within the firms and the professional standards and ethical codes to which auditors must adhere, as well as the regulatory

and oversight regimes that are currently in place to ensure that quality and objectivity are maintained. The learning and professional development students must undertake in order to qualify into the profession requires them to develop a range of skills in ethics, professional judgement and scepticism intended to ensure the objectivity of their work.

9. In January 2010 the FRC and ICAEW published the Audit Firm Governance Code. The Code applies to eight audit firms that together audit about 95% of the companies listed on the Main Market of the London Stock Exchange. For these firms, the Code sets a benchmark for good governance which other audit firms may wish to voluntarily adopt in full or in part and requires explanation for non-compliance. The Code sets out expectations of the role of independent non-executives in the firms' governance structures. It also codifies much existing good practice and references matters that audit firms must comply with as regulated professional partnerships.

Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

10. No. Again we would argue that the competitive structure of the current audit market does not have a significant bearing on auditor objectivity. Auditors are subject to significant independence requirements which are designed to protect objectivity and the ability to challenge and disagree with directors’ opinions.

What is the role of auditors and should it be changed?

11. Auditors give shareholders confidence that financial information reported by a company is “true and fair”. They do this by following a process whose standards are set and enforced by independent regulators. The role of auditors under UK law is explored in detail in the Audit Quality Forum publication *Audit Purpose* which is available on the ICAEW website at www.icaew.com.

12. An audit does not provide absolute assurance about the state of a company’s financial health. The operation of a business involves judgements on a wide range of areas and this brings with it risk. No matter how strong financial reporting, auditing and corporate governance measures may be, they cannot eliminate bad business models or poor judgements by directors.

13. In the wake of the financial crisis all market participants need to reflect on what lessons can be learned to help mitigate the risk of these events happening again. To this end ICAEW has recently published a set of recommendations for improving the audit of financial institutions, *Audit of Banks: Lessons from the Crisis* published in June 2010:

*Bank reporting*

Risk information is often presented in a piecemeal manner in bank annual reports, spread between the audited financial statements and the unaudited front sections. Banks need to focus on clearer presentation which allows users to understand the big picture, which is currently often obscured by the volume of detailed information. Summary risk statements are a potential way of providing this big picture. Auditors should be asked to provide assurance on new summary risk statements to provide confidence to readers of financial statements.

Audit committees have an important role to play in supporting better reporting. Auditors play a key role in making sure audit committees are equipped with the information they need to perform their role. A guide to good practice in audit committee reporting would help improve performance.

*Auditor reporting*

Insufficient information is provided under the current framework about the work that underpins an audit. This makes it difficult for investors to assess the performance of bank auditors or to understand the key areas of challenge. To address this gap, banks should confirm that key areas of judgement discussed with auditors are set out in the critical accounting estimates and judgements disclosures in the financial statements. Our Financial Services Faculty is setting up a forum for investors and auditors to help make the audit more transparent. Auditors should also have more involvement in reporting on the front sections of annual reports. Their responsibilities for this are currently very limited.

*Dialogue with supervisors*

Regular exchange of information between auditors and bank supervisors enables both parties to perform their duties more efficiently and effectively. Dialogue between auditors and banking supervisors was not consistently good enough before the crisis, with the regulator not placing sufficient value on such dialogue. There have been improvements in both the frequency and quality of dialogue but this remains variable and is dependent upon the attitude of individual supervisors. Further improvements are needed,
including improvements to promote greater consistency between supervisors and ensure that discussions are a two-way process for information sharing.

Support for supervision

Auditors and other external experts have particular skills that can support banking supervisors in performing their functions. Supervisors have the power to utilise these skills but have done so rarely, typically only where particular problems have been identified. There is scope for making greater use of external experts on a thematic basis, as part of supervisors' overall monitoring regime and as preventative or diagnostic measures.

Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

14. Notwithstanding concerns expressed recently by regulators we have seen no hard evidence to support claims that auditors were not exercising a high degree of professional scepticism in the run-up to the financial crisis whether as a result of a lack of competition or any other factor. Successive reports from the independent Audit Inspection Unit (AIU) have indicated that UK audit quality remains high.

15. The increased number of going concern qualifications and “emphasis of matter” modifications in audit reports over the past two years suggests that auditors have continued to push back where they felt the need to do so.

What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

16. Auditors were operating in the same environment as other market participants including regulators and Government and, like these other market participants, did not anticipate the systemic collapse in confidence across the capital markets that was fuelled by doubts about the viability of certain specific financial institutions. As the House of Commons Treasury Committee (TSC) concluded in May 2009 “we have received very little evidence that auditors failed to fulfil their duties”.

17. The banking crisis did however highlight weaknesses in the level of dialogue between auditors and bank supervisors. Meetings between auditors and the FSA were too infrequent, the range and quality of information shared by bank supervisors with auditors was limited, and the FSA had no obligation to share relevant information with the auditors. In hindsight, better channels of communication may have helped mitigate some of the effects of the crisis.

18. The need to improve the level of engagement has been acknowledged by the FSA and this has been improving since the start of the crisis.

19. Moving forward, auditors have an important role to play in better supervision of the banking sector. Auditors and other experts have particular skills that can assist banking supervisors in performing their functions.

20. As part of the improved dialogue between auditors and supervisors there needs to be a better balance of information shared. Currently there is a duty on auditors to report matters to the FSA which may be material to their supervisory responsibility but no corresponding duty on the FSA to share information with auditors that may be material to the audit. It would also be helpful for auditors to raise concerns with senior management within regulators if they consider the level of engagement from the supervisory team is inadequate.

21. To support the regulator in its supervisory work auditors could look at areas of risk in greater detail during the audit. Under section 166 of the Financial Services and Markets Act (FSMA), the FSA can commission a report to be prepared by a “skilled person” (s166 reports). Skilled persons include bank auditors. These reports could be used by the FSA on a thematic basis, or as a diagnostic and monitoring tool where the regulator is seeking to identify risks or problems in the system, or in assessing performance or compliance. The resulting exchange of information could be a powerful tool in the better supervision of banks.

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6 Deloitte research.
7 Treasury Committee Report: “Reforming corporate governance and pay in the City”, 15 May 2009, paragraph 221.
How much information should bank auditors share with the supervisory authorities and vice versa?

22. As a guiding principle, bank auditors should be prepared to disclose anything to bank supervisors and vice versa. How this can be achieved in practice is something ICAEW is currently working on with the Bank of England, the FRC, the FSA and the major audit firms.

If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

23. There are already very strong incentives for auditors to be objective. They report in accordance with independently set standards on the truth and fairness of financial statements, adhere to rigorous independence and ethical requirements and are subject to regulatory oversight. All of these requirements act as a check and balance on the professional judgement that they exercise. In recent years the AIU has also reported annually on the quality of individual firms, providing another important incentive for auditors to be objective.

Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

24. Yes. Conflicts of interest are one of a number of potential sources of threats to auditor independence which arise as a result of self-interest, self-review, advocacy, familiarity and intimidation. These threats are dealt with through effective disclosure as well as a regime of safeguards, selective prohibitions on consultancy services and, crucially, review by the audit committee, which is central to UK corporate governance.

25. There will always be specific circumstances where the provision of non-audit services is unacceptable and ICAEW believes the current framework should be kept under constant review. However, there is no evidence that the provision by auditors of non-audit services to listed entities that they audit has actually compromised audit quality and we do not believe that the provision of these services diminishes audit quality. Our understanding is that the overwhelming majority of respondents to the current Auditing Practices Board (APB) consultation on non-audit services see the current regime as largely effective and reject outright prohibition of non-audit services as proposed by the TSC in favour of better disclosure provisions.

(a) Should more competition be introduced into auditing? If so, how?

26. As a general principle we support greater choice in the audit market. We also believe the current industry structure is the result of market dynamics which would limit the effectiveness of any direct market intervention. Market based measures such as those set out by the Market Participants Group of the FRC should prove most effective and durable over time.

(b) Should the role of internal auditors be enhanced and how should they interact with external auditors?

27. Yes. Internal auditors should have a leading role within an organisation in providing assurance on the management of risk. The remit of internal audit should, in theory, be very wide-ranging across all parts of an organisation. Although its role is set by the board, the audit committee and management, in practice what internal audit can actually achieve is limited by resources and expertise. Their work should be focused on areas of greatest risk within the organisation which often go well beyond financial risks and controls.

28. The relationship between internal and external auditors is established by standards for external auditors. It is good practice, even if external auditors decide not to use the work of internal auditors, for there to be good communication between the two functions. Internal audit can be a useful source of information about the risks and controls within the organisation and how management are addressing these issues. However, external auditors do need to remember that internal auditors are responsible to companies and not investors and be mindful of this distinction.

(c) Should the role of audit committees be enhanced?

29. Yes. Audit committees have a vital role to play in terms of promoting good corporate governance and in challenging management. Their responsibilities have evolved over time and been considered again by the Walker Review on Corporate Governance in Financial Institutions, and also by the recent wider review of corporate governance conducted by the Financial Reporting Council. In particular we would support more information being made available by audit committees about their discussions with auditors, to provide evidence that auditors are performing their duties with due rigour, to ensure wider stakeholders are better informed about the way in which audit committees handle their governance responsibilities and to provide greater clarity around the nature of the judgements the company has made in the accounts.
(d) Is the auditing profession well placed to promote improvement in corporate governance?

30. Yes. Although it is for companies themselves to determine their governance structures, auditors are an integral part of the corporate governance process and have a duty to report matters of significance and provide challenge to management’s critical accounting estimates. This normally happens through the audit committee.

31. ICAEW has established a working party that will publish guidance in early 2011 to strengthen the consistency and quality of communication between auditors and bank audit committees. This will improve corporate governance in banks, as it will enable audit committees to better challenge executive directors on accounting judgements and estimates and financial statement presentation.

24 September 2010

Memorandum by the Institute of Chartered Accountants of Scotland (ADT 7)

INTRODUCTION AND KEY POINTS

Introduction

The Institute of Chartered Accountants of Scotland welcomes the opportunity to submit evidence to the House of Lords Economic Affairs Committee inquiry on Auditors: Market Concentration and their Role. The Institute is the first incorporated professional accountancy body in the world. The Institute’s Charter requires it to act primarily in the public interest, and our responses to consultations are therefore intended to place the general public interest first. Our Charter also requires us to represent our members’ views and protect their interests, but in the rare cases where these are at odds with the public interest, it is the public interest which must be paramount.

Key Points

— This is a global issue and is not restricted to the UK listed company audit market.

— We do not believe that there is a lack of competition in the listed company audit market but rather that the level of market concentration is not dissimilar to that found in certain other sectors. However, we do believe that if the level of competition was to contract further, for whatever reason, that there would be a problem. We therefore believe that it is imperative that a change to the auditor liability regime is made in early course. Auditors should only be held accountable for their share of the blame in relation to any successful negligence claim against them and that is why we favour the introduction of a mandatory proportionate liability regime.

— An ICAS Working Group is currently considering the role of the auditor and whether this needs to be developed further. Recent research has indicated that there is significant demand from the investment community for at least some degree of external assurance on the management commentary section of the annual report. The Working Group’s report is expected to be published before the end of the year and we will send a copy to you as soon as it is finalised.

— We do not believe that the level of competition has any impact on the objectivity of the auditor.

— We believe that the role of the audit committee is already well established within the listed company sector. It is our belief that it is the composition of the audit committee and the diligence of its members which is key. We do, however believe that there is a greater need for transparency over the work of the audit committee. Current reporting requirements on the work of the audit committee can often result in “boilerplate” disclosures which add little to the stakeholder’s understanding of their role and their interaction with the external auditors. The audit committee plays a critical role in challenging management’s judgements and more disclosure in the audit committee report could further the transparency of both the external audit process and the internal assurance processes within a company.

— We believe the non-mandatory approach to internal audit to be appropriate. However, we also firmly believe that it is beneficial for listed companies to have an effective internal audit function. In order for the internal audit function to be effective it must have support at board level and not be seen as a mere compliance related function.

— It should be noted that there are various different Government, regulatory and professional bodies currently reviewing the role of the auditor. These include, but are not limited to the following:

(i) the European Commission which is expected to publish its Green Paper on Auditing, in October.

(ii) the Financial Services Authority/Financial Reporting Council in their joint discussion paper 10/3 “Enhancing the Auditor’s Contribution to Prudential Regulation”.

(iii) the Auditing Practices Board in its discussion paper “Auditor Scepticism: Raising the bar”.

(iv) the ICAS “Future of Assurance” Working Group which comprises stakeholders from the investment community, industry, academia, the media and the profession.

We would therefore encourage the Committee to also consider the findings of the above consultations/projects before finalising its recommendations.

RESPONSES TO SPECIFIC QUESTIONS

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

Accountancy firms are businesses and like other businesses, firms have merged for similar reasons to mergers which have taken place in other sectors. The current market position arose over a number of years and as a result of various factors which we outline below. It needs to be highlighted that this is a global issue and is not unique to the UK listed company audit market.

A number of major industry sectors have only 4 or fewer major dominant players. This does not necessarily indicate that a lack of competition exists eg the record industry in the UK only has four major players, there are four main food retailers in the UK, and the global private aircraft manufacturing sector only has two. Whilst we appreciate that in certain niche sectors entities may be restricted to less than four accountancy firms from which to choose their auditor, the vast majority of listed companies have access to greater choice. Additionally, for non quoted companies there is plenty of choice in the audit market.

The factors which have led to the current level of concentration in the listed company audit market can be summarised as follows:

(i) Growth of multi-national companies—responding to customer needs

As companies began to expand their respective operations beyond their domestic markets, professional accountancy firms did likewise to enable them to provide the necessary services to support their clients. This client driven expansion partly explains the larger accountancy firms’ initial international expansion which was effectively driven by the needs of British and US based multinationals for worldwide service in the 20th century. The larger accountancy firms responded:

(a) by forming local partnerships in different jurisdictions or

(b) by forming networks with local firms already in existence in the particular jurisdiction concerned.

Even fairly recently, due to business demand, auditors needed to establish operations in China, where there was no established accountancy profession.

(ii) Quality

Linked to (i) above, is the need for an audit firm to be able to satisfy itself in relation to the quality of work undertaken, regardless of which jurisdiction the work is performed. Where clients had sizeable operations in different countries it was more difficult for audit firms to ensure the quality of audit work in such jurisdictions where the audit of some client affiliates (subsidiaries, associates etc) was undertaken by firms not connected to the parent company auditor. The need for the parent company auditor to ensure that firms in different countries audited to the same standards resulted in the establishment of networks to allow the sharing of knowledge, agreed methodologies, training requirements and quality assurance etc. It also made it easier to control the group audit when all significant affiliates of the company were audited by a member firm of the network. In this respect many clients would also rather only have to deal with one firm auditing all of the group entities.
(iii) Barriers to Entry
Per the figures in Appendix 1, there is a substantial gap between the revenue of the lowest of the Big Four firms and the revenue of the next accountancy firm on the list. Therefore, a fundamental change in the market or in the legal/regulatory environment would be required to foresee a situation where a firm not currently in the Big Four was to effectively challenge the market share of even the lowest ranked Big Four firm. The barriers to entry are substantial and are briefly summarised below.

Available Resources/ Breadth of Network
In relation to servicing multi-national companies, not all networks have associate firms or sufficiently resourced associated firms in all key jurisdictions. Many large corporates therefore argue that only the Big Four firms provide the global reach that is required to service their particular operations. This will obviously depend on the nature and complexity of the entity’s operations and the number of jurisdictions within which it operates, however, it is also not just the existence of a network firm in a particular jurisdiction but also the quality of the individual firms within that particular network which is key.

Litigation Risk
The auditors of large multi-national companies are potentially exposed to legal claims the size of which could threaten the very existence of the firm. In theory, the larger the size of the firm the greater access it has to resources to meet any such successful claim.

Depth of Specialism
On certain audits the depth of specialism required eg for the audit of a major bank, is unlikely to be present in sufficient volume outside of the Big Four firms.

Regulatory Costs
The costs of having to comply with various different regulatory regimes across the globe are a significant barrier to entry for firms seeking to break into the listed company audit market.

(iv) Growth by Merger/Acquisition
Over the years many smaller firms have disappeared as firms have merged for a variety of reasons. Up until 1989, the audit market was dominated by the largest eight accountancy firms. Following further mergers the market was left with the Big Five which became four when Arthur Andersen collapsed due to the reputational damage suffered following the demise of Enron.

(v) Economies of Scale
Undoubtedly, accountancy firms would have viewed economies of scale as a potential benefit of a merger eg the savings in costs in relation to developing methodologies, systems, technical support, administration etc. However, significant costs had to be incurred to merge the working practices and systems of the firms involved.

2. Does a lack of competition mean clients are charged excessive fees?
To the best of our knowledge there is no evidence to suggest that clients are charged excessive fees. The Transparency reports produced by the larger accountancy firms show lower levels of profitability for assurance services than for other services provided. The vast majority of listed companies are in a position where they can instruct a number of audit firms and have the ability to put the audit out to tender on an annual basis, if they so wish. We do accept that in a few rare situations, conflicts of interest may restrict the choice to less than four firms due to the level of specialised knowledge required, particularly in certain niche sectors. Developments in corporate governance and in particular the increasingly important role of the audit committee also serve to prevent firms charging excessive fees. ICAS produced revised guidance in 2007 entitled: “Appraising Your Auditors”9. The Guide provides practical assistance to audit committees in handling the responsibilities recommended by the FRC Guidance on Audit Committees. In particular, the Guide helps audit committees in their critical roles of monitoring the relationship between company and auditor, overseeing the independence and objectivity of the auditors and, when appropriate, selecting new auditors.

Additionally, surveys of audit fees in the FTSE sector are regularly undertaken and the price charged for an audit is specifically disclosed in the annual financial statements of a company. Therefore, the fee charged for an audit is transparent and companies can benchmark the cost of their audit versus that of their competitors. We would also like to emphasise that the audit fee must be adequate to allow a full and proper audit to be undertaken in accordance with auditing standards.

3. **Does a narrow field of competition affect objectivity of advice provided?**

We do not believe that the existing field of competition impacts on the objectivity of the advice provided and we are not aware of any evidence to the contrary. Objectivity is a state of mind expected of a professional and in our view is not subject to improvement by increased competition.

4. **Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?**

As with our response to the previous question a key ethical requirement is for auditors to be objective. We do not believe that the level of competition in the marketplace is a factor in an auditor’s ability to challenge his client.

5. **What is the role of auditors and should it be changed?**

**Role of Auditor**

The role of the auditor is set out in sections 495-498 of the Companies Act 2006. This is summarised as follows:

The auditor’s primary role is to report to the company’s shareholders on the truth and fairness of the company’s annual statutory financial statements. The auditor also has to report on the consistency of the information contained in the directors’ report with that contained in the financial statements. There are other related duties which can be found at the above sections of the Companies Act 2006. For listed companies, the auditor also has to report on whether the auditable part of the directors’ remuneration report has been properly prepared and additionally review certain listing rules requirements.

**Role of Auditor—recent developments**

Questions have been asked in recent times as to whether the role of the auditor is too narrowly defined eg paragraph 221 of the report of the Treasury Select Committee (TSC) “Banking Crisis: reforming corporate governance and pay in the City” published in May 2009 stated:

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

Therefore, notably the TSC found little evidence to suggest that auditors had not properly performed their duties but questioned whether there was value in the audit. At a prestigious ICAS event “The Aileen Beattie Memorial Lecture” held in April 2010, none of the panelists which included a senior investor representative and a FTSE 100 company executive, believed that the statutory audit should be abolished and assurance needs left to the market. They all expressed their support for the statutory audit and the role it plays although it was recognised that the auditor could be asked to do more in certain areas.

Recent research undertaken on behalf of ICAS (“Meeting the needs? User views on external assurance and management commentary”) identified that there is significant demand for at least some degree of external assurance on the management commentary section of the annual report. This could therefore present an opportunity for additional assurance to be provided by the auditor.

It would appear that there still remains an expectation gap between what certain stakeholders believe that the auditor is responsible for and what in fact his responsibilities are. In our view, moves could be made to meet some of these expectations but there are certain expectations which we do not believe can be met. To progress

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this issue, ICAS established a “Future of Assurance” Working Group earlier this year comprising representatives from the investment community, academia, the media, industry, regulators and the profession. The Working Group has now met twice and it is anticipated that it will publish its proposals before the end of the year. It is our intention to forward a copy of the final report to you once it is finalised. Matters that are being considered include the following:

(i) Could the auditor do more in terms of reporting on “going concern”?
(ii) Should the auditor provide assurance on the front end narrative section of the annual report?
(iii) Would a more informative and discursive audit report be seen as beneficial?

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

There is no specific evidence to answer this question in the affirmative or the negative. The Financial Services Authority and Financial Reporting Council have accused the auditing profession of lacking “professional scepticism” in its recent discussion paper13 and the APB has published a paper14 on this topic. However, the FSA/FRC paper does not contain any specific evidence to substantiate this claim.

The auditor’s role as stated above is to report on the truth and fairness, or otherwise, of the annual accounts. The auditor has to assess the assumptions and estimates made by management. This assessment is conducted against the requirements of the applicable accounting framework, with some accounting standards requiring a greater degree of judgement than others. Where management’s judgement falls within the parameters of an accounting standard, it is difficult for the auditor to argue that their judgement is more appropriate than the judgement of management. Ultimately management is responsible for the preparation of the financial statements and they will naturally understand their own business in greater depth than their auditors. The auditor’s role is to provide assurance that those financial statements are true and fair against the applicable financial reporting framework.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

First and foremost, the auditing profession was not responsible for the banking crisis, as has been explained in various reports which have been published since the crisis eg the Turner Report15.

“At the very heart of the crisis lay an interplay between macro-imbalances which had grown rapidly in the last ten years, and financial market developments and innovations which have been underway for about 30 years but which accelerated over the last ten to 15, partly under the stimulus of the macro-imbalances.”

Given the role of the auditor as discussed above, we are not aware of anything that auditors could have done to mitigate the banking crisis. Going forward, improvements could be made to the current regime by requiring regular meetings of all the auditors of large financial institutions with the body charged with monitoring financial stability.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

As one of the issues in the years leading up to the credit crisis appears to have been the lack of meetings held between the FSA and auditors, it is essential that greater dialogue between these two parties is encouraged. It is therefore crucial that plans are introduced for regular meetings to be held to facilitate the sharing of relevant information where possible. Note we stress the “sharing of information” as we believe this has to be a “two-way” process and believe that increased dialogue can assist both parties in discharging their duties appropriately. Whist we have support for the concept of the proposed default position proposed by the FSA/FRC. “Both parties need to learn that, where there is a concern, the default should be to share the information unless there are restrictions that would prohibit this.” we have concerns that there would still possibly be situations where the auditor is not made aware of something that might have a material impact on the audit. Therefore, in our opinion the best way to facilitate the appropriate sharing of information would be to introduce a reciprocal mandatory reporting obligation on the FSA to that which auditors are currently subject to.

9. **If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?**

We believe that there is no need to strengthen the current framework in this respect. Auditors do provide objective and on occasion unwelcome challenge to clients. Generally, the unwelcome challenge will be acted on by the board of directors rather than run the risk of having the audit report on their company’s accounts qualified. Additionally, improvements have already been made to auditing standards and these will become effective for accounting periods ending on or after 15 December 2010. Likewise, revised ethical standards for auditors will become applicable early in 2011.

10. **Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?**

Conflicts of interest can arise in certain situations eg where audit firms provide non-audit services to their audit clients. The extent of the conflict determines whether or not the auditor is able to provide the service in question. Some threats may be capable of being mitigated by the use of appropriate safeguards by the audit firm eg use of different personnel etc whilst others cannot be satisfactorily safeguarded and therefore the service cannot be provided.

Following the aftermath of Enron et al, the Auditing Practices Board was tasked with producing ethical standards for auditors which audit firms are required to comply with. The APB published its standards in late 2004 (revised 2008) and they are one reason as to why the level of non-audit services provided by auditors to their listed audit clients has decreased significantly since 2001. The ratio of non-audit to audit services peaked in 2001 at a level around 3.1. By 2008, the ratio had fallen significantly to 0.7.

In May 2009, Treasury Select Committee recommended that:

> “We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.”

The APB consulted late 2009/early 2010 on whether audit firms should be prohibited from providing all non-audit services to their listed audit clients. ICAS specifically set up a Working Group, comprised of representatives from the investment community, industry, academia and the profession to respond to the consultation. The Working Group also sought the views of leading investors and directors of listed companies and issued its paper in January. Out of approximately 150 responses to the APB’s consultation, only three were in favour of a complete prohibition being introduced. Therefore, the overwhelming message was that there should not be a complete prohibition on audit firms providing non-audit services to their listed clients. Additionally, the vast majority of respondents supported the “threats and safeguards” approach adopted by the APB in its standards. The APB however has taken the opportunity to make proposals which could further tighten up the types of the non-audit service that the auditor can provide. This consultation does not close until 23 October.

11. **Should more competition be introduced into auditing? If so, how?**

ICAS supports the work undertaken by the FRC in raising the matter of limited choice in the audit market for listed companies, although we appreciate the limited impact that the proposals of the Market Participants Group have had to date. It is important that this is kept to the fore and the debates over the last year have certainly focused more attention on the issue. The ICAS view remains that the overriding priority in the short-term is to ensure that all of the big four firms remain in existence. In this respect we believe that reform of the current liability regime is urgently required. In 2007, the previous Government appeared to accept the argument for removing the “unlimited liability” regime for auditors. However, the optional contractual system put in place has had no impact on the market. There are no quick or easy measures, however, that can be put in place to bring forth another “very large auditor” and, of course, the issue is made more difficult as it goes beyond the UK.

Other than legislation to introduce a fairer liability regime as indicated in our response in August 2006 to the FRC’s initial consultation about choice in the UK audit market, we believe that this issue in general should be left to market forces. Market based measures are more likely to effect gradual and sustainable improvements than regulatory changes, which may have unintended consequences. We do not support regulatory intervention to artificially increase competition in the audit profession. As noted above the listed auditing market is not unique, there are a number of other industry sectors where the market is dominated by

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four or in some cases fewer major players. The possibility also exists that a new large accountancy firm might enter the market from one of the rapidly developing economies eg China or India.

We have long argued that developing and implementing proportionate liability should assist in increasing auditor choice and that this should not be at the expense of audit quality. Companies need access to quality audits at a reasonable cost but there is a high risk attached to auditing multinational companies, which is due to the auditor being exposed to potentially very high claims compared to the profits of the auditing unit concerned and this acts as a deterrent to new entrants to the multinational market.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

It should be realised from the outset that the roles of internal audit and that of the external auditors are entirely separate. The role of the external auditor as noted above is enshrined in legislation whereas there is no statutory requirement for any size of company to have an internal audit department although the majority of large listed companies do so. The role of the internal audit function is determined by those charged with governance of the organisation. Indeed the UK Code on Corporate Governance which listed companies are required to apply on a “comply or explain” basis implies that companies complying with the Code should have an internal audit committee in the accountability section of the Code.

C.3.5 The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

We believe this non-mandatory approach to internal audit to be appropriate. However, we also firmly believe that it is beneficial for listed companies to have an effective internal audit function. In order for the internal audit function to be effective it must have support at board level and not be seen as a mere compliance related function.

Interaction with External Auditor

The matters which the external auditor should consider in situations where a client has an internal audit function are set out in International Standard on Auditing (UK and Ireland) 610 “Using the Work of Internal Auditors”\(^{18}\)

“(a) To determine whether, and to what extent, to use specific work of the internal auditors; and

(b) If using the specific work of the internal auditors, to determine whether that work is adequate for the purposes of the audit.”

In determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, the external auditor shall evaluate:

(a) The objectivity of the internal audit function;

(b) The technical competence of the internal auditors;

(c) Whether the work of the internal auditors is likely to be carried out with due professional care; and

(d) Whether there is likely to be effective communication between the internal auditors and the external auditor.”

The standard basically adopts the principle that it is for the auditor to decide to what extent he wishes to rely on the work undertaken by the internal audit function which at least to some degree will be determined by the nature of the work performed during the period by the internal audit function and the auditor’s assessment of the quality of that work and independence of internal audit within the organisation. In our view this position is appropriate. We note that the International Auditing and Assurance Standards Board is currently revising this standard but we do not believe that the revision will alter the fundamental principle that it is for the auditor to decide to what extent he wishes to rely on the work of internal audit. We also support the function of internal audit as a mechanism for providing assurance within a company and as a basis for the directors to prepare their financial statements with confidence.

13. **Should the role of audit committees be enhanced?**

We believe that the role of the audit committee is already well established within the listed company sector. It is our belief that it is the composition of the audit committee and the diligence of its members which is key. We do, however believe that there is a greater need for transparency over the work of the Audit Committee. Current reporting requirements on the work of the Audit Committee can often result in “boilerplate” disclosures which add little to the stakeholder’s understanding of their role and their interaction with the external auditors. The Audit Committee plays a critical role in challenging management’s judgements and more disclosure in the Audit Committee Report could further the transparency of both the external audit process and the internal assurance processes within a company.

14. **Is the auditing profession well placed to promote improvement in corporate governance?**

Auditors can provide a mechanism for improving corporate governance. In isolation it is difficult to envisage how effective an audit firm could be in this respect without support from the other constituent parts i.e the directors and the shareholders. Auditors are ideally placed to make recommendations to those charged with governance in relation to weaknesses in the governance framework in place within an entity but ultimately such recommendations need to be acted on by the company.

24 September 2010

**APPENDIX 1**

GLOBAL REVENUES OF THE 6 LARGEST ACCOUNTANCY FIRMS
FOR YEARS ENDING 2009

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<th>KPMG (4)</th>
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<td>$9.95b</td>
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<td>$1.64b</td>
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**Sources**

(1) www.pwc.com
(2) www.deloitte.com
(3) www.ey.com
(4) www.kpmg.com
(5) www.bdo.com
(6) www.gti.org

**Examination of Witnesses**

Witnesses: Mr Charles Tilley, [Chartered Institute of Management Accountants, CIMA], Ms Helen Brand, [Association of Chartered Certified Accountants, ACCA], Mr Robert Hodgkinson, [Institute of Chartered Accountants in England and Wales, ICAEW], and Mr Iain McLaren, [Institute of Chartered Accountants of Scotland, ICAS].

**Q50 The Chairman:** Welcome to you all. I am Richard Best. I am taking the chair because Lord MacGregor cannot be with us today. The interests of the different Members are in the Register and people will declare any special interest in today’s proceedings. Two members of the Committee, Lord Currie and Baroness Kingsmill, are not taking part in this inquiry but the rest of us are. Let me get you in the right order. Ms Brand, Mr Tilley, Mr Hodgkinson and Mr McLaren, you are all extremely welcome. Thank you very much for joining us and thank you for the extensive written evidence that we have received from all of you. We would be grateful if you could speak in a loud clear voice for the transcript and for the webcast that will be made. When we come to the question time, please do not repeat what has already been said by one of your colleagues. We will take silence to mean you agree with what has already
been said, since we have got all four of you behind us, but if you disagree with anything that has been said please do join in. Would any of you or all of you or none of you like to make an opening statement, or can we go straight into the question time?

Mr Tilley: Thank you. If I could have a brief opportunity to make an opening statement, and thank you for that opportunity. I represent CIMA. Our members do not undertake audit activities themselves but are in senior positions in business and are therefore very interested in the effectiveness of audit. At the present time we believe that audit itself is fit for purpose in terms of the review of financial statements. Having said that, we believe that there is a missed opportunity in that audit is narrow in terms of its focus on the financial statements and there is obviously a great interest in knowing about the long-term financial sustainability of organisations. The annual report is an important mechanism in communicating the stewardship of the board in judging whether the company is being run in an effective, sustainable manner. Putting those statements together is very challenging to do well and we believe well managed businesses do that well. If they find putting those statements together difficult then potentially it is because they are not so well managed.

So we believe that reporting at the front end of the annual review is very important. There are various initiatives being undertaken to look at that but I think an opportunity is there for assurance of that report and therefore looking at the long-term sustainability of the organisations. Just one other point to make: this is obviously a global issue as well as a national issue, requiring, therefore, international agreement in many aspects and we should not underestimate that challenge. Thank you very much.

Ms Brand: Thank you. I think that as in the audit market, competition in the professional bodies is also healthy and it probably does drive up quality and standards in that respect. ACCA, as you are probably aware, is a global organisation. We now have over 50% of our membership and 85% of our student base outside the United Kingdom, so I think we do operate in different kinds of markets and we do deliver different things to the market. So I think there is value in the diversity that you see before you and I do think there is a possibility you will hear some different views as we go through this today.

Mr McLaren: I would take the point on efficiency but it has to be balanced with what we give the public interest and business, in terms of being diverse. There is no doubt that the reputation of all our professional bodies relies on the quality of the people that we manage to attract and I think it is accepted that a very good job has been done there. We get very high-quality graduates and non-graduates into the accounting professions. But it seems to me if we were to consolidate, one of the things that would be lost would be an element of competition. Certainly, in terms of audit training we compete vigorously, particularly with the English institute, and our customers tell us that they appreciate that. No one in this day and age likes to have a sole supplier. It is a very risky position for a business and I think there is quite a compelling argument to continue for that reason. I think the other thing that should be borne in mind—if there were great public interest drivers to achieve consolidation maybe they would take precedence—is that at the end of the day we are all member organisations with long histories. My own is 156 years. Given that they are membership organisations, what we hear from our members currently is that they would not welcome any consolidation. In fact, contrary to perhaps public perception, Scots CAs pay £100 a year more than their English counterparts for that privilege.

The Chairman: Thank you very much.

Lord Tugendhat: Do you think there is strong competition in the audit market for the audit of large entities? I am thinking not just of FTSE 100 but of the top echelon of FTSE 100, in particular the banks. Do you think there is strong competition? If so, can you tell me, please, how does it manifest itself?

Mr Hodgkinson: Maybe I could start off by saying of course there is concentration for the largest audits and that is recognised. I think that also therefore has an impact on choice but I think we need to distinguish the range of choice from the degree of competition. So far as the public are concerned I think the question around concentration is whether the audit market...
works in delivering quality and innovation and whether auditing regulation works in terms of public accountability. I won’t answer at too great a length but there is plenty of evidence that we can bring forward to say that the audit market delivering good outcomes happens but that is not grounds for being complacent. Certainly my body is very keen to see that we’ve been contributing to thinking about how you can enhance public confidence that, despite lack of choice, there is competition and it is delivering good outcomes.

Q53 Lord Tugendhat: I am not clear how it manifests itself. One can compete on price, one can compete on service, one can compete on the fact that one has a record that people do not get into trouble if they follow your advice. I have hired auditors in my time. I would be interested to know how you think they compete with each other. What are the selling points?

Mr Hodgkinson: I think rather than focus on the selling points, which are important, it is worth looking at this from the buyer’s perspective. Audit committees have over the past 10 years assumed a far greater role in making sure that the choice of auditors is being exercised in a competitive and challenging way. So there are audit committees and the guidance and reporting that they produce about what is happening in the audit. We also need to bear in mind that buyers of the service have a lot of evidence to hand on the results of public inspections. Only last month the Audit Inspection Unit published detailed reports on its examination of individual audits, and the results of examination of individual audits are communicated to the audit committees involved. So I think that the public can have a degree of confidence that auditors are challenged and there is always that threat of the tender.

Q54 Lord Tugendhat: Let me ask you one other question. We have only four big audit firms and we don’t have that many big banks either for that matter. You have a situation where one of the big banks puts its audit out to tender and an audit firm is anxious to secure that piece of business. Even in a big audit firm there is a limit to how many good auditors you have. Isn’t there a danger that in order to get the business of the newcomer, bank A, the existing client, bank B, finds that its audit team is a bit denuded? There is a limit to how many auditors you have. They are not all equally good. Can you really tell me, hand on heart, that a firm of auditors can offer an equally good service to three banks rather than if it had only one bank?

Mr Hodgkinson: That is a good question and it is not the sort of question that maybe I can best answer because it is precisely the sort of question that an audit committee chair would put to people proposing for their audit, and it is a valid question. There is always this trade-off that we have to deal with. Some of the entities at the top end of the FTSE that we are talking about are hugely complex, difficult organisations to audit and talent is limited. That is part of what has driven the concentration.

Q55 Lord Tugendhat: But if I may say so, and I have been on audit committees doing this, you are telling me what the audit committee might ask. You are a professional outfit. Can you not give me an opinion as to what the answer to my question might be rather than telling me I must go and ask audit committees?

Mr Hodgkinson: Well, both in the work that we do and the Audit Inspection Unit does the question would relate to the fundamental ethical obligation on professional accountants, including auditors, which is not to take on work that you are not equipped to take on. That is the starting point for professional responsibility. So it is the sort of question that is asked of auditors by—

Q56 Lord Tugendhat: I can see that you are reluctant to give a view on the question I have asked.

Mr Hodgkinson: The results of the public inspections indicate that that isn’t a problem. When you look at the reports of the Audit Inspection Unit I would struggle to recall one that questioned the industry expertise and competence of audit teams. There are other issues but I do not think that fundamental—

Q57 Lord Tugendhat: It is some years since I have been in a position on an audit committee, but certainly when I was that question did arise and I remember we took a view that the firm of auditors already was unable to provide a service of equal quality, but maybe things have changed since then.

Mr Hodgkinson: I would think you would therefore switch the auditor if that is the case. That is the market discipline.

Q58 Lord Smith of Clifton: You say under the professional ethics a company should not take on an audit if they were not competent. Would one of the Big Four say they cannot do it because they do not feel they have a range of expertise to handle this additional client? Has there ever been a case where they have said, “We’ll have to withdraw from this tender because we don’t feel we have a sufficient number of experts to handle this particular large client”?

Mr Hodgkinson: Well, I am sure there has been. I am not privy to the audit tendering process, but it would also be part of the assessment of the audit committee as to who to invite to tender. I am pretty convinced that expertise is not at the heart of the concerns that we need to address. I accept there are concerns about
consequences of concentration, non-audit services and audit expectation gaps but, if I might say so, it is an unusual challenge of expertise.

**Q59 The Chairman:** Can we have a view from Mr McLaren and then from Ms Brand?

*Mr McLaren:* I was in a Big Four as an audit partner for 27 years, until about three years ago, and I take your point, no, I do not think there ever has been a case to my knowledge where the firm has declined. There may have been a conflict in perceptions because you had another client who might take a dim view, but that is a separate issue on which you have to form a view. If we just go back to banks, banking is a global business. I certainly know within my old firm from people who had worked in Deutsche Bank that it was all conducted in English. The Germans speak good English and came across here; Dutch people move across; I think Deloitte have moved American partners. For these very large clients that you are talking about there is not an issue, because the big firms will look at them on a global basis and there is enough resource to deal with that. The other point I would make is I think you are all aware of the five-year rotation for these clients. So you do have an ongoing pool of partners who perhaps come off one of the very biggest banks, might be doing some other less important work and then that can be incorporated along with another bank if the opportunity came along. So I really do not think that in practice in my experience there is a fundamental problem.

*Ms Brand:* I was going to agree about competence not being the issue around this but I do think, as was suggested, there is a risk associated with the small number of firms available to conduct the audit and that risk of failure of one of those firms does create an issue. ACCA would certainly be supporting moves to broaden that choice—genuine choice, so they can compete properly for those audits—to mitigate that risk of failure.

**Q60 Lord Maclean of Rogart:** Analogous to the medical profession, would there be any advantage in centrally undertaking a proportion of the annual audit work that relates to systemic risk so that the results of the work could be made available to audit firms to factor it in to their individual audits, such as, for example, a consideration of banking clients as going concerns?

*Mr Tilley:* I think that process has taken place in the past. The Financial Reporting Council addressed precisely the issue of a going concern about this time last year and I think it was very helpful to audit committees on one side and the audit firms on the other in terms of addressing the issues that arose. I think identifying systemic risk more widely and what could possibly be done would be extremely challenging.

**Q61 Lord Maclean of Rogart:** My understanding, Mr Tilley, is that the Financial Reporting Council engaged in that after the event.

*Mr Tilley:* It was after the start of the financial crisis but it was extremely helpful in terms of addressing the year-ends that were coming up. It was either last year or the year before. Iain, I don’t know if you can remember.

*Mr McLaren:* The year before.

*Ms Brand:* The year before.

*Mr Hodgkinson:* Could I just talk about something as well that has been and is in progress to help with the issue that you identify? We produced a report on *Audit of banks: lessons from the crisis*, which was looking at things that could actually be done, and on 22 November there will be, as we recommended in that report, a coming together of investors in financial services, financial institutions and their auditors to talk about concerns affecting the industry as a whole for the coming reporting season. It was a suggestion that we made in that report that we are acting on that there should be wider sharing. Whether it directly fits the medical analogy I do not know, but we are trying to make sure that concerns can be voiced and shared ahead of the reporting season.

**Q62 Lord Lawson of Blaby:** I would like to come in on the question of the banks, because that is what concerns me very greatly indeed. It is quite clear, and I think it is generally accepted, that the banking supervision in this country—not exclusively in this country, but let’s focus on this country—failed badly. This was a combination of a flawed system and unsatisfactory performance by the supervisors. What concerns me in the context of our inquiry is that I know of no case where auditors caught catches which the supervisors dropped. I know of no case where bank auditors assisted the supervisors in catching the ball. Therefore it is in that context I would like to ask you what you think should be done. I shall make it a bit more specific. You will have read the document by the Financial Services Faculty where among their specific recommendations, if I may read them out, they said that auditors should “be proactive in setting up regular meetings with supervisors”. They should “be open in dialogue with supervisors; and raise concerns at a higher level within the regulator if they consider that the level of engagement from supervisors is inadequate”. Do you agree with that? What should be done about it? Do you feel inhibited? When I framed the 1987 Banking Act, which is concerned largely with this area, I had considerable resistance from the accountancy profession, who said
Mr Holden: Can I respond in the first instance? There were a lot of points, so forgive me if I do not pick them all up. The Financial Services Faculty report I must agree with since it is ICAEW’s Financial Services Faculty that raised that point and we have already started to take pragmatic proposals to carry forward that suggestion and establish the protocols for re-establishing better dialogue. I think there will be three meetings before Christmas of a group that we helped to convene, with the Bank of England, the FSA and the major audit firms, to look at how that dialogue works better. Maybe if I just go back to the point that you made about auditors catching things. It is one of the difficulties of the audit profession and the public trust in it that when auditors catch things or influence outcomes it is quite invisible. That is just because of the nature of the reporting that auditors do. I think some of the research from Professors Beattie and Fearnley, who I know you have spoken to, helps to show that a lot happens behind closed doors and that the audit process does change outcomes but it does it in a way that is not readily apparent. That leads to proposals for a longer, more informative form of audit reporting, which always hit problems because there are difficulties about having the auditors talking about what has happened behind closed doors. Our proposal in that Financial Services Faculty report, to try and bring some sunlight into this and break this logjam of audit reporting, is to say that audit committees do have the opportunity to report in a more freeform way that auditors do not have under auditing standards and that they should take the opportunity through the audit committee report to talk about the value that has been derived from the audit process and how they have looked at particular areas of significant judgement, and benefited from the audit process. I am trying to set up some practical ways of addressing that the real deep-seated problems are recognised.¹

Lord Lawson of Blaby: I don’t believe it did happen. So if you’re saying it should happen in the future, I am very glad.

Q65 Lord Maclean of Rogart: This is somewhat similar ground, because I just wanted to clarify Mr Tilley’s answer to my earlier question. What he reported as having happened with the Financial Reporting Council was, as I said, after the event. Is there any professional consensus among the regulators as to the appropriateness of advising auditors, and particularly perhaps the smaller audit companies that are not able to do the systemic research themselves, of the existence of factors that ought to be taken into consideration when they are conducting their individual audits?

Mr Tilley: The role of the auditor as currently defined today is to report on the financial statements in accordance with accounting standards and regulations. That is their role. The issues of systemic risk, I believe, fall to the regulators around the world and, as well, the boards of the companies. I believe those are where the responsibilities sit.

Q66 Lord Hollick: Mr Hodgkinson, sticking with the financial crisis and the banks, in your submission you say, “We have seen no hard evidence to support claims that auditors were not exercising a high degree of professional scepticism”. Is there any evidence to suggest that they were exercising any professional scepticism? It seems to me on the question of liabilities and funding of liabilities and the terms under which mortgages were being written in the years 2005 to 2007, there was ample ground for expressing scepticism. But where is the evidence that there was scepticism coming from the audit partners?

Mr Hodgkinson: I think it is worth acknowledging that professional scepticism is central to what auditors do—so central that it runs through the auditing standards; it is a golden thread through auditing standards. So you will find, if you look at the reports produced last month for the major firms that indeed there are some references on individual audits. Yes, there could have been more scepticism, but the suggestion that there is a pervasive issue, and it is not one in which there are points to pick up on in

¹ Question 63 unallocated.
individual cases, I think is misconceived. I suppose that is why as a body, as a profession, we are ourselves a little bit sceptical about the broad-brush allegation that there has not been scepticism, because it is at the heart of what an audit is. The audits of the major firms and public interest entities are being looked at in great detail and there are, on public record, the reports of the results of those inspections. In the overwhelming majority of those reports, there is evidence that scepticism is being applied. We also need to bear in mind that scepticism is not something where the more of it you have the better. Professional scepticism is about striking a balance, because if people were to show unrestrained scepticism we would still be waiting for the first audit to be finished. It is about knowing when to question further and when to say, “We move on” because otherwise you get something that is unproductive. Striking that balance is an important activity and it is right at the heart of audit, so there is no problem here in focusing attention on it and saying, “We need to examine it”.

**Mr Charles Tilley**: Can I ask a very brief question? If a situation arises in which the auditors are sceptical about a point, the sort of point that Lord Hollick raised, and they are worried and they press the audit committee and the management on that point, do you think it would be helpful if the audit report stated that we were concerned about this particular issue but we were convinced by management that it was okay? I am not suggesting a question and answer but that the auditors would register that they had expressed a doubt on something and that they had been convinced by management.

**Ms Brand**: One interesting suggestion that has come up in the work we have been doing globally, and this was in an audit forum we held in Singapore, was that maybe the publishing of the management letter might be a useful form of exposure for those kinds of issues, because in that letter you would have the response of management. Of course, that would have to mean that you do not then start holding back in the management letter, but that might be one mechanism to achieve that.

**Ms Brand**: Of course, my members do both auditing and are accounts in business. Yes, we do see there is a wider role. At the moment, the auditor does have to look at the entire report and say whether it is consistent with the financial statements, so there is that review already and if there are inconsistencies it may be necessary to restate the financial statements. If they were to audit fully a 600-page annual report then the second audit would still not be finished. It would have to be focusing on the particular issues I raised or a selection of issues that were particularly pertinent to the future sustainability of that business.

**Ms Brand**: I think some form of assurance might be the way forward. Whether that is the full audit is a different question.

**Mr Tilley**: I think this is a hugely important point. At the moment, we are getting to a point where we have annual accounts with 500, 600 pages and one question who reads all of the pages that are there. We need to think about whether we can change the reporting model. For instance, do we have at the front of the report, set out very clearly, what the business model is, how it works in the environment that the business is operating in—it’s marketplace, its competitors and so forth—and then how that business model is sustainable going forward into the future? The financial statements are hugely
important and the foundation, if you like, of any business but reporting on the sustainability of the business model is crucial. How can auditors do that? I think that is a very challenging issue. Helen has already raised the issue of liability, for instance, but I think it is more about assurance over the processes of putting together the report that talks about the business model and what its ongoing sustainability is. One needs to be thinking about the future of the annual report and how the front end is structured, and ensuring that that report is balanced so that the views expressed in it cover both the positive and the negative issues. That is the real challenge. The assurance over the processes that go forward, with management and the board putting forward to their shareholders and other stakeholders how they have run the business, is a key area that should be looked at.

Mr McLaren: My own institute has a project under way just now on the future of assurance, drawing people in from academia and the profession and a large component from industry. There is a consensus emerging that, as Charles was saying, we need something to look at the front end, the prospective statements, including not just viability and going forward, but other statements that really are of interest to what investors and the community at large are looking for. The past is the past. Yes, you want to know its right, tick, and that’s the statutory bit, but the bit about the future is of real interest when public companies are making announcements to the market. The thinking that has been touched on already—and this is not finished, but when it is we will be happy to pass a copy of our work to the Committee—is that the split should also have a slightly different form of report, so it would be assurance but not “true and fair”, in other words correct. It would be something like perhaps “balanced and reasonable”, because I think you have to be careful. The auditor is one removed. To pick up something that was said earlier about exposing management letters and the discussion about whether you should extend the audit report, in my view you want to keep the nuclear option. I also think there are some issues about what you can say in private to an audit committee in a company that, if you try and expose it to the public, will get inevitably watered down because of litigation. Coming back to the fundamental point, we believe there is an interest in some form of assurance over that front end but that perhaps it cannot be done to the same standard as the historic numbers can be audited.

Mr Hodgkinson: I appreciate a lot of the comments that have been made and I agree with a lot of them. However, I think it is quite important that we do not just agree in principle and then say, “And it is a huge task”. I think it is important to start making some progress here and getting some runs on the board. In the report that Lord Lawson referred to, we said that this is something that people can start experimenting on. We do not have to say that the whole 400 pages is going to be subject to an audit opinion, but we could start to see some innovation and market experimentation with audit committees on behalf of the board saying, “It would enhance the credibility of our annual report if we said we have asked the auditors to look at this particularly important table, these particularly important numerical disclosures or a high-level risk statement. Here’s something specific that we’ve worked on”. It would allow some differentiation and experimentation on which you could build to incorporate it into law. The huge risk in just saying, “Let’s make a legislative or regulatory change with no real experience” is you get the sort of problem that we saw in the United States after the Sarbanes-Oxley Act, where there was an extension of the audit that looked quite innocuous, it took a few words of legislation to say that auditors should report on the effectiveness of internal control over financial reporting. It has taken eight years to finally get a kind of truce on which companies would be subject to that requirement, what the criteria would be for reporting and how auditors would do the work, and it cost American business a lot on the way. So I think we need to look, as we do in our report, at ways of getting real experimentation and innovation based upon what people think would be of value rather than grand sweeping regulatory gestures.

Q70 Lord Hollick: Within the auditing profession’s monopoly rights to practise, is it acceptable for audit firms to decline to audit high-risk clients?

Mr McLaren: If I can start off, I am not aware of anyone not having an audit, at the end of the day. Given the market-based system that we have just now, any market participant must be entitled to exercise the right, for whatever reasons, to decline to go forward. As was discussed earlier, they may feel they do not have the competence or that there are inherent conflicts. In my experience, I do not know that anyone has ended up without an auditor.

Q71 Lord Smith of Clifton: This is the low bowling question: isn’t it time that the auditors simply agreed to stop doing non-audit work for their audit clients, rather than hiding behind ever more complex and refined rules to allow them to assert that there is no problem? This is the argument that there are Chinese walls. You bowl over the tender, then you say to them, “Ha ha, but then you need our consultancy services to get you up to scratch”. What do you have to say about that?
Mr Hodgkinson: I think the short answer would be, “No, it isn’t time to do that” but let me give a little bit of colour to that. We fully recognise that the fact that auditors provide non-audit services to audit clients raises a question and there is a clear need for the public to be reassured that auditors are being objective and they are standing up to the companies that they audit. That is the point of substance, that we want to know they are being objective and stand up to the companies they audit when they need to. This is something that has absorbed a huge amount of time, rightly, over the past 10 years, latterly with the Auditing Practices Board at the instigation of the House of Commons Treasury Select Committee suggesting the sort of outright ban that you have alluded to. After quite an exhaustive process of public consultation, there is no substantial body of opinion that wants that outright ban. There are benefits in a market system of companies being able to engage their auditors, who are trusted and seen as having a degree of objectivity, to do non-audit services, subject to the sort of controls and safeguards that are needed to reassure the public and selective bans on things that are not appropriate. So this is an area of acute concern that the outright ban solution is not appropriate. I think we need to keep the approach under review. We need better disclosure, because one thing which I think is now agreed out of the recent APB, Auditing Practices Board, discussion is that some non-audit services are very related to the audit and if we want to look at how the audit will develop in a marketplace, it would be through auditors providing some audit-related services which make the audit more valuable. So in the public disclosure, enabling people to see audit-related disclosure as different from perhaps more contentious non-audit services, will also be helpful.

Mr Brand: To add to that, I do think in the current economic environment where we are looking for business-led recovery, the very valuable advice, particularly at the smaller end of the market, that auditors give to their clients is particularly important. From all of our research, the most trusted advisor to small businesses is the accountant and I think to risk removing that advice from them would be dangerous in the current environment. So I think that does have to be borne in mind.

Mr McLaren: There were 150 responses to the Auditing Practices Board’s consultation paper on non-audit services at the beginning of the year. Only three people—an academic, a politician with well known views on this matter and one other—supported an outright ban. So the market response is certainly not there. Of course, at the end of the day, in my view, the audit committee needs to step up to this plate. The auditors cannot force those other services on them. Okay, it is easy for management, but we have talked already about having audit committee reports individually signed as the auditor now signs, and having to articulate why they have gone to the auditor for services. Some are very self-evident: capital transactions, where you require a long form or a comfort letter and working capital letter. It is much more efficient to have that done by your auditor, but it needs to be challenged and the audit committee is the place to do that and to articulate to investors why they are comfortable and investors can make up their minds.

Mr Tilley: Just building on the point that has just been made, my experience would be that audit committees focus very clearly on the issues where the auditors are providing services which are beyond the audit and are very careful to guard against the importance of the independence of the auditor going forward. So I think it is an area which further work can be done on, but the audit committee is very cognisant of it.

Q72 Lord Lawson of Blaby: If I may come in on this, and broaden it slightly to relate to not merely auditing and advisory services, but also external audit and internal audit, I think the same issue arises. One of you, if not more than one, at some point stated how international you are now, but if I am not wrong, in the United States it is not permissible to be the auditor for a company and provide the consultancy advice for the same company. I think it is also not permitted now to do the external audit and the internal audit, because they see, quite rightly, that there is a conflict of interest. If I may express the conflict of interest in a way that picks up on what you said, you said that the golden thread running through auditing was scepticism. But that is not at the heart of these other services, so there is a real fear that the proper scepticism of the external audit will be watered down because of the internal. Even if you tell me that never happens—and I rather doubt whether I would entirely believe you, bearing in mind the size of the fees involved—would it not reassure the public if there were this separation?

Obviously there is plenty of capacity. The Big Four are not going to wilt away if they are prevented from doing internal audit or advisory consultancy work for the same company they are doing the external audit for. They will be able to survive that and they will continue to be great companies. Helen Brand was saying that these services are useful for companies. They are, but they don’t have to be done by the same company. I think that they should be done, but not by the same company. I am puzzled by the way that you, at one and the same time, seem to say that it is perfectly all right, perfectly kosher because of these Chinese walls, there is absolutely no contact between the two, and then you say the great advantage of the
same firm doing it is the contacts and the synergy. I do not think you can have it both ways.  

Mr Hodgkinson: Just to pick up on a number of the points that you made there, I think that the stark contrast between the United States and the rest of the world, which I also read in last week’s *Economist*, is a simplified view, because there is no simple permission in ethical standards here that external auditors can do internal audit work. The key principles involved make it pretty clear that a certain characterisation of internal audit cannot be done. Where there is a management role, where there are decisions about what controls should be adopted, about where priorities are in internal control, that is completely out of bounds. However, it is recognised that some companies, and some audit committees, might benefit from the auditors doing some work to check on things in a way which is complementary to their audit work, which would help the work of the audit committee. That is particularly important for smaller listed companies who might have challenges in recruiting a full internal audit function with the right skills. But it is absolutely clear that that cannot involve having the external auditor as head of the internal audit function. It needs to be owned within the company.

When we talk about the kind of safeguards on non-audit services, it is not primarily about Chinese walls. That might be one of the safeguards, but there is no presumption that every non-audit service must have a Chinese wall, making sure there is no interaction. You need to make sure that the risks that could be involved in having interaction do not threaten the objectivity or the appearance of objectivity of the audit work.

So the approach is a little more subtle and it does place a huge reliance on professional responsibility. In fact, it was my institute that came up with this idea of threats and safeguards to auditor independence. We have striven to make people think about these issues: do not just have simple blanket prohibitions or permissions which say, “You cannot do internal audit” and then we get an esoteric debate about what is internal audit. People should be thinking about the issues involved and the real threats to the objectivity of the audit.

Q73 Lord Lawson of Blaby: The Americans did change their legislation following the Arthur Andersen, Enron, experience, didn’t they?  

Mr Hodgkinson: Yes, they tightened it up, but theirs is a far more rules-based approach, rather than one which encourages people to think through the issues and not just say, “Have we ticked a box which says that we are doing a service which is permitted?” Under the international framework which we follow, you can tick a box, but you are not through when you have done that. You still have to ask the question whether you are facing a risk, a threat to your objectivity or how that is perceived. We go beyond that tick in the box approach.

The Chairman: Before Ms Brand comes in, Lord Tugendhat.

Q74 Lord Tugendhat: In the written evidence which was given to us before we started, one of the Big Four, I think it was Deloitte—there may even have been two—said that auditing FTSE 100 companies was one of their less profitable lines of business and almost gave the impression that they were doing it as a public service. If this is a less profitable line of business for them, it suggests to me that perhaps the non-audit services are a more profitable line of business for them, and that there is a danger therefore in their principal function being perhaps relatively underpriced and their subsidiary function being the one where the money is. I think that comes back to the conflict of interest point that Lord Lawson made.

The Chairman: Let’s just hear from Ms Brand.

Ms Brand: It was on the previous point. I just want to say that one of the issues that we think audit committees should be looking at in relation to the internal audit / external audit, the profession has to hold its hands up: the perception of that is not great, and I think that audit committees ought to be asking, “What will the perception of the shareholders be of this?” So it is not only the ethical standards and so on, but the perception this is creating.

Mr McLaren: In relation to your point about profitability of audit, I think that is common currency and understood. I think you perhaps have the proportions wrong on the percentage of activity that is audit work relative to the non-audit, consultancy, tax and other business. Audit will be 30%, 40% maximum, so it is the minority activity. I think what it gives the firms is a licence to operate from that base, which is perceived around the world to be high standard, for all the reasons that are troubling us in other ways—why is there not enough change, and so on. The fundamental market response is that people are happy with what they are getting. There is enough competition, they have the global reach and they do a good job. So you have them leveraging off that into other areas where they can make a better margin, and that is the business reality.

Mr Hodgkinson: Could I just make one other point there? The disclosure of margins by area of business is something that came out of the Financial Reporting Council’s study on the Market Participants Group into competition and choice, and was meant to be a disclosure that would provoke the sort of challenge and inquiry that you have embarked upon. It is good to have that into the public domain. I do not think that the differences in margins are that stark as to
raise fundamental issues, but the fact that that information is being disclosed on the basis of guidance that ICAEW prepared is a helpful contribution to the debate.

**Q75 Lord Hollick:** I have long been concerned about the situation around tax advice and their auditing tax. I think it is still the case that many companies use their accountants to come up with very sophisticated, shall we say, tax schemes, and then the audit side audit them, so the risk to the firm is substantially high. One of you talked earlier about this. Isn’t that a no-go area where they should not be on both sides of the street; they should not be marking their own exam paper, if you like? Isn’t that one such area?

**Mr Hodgkinson:** The area of tax, you are quite right to highlight, is an area of concern. The way it is phrased in the ethical standards is that it is not a no-go area, and there are some real, practical issues here, particularly at the smaller end of the market. For most businesses, that use of their accountants to help with tax work is quite important. But the way that the issue is framed, I agree that many people—if they are on audit committees or even if they were management—would have a concern. You need to make sure that auditors are not auditing their own work, that self-review threat is recognised and there is a potential conflict. That is recognised, and I think that the market has moved on, so that businesses and their audit committees would be far more likely now, particularly at the top end, to separate the provision of those services.

**Q76 Lord Lawson of Blaby:** If I can pick up on something that Mr Hodgkinson said, which is slightly relevant; I am not persuaded that it wouldn’t be both in the public interest and in the interests of the corporate sector—and possibly even in the interests of diversity, as it were, within the accountancy profession—if there were a necessary separation between the company that did the auditing and the company that did the consulting, the tax advice or whatever it happens to be. But in your defence of the status quo, you explained that auditing—I was not quite sure of the connection, but it is an important point all the same—was not just a matter of box ticking, and that in the United States they did need to make this separation because in the United States auditing is much more a matter of box ticking. The evidence that we were given last week was that in fact auditing in this country has become very much a matter of box ticking. I do not know whether you read the evidence that was given to us, but that was clearly what came out of these very expert academics in the subject.

**Mr McLaren:** Could I kick off on that? I am obviously three or three and a half years out of date, and maybe it has changed, but I doubt it, fundamentally. I did understand the point that the academics were making and, in part, the balance of our audit inspection, which I think is a good thing, inevitably focuses—as has been discussed here earlier—on what you can see out of an audit, and you can’t see the inherent quality, unfortunately. You can see a file that is full of points. So I think there is a real issue about that sort of review driving box ticking. The big firms will now be more and more putting checklists together so that when you are AIU inspected, you will have the perfect file, so you do not get adverse comment. I understand that there can be a rather large jump to say that auditors have thrown their scepticism and their professional training out of the window. I think that is a jump too far. Personally—we talked about it earlier—this scepticism project I think is a good one. There was one thing that I saw as an elapsed auditor; one of the statements was that there has been far too much focus on corroboration rather than challenge. That struck a chord with me because I realised that post the AIU requirements for absolute documentation there probably had been a drift that way. I am not suggesting for a moment that all scepticism on key issues has gone out of the window, but the fact that has been raised and will perhaps be embedded in the training in a formal way—it was a sort of by-product before throughout the training—I think will be healthy. If there is an expectation here, and if there is any issue in reality, I think it will help address that.

**Mr Hodgkinson:** I recognise the concern about box ticking, but I am not sure this is an either/or question. Box ticking is a pejorative term. I think the challenge is to make sure that, having done what you have to do to show you have complied with standards that have been set to build the accountability of the auditing profession, you do not say, “Well, that’s the end of it”. You still have to have that professional judgement that says, “Are there things that there might be no box to tick, but I think I should do them?” Overall, does the answer, even with a sheet full of ticks, mean I’m still unhappy?” So I do not think it is an either/or, and there is certainly no going back to a world in which professionals might just say, “I know I’ve done a good job and I’m not accountable for saying how I’ve done it”. I think it is both. You have to have the demonstrable compliance with standards because that is the way things have gone, but you also have to make sure that is not at the expense of standing back and saying, “Do we overall have the right opinion? Are there more things we should be doing?”

**Q77 The Chairman:** It has been suggested to us that a different way of reducing the audit market concentration, which is the concern of our inquiry,
would be to follow the French example and make it compulsory for the audits of the large firms to be joint audits, bringing on another bunch of auditors. How does that play out in your professional bodies? Do you like the sound of that?

Mr McLaren: I have been involved only once in a joint audit. They were reasonably popular in the 1970s and prior to that, and in part, I think the French started doing this in the 1960s. You did not have the global reach, but businesses started going global and getting bigger. You have to remember the Big Four only came into existence from 1987 through to 1998; there was a Big Eight or Big Ten prior to that. So I think that joint audits arose out of that. I was involved in one, as I say, many years ago. It was not a very satisfactory arrangement for either party because, as I have explained earlier, there is a dynamic nature to audit, which is the actual tone of the questions and so on. The file of the conclusions cannot give any truth about that. So you only have part of that sight of the audit that you have to jointly sign up, so you are relying wholly on the quality of the other firm, and inevitably there is going to be, at the very best, inefficiency while you assure yourself that that is up to your standards.

Turning to the modern day, I think Denmark had this, as the French did, and abandoned it in 2001 because they found that it was just causing additional costs for no business benefit whatsoever. I think the final point I would say, as there has been inevitably a focus on the financial crisis and the audits of banks, the reality is you could get no one to take joint accountability for a bank audit other than the Big Four at this point in time. There are not the basic skills. You could share a bit of the audit with someone, but you could not have joint opinions, which is what the French system has. From personal experience and other observations, I would not think that this is a runner to address the problem of concentration.

The Chairman: Any other comments?

Mr Tilley: I am also an ex-Big Four partner, and my one experience of a joint audit was similar, but I would emphasise the accountability—or loss of accountability and, in particular, the risk of things falling through the cracks. I think it can become a bureaucratic nightmare, and very importantly there is the issue of moral hazard, which is that the company can play one auditor off against the other.

Mr Hodgkinson: Could I just add a couple of reflections? You are right to refer to French practice, and I do not think we should out of hand suggest that the French might not have good ideas which work in their environment, but as Iain said, that practice is quite long-established. I think it is the sort of thing that people should actively consider. Let’s just be clear, what we have at the moment is a permission to do joint audits. An audit committee could appoint all the Big Four, if you wanted to, to be joint auditors. There is no market prohibition on this, and if people saw an advantage in doing it, they could experiment with it. I think the issue is that if nobody is doing it and they have the choice, then you would need to be pretty certain before mandating that they should make the choice. It might be for the reasons of cost and potential ambiguity that colleagues have referred to that people do not do it. But companies can experiment with this if they want to, and who is to say that there might not be ways of it working, but to mandate it as a way of improving quality or addressing the concentration issue is something that you need caution on before going that way.

The Chairman: A blind alley. Ms Brand.

Ms Brand: I don’t have any additional points.

The Chairman: No points. Lord Tugendhat, would you like to take the next one?

Q78 Lord Tugendhat: The question I wanted to ask concerns regulatory capture. Again, we keep coming back to the fact that there are the four big auditors, but as there are just the four big auditors, to what extent do you think they dominate the governance of professional bodies? Their opinion must weigh very heavily. Do they generally speaking follow the same line and take the same view or not?

The Chairman: We have three ex-partners from those firms.

Mr McLaren: Indeed. Well, speaking from an institute point of view, do they influence the profession? Our governance is surprisingly underweight. We have a council of 32 in Scotland, and including myself and one other retired, there are only two other active Big Four partners out of 32, and three of those are public interest members. So in a sense, they are under-represented there. Looking at presidents, I looked back the last 15 years. There have only been five that have come from Big Four backgrounds. So, certainly on the governance side there is not an issue.

You talk about regulatory capture and we talked about the AIU. When I was in the Big Four I was subject to the AIU inspection on one of my FTSE 350 clients, and I can assure you it is a very rigorous process. But, yes, there are issues. You will see on the latest overall report that there are what they call serious failures or significant deficiencies. I cannot remember the term, but they are a major category. They do a report on smaller firms, and smaller firms markedly get a poorer score there. Now, that is inevitably reinforcing the view that big is better and so on. Yet there is a body of thought that the Big Four have all the resources to defend themselves, take a lot of time, a lot of resource, which perhaps the smaller firms do not do. The other point is that the focus of
that report is on failings. I know and we know as an institute and I am sure the other institutes know that the good firms do not get put up in lights. In the small firms, half of them are probably doing an excellent job, as good as any of the Big Four, but it does not come out. So, I think there are issues in terms of regulatory capture which happen, if you like, as by-products. They are not intended, but they are by-products of some of the regulatory environment in which we are in.

**Mr Hodgkinson:** May I just make a couple of additional points? I would echo the points about representation in our governance structure. When you look at current Big Four partners or recently retired, that’s one of our three office holders from that background, but only three out of 16 board members and only 11 out of our council of 101. The constituencies are very broad in which our members are represented. As a very tangible proof that we can do things which on the face of it you might not think the firms would welcome, I was project director on a recently completed project to draft an audit firm governance code, which will apply to the eight largest firms with effect from 1st June this year. That is something which we were entrusted with by the Financial Reporting Council, which is overseen by a regulatory board that has a majority of non-accountants on it and is chaired by a non-accountant. So there is no capture on probably the most critical part of the organisation in relation to the issues we are discussing today.

**Mr McLaren:** I would add to that in our discipline the majority are independents. I took the trouble to find out how many Big Four members we had out of our 18,000, and it is 15%, one in six. So, the point is, it is in proportion for a membership body.

**The Chairman:** Well, Lord Maclellan, would you like to ask the final question?

**Q79 Lord Smith of Clifton:** The absence of the Big Four shows how relatively unimportant the professional institutes are because they go off and make their money and they do not give back to the profession. The wealth of their experience should be put back into the experience. It is no good just having the little minnows getting their CVs, working up the professional organisations, when you have an absentee landlord. It is not regulatory capture; they should be there in rather greater numbers.

**Mr Hodgkinson:** Well, if I gave that impression that would be wrong. The firms are very important in the underlying technical work that we do and their contribution is very important. I was saying in the governance structures there is a fair reflection of our underlying membership, which is predominantly not in practice, predominantly not in the Big Four and predominantly not auditors within the Big Four. It is something which we monitor very zealously to make sure that our structures are reflecting the underlying membership, and that is an appropriate balance. There is certainly no feeling that the major firms absent themselves from the professional bodies.

**Ms Brand:** I am sorry, just one aspect further on the governance point in terms of regulation and discipline within our organisation. That is overseen by a regulatory board that has a majority of non-accountants on it and is chaired by a non-accountant. So there is no capture on probably the most critical part of the organisation in relation to the issues we are discussing today.

**Mr McLaren:** I would add to that in our discipline the majority are independents. I took the trouble to find out how many Big Four members we had out of our 18,000, and it is 15%, one in six. So, the point is, it is in proportion for a membership body.

**The Chairman:** Well, Lord Maclellan, would you like to ask the final question?

**Q80 Lord Maclellan of Rogart:** If there is one measure you would propose to assist in widening choice in the audit market, what would it be?

**The Chairman:** Can we ask you to have a go at that tsunami?

**Lord Maclellan of Rogart:** Then I have a supplementary.

**Ms Brand:** It would be to remove restrictive covenants. I think that the situation where banks or organisations themselves are stipulating upfront that they will only employ a Big Four firm probably is a restriction of fair trade and it is something that I think the OFT is looking into. We would support that further investigation.

**Mr Tilley:** I think it is a very challenging question, but I believe that the missed opportunity that I referred to earlier in terms of assurance over narrative report in the front end of the accounts could potentially offer the opportunity for smaller firms to be involved.

**Mr Hodgkinson:** Oblige regulators to consider how regulation affects availability of choice. Make it a criterion for regulatory action because it is clearly of public interest.
Q81 Lord MacLennan of Rogart: May I just ask whether any of these three issues have been considered by the CCAB and, if so, where did the balance of opinion lie with respect to them? I recognise that it is a consultative not a legislative body, but it would be interesting if you could give us any evidence from that source.

The Chairman: Can any of you speak on behalf of the CCAB?

Mr Tilley: I was at the CCAB only yesterday. I think the issues we have just referred to have not been specifically addressed by the CCAB, but I think it would be fair to say that all of the bodies represented here are talking about these issues in common. It is something that we might take away and consider. Thank you.

Mr McLaren: Can I finish off just by saying I think liability is an issue that needs to be looked at. There are obviously the changes in the 2006 Act which have not stuck for reasons that are I think well rehearsed. I think proportionate liability may encourage some mid-tier firms to perhaps have a go. I agree with Helen on restrictive covenants, but I think we have to be realistic here that if you have done a leveraged buyout and you have put many millions behind a business, you are going to change a restrictive covenant into an auditor suitable and the default position currently will be, “Go to a Big Four and you’ll get our immediate tick; go to someone else and you’re going to have to convince me.” So, I think we have to be realistic.

The final thing I would say, because I sit on a number of audit committees and I am chair of a FTSE 100 audit committee, I really do think there is more mileage in putting audit committee chairs, as I said, under the spotlight to account to the shareholders why there has not been an audit tender. We now have the default position, of course, of nine years for directors or then you are not independent. Perhaps we could have 10 or 12 years and, if not, you would have to explain. That would mirror what is happening in other governance areas. I think more can be done through the audit committee to perhaps have some effect on this. I think we have to realise that changing this concentration issue may not be possible because of the gap, and if it is to be achieved, it is probably going to be quite a long haul.

Mr Hodgkinson: Final word, picking up on Lord MacLennan’s challenge there. The forum in which these issues are addressed is the Financial Reporting Council with its regular reporting on the Market Participants Group report rather than being in the CCAB. All the issues that have been addressed, including the one about restrictive covenants, were addressed by the Market Participants Group three years ago and they are subject to continuing review. There is on that question of governance the question as to whether the recommendation they did make, which was that there should be disclosure, has been followed and whether more disclosure is needed or whether there needs to be some more direct action. The forum in which these issues are addressed exists, but I do not think that the simple overriding criterion referred to of making choice an issue for regulators in their determinations is something that they have considered, but they might want to.

Q82 Lord Lawson of Blaby: I do not want to detain the Committee, but I did not fully understand the proposal that Mr Hodgkinson made when we went along. I do not want him to elaborate it now, but do you think it would be possible to ask him if he might let us have a brief note spelling out precisely what he is proposing and how it would work out in practice?

The Chairman: That would be very helpful if you could do that for us.

Mr Hodgkinson: Thank you.

The Chairman: Thank you all very much indeed. We heard about dropping catches, runs on the board, low bowling, and it is time I think to draw stumps. Thank you all very much indeed for joining us. We much appreciate it.

Lord Smith of Clifton: On behalf of Baroness Kingsmill, who has had to exempt herself from the Select Committee, one of the things we were looking at was the question of gender balance in the workforce. The financial sector is represented here overwhelmingly by one and it is a delight to have Ms Brand here representing 51% of the population.

The Chairman: And we are not doing so well here. Thank you all very much for joining us. It has been very helpful.
Supplementary letter from Mr Robert Hodgkinson,
Institute of Chartered Accountants in England and Wales (ADT 8)

I write in response to the request made by Lord Lawson at the Committee’s session on 19 October 2010. At
the end of the session, Lord Maclennan asked “If there were one measure you would propose that would most
assist in widening choice in the audit market, what would it be?” I replied “Oblige regulators to consider how
regulation affects availability of choice. Make it a criterion for regulatory action because it is clearly of public
interest.”

Lord Lawson requested a brief note on what I was proposing and how it would work out in practice. I
summarise these matters below and also take this opportunity to set out the various actions that ICAEW is
taking to follow-up on our Financial Services Faculty’s report “Audit of banks: lessons from the crisis”, which
Lord Lawson referred to earlier in the session.

THE PROPOSAL AND ITS PRACTICAL APPLICATION

All regulators involved in the audit market should be required to consider the consequences of their actions
on the public interest objective of increasing choice in the audit market.

My proposal is that audit regulators should include the issue of choice in their regulatory principles. Where
relevant, they would consider choice in each aspect of their work such as framing new or revised regulations
and standards, or reporting on monitoring and enforcement activities.

In so far as practical application is concerned, I suggest that at the outset of a piece of work the regulator would
formally determine whether the output might affect the availability of choice in the audit market because of
its impact on potential providers and purchasers of audit services. If it might do so, then the regulator’s
internal processes would require the regulator to confirm that in deciding on a course of action it had given
full consideration to the impact on choice in the audit market. There would also be reference to choice in the
impact assessments that accompany the regulator’s output.

One benefit of this suggestion is that future inquiries into choice in the audit market would be better informed
about practical experience of trade-offs between choice and other public interest issues, including audit quality.
It may help the Committee if I provide a little background to this proposal.

BACKGROUND INFORMATION

Choice in the audit market is, in the first instance, currently driven by company boards and their audit
committees who choose who should be put forward for appointment as auditor by shareholders. As a possible
result of the work of your Committee and that of the European Commission, shareholders may in future take
a more active interest in the appointment and reappointment of auditors. One consequence of increased
scrutiny from shareholders might be that audit committees are even more attracted by the perceived safety of
choosing one of the four largest firms. Against this backdrop it will be very challenging to widen the listed
company audit market.

Over the past few years the Financial Reporting Council (FRC) has undertaken specific work to try to actively
influence choice. In particular, its Market Participants Group (MPG), whose membership consisted of
investors, companies and audit firms, published a report in October 2007 report entitled Choice in the UK
Audit Market. Of the report’s 15 recommendations:

— 12 focussed on increasing choice of auditor for public interest entities;
— two were about reducing the risk of an audit firm leaving the market without good reason; and
— one sought to reduce uncertainty and disruption costs in the event of an audit firm leaving the market.

Of the 12 recommendations on choice, some looked at supply-side measures intended to encourage firms other
than the four largest to offer audit services to large public interest entities. Other recommendations referred
to demand-side measures, including making boards more accountable to shareholders and reducing the
perceived risks to directors of choosing a smaller audit firm. In the period between October 2007 and June
2010, the FRC published five progress reports on the 15 recommendations. In their written submission to your
Committee, the FRC states that the majority of the MPG’s recommendations have been implemented but to
date have had minimal impact on market concentration.

However, in addition to these specific initiatives to help widen choice, the FRC and its subsidiary boards
undertake many on-going, broader activities such as framing new or revised financial reporting, auditing and
ethical standards and reporting on monitoring and enforcement activities. In my opinion, the outputs of these
broader activities are very likely to influence the perceptions of, and the choices made by, audit committees
and shareholders as well as audit firms. My proposal seeks to address this matter. Audit regulators need to consider the consequences of all their relevant actions on perceptions of key participants in the audit market. Currently the words “choice”, “concentration” and “competition” do not feature in the FRC’s document “Regulatory Strategy: Our Role and Approach” (Version 4) dated April 2009. By way of contrast, the Financial Services Authority (FSA), in pursuing its functions under the Financial Services and Markets Act, is required to have regard to additional matters that it refers to as “principles of good regulation”. There is a competition principle which states “The need to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate.” The FSA states that one of the aims of its principles is to avoid unnecessary regulatory barriers to market entry or business expansion. It goes on to note that competition and innovation considerations play a key role in its cost-benefit analysis.

Thus, my proposal is that relevant regulators (particularly the FRC) should include the issue of choice as one of their principles for regulation and ensure that, where relevant, it is considered in each aspect of its work not just in relation to the specific recommendations of the MPG.

**Follow-Up Actions to ICAEW Report on the Audit of Banks**

Finally, I would like to take this opportunity to follow up on my oral comments to the Committee by summarising a number of initiatives ICAEW is undertaking as a result of our report “Audit of banks: lessons from the crisis”, which Lord Lawson referred to in the session on 19 October 2010. We:

- have established the Financial Services Faculty Auditor-Investor Forum to highlight and discuss key risks across the financial services sector. The Forum will meet for the first time on 22 November 2010 with the aim of promoting wider understanding of the key areas of focus of auditors of financial institutions in the upcoming reporting season and potential difficult issues in preparing annual reports, including any systemic risk concerns. This should promote greater confidence that auditors will be considering and addressing these issues;

- have established a working party to develop good practice guidance for communication between auditors and audit committees in financial institutions. The objective of this initiative is to provide better information to audit committees and to encourage better disclosure by audit committees about their dialogue with auditors. We aim to publish draft guidance before the end of 2010 and final guidance after the next reporting season; and

- have assisted the Bank of England and the FSA in establishing a working group to examine and revise protocols for dialogue between auditors and supervisors. This will look at both the information that auditors should share with supervisors and the information that supervisors should share with auditors.

We believe that each of these initiatives will promote important incremental improvements that can be made relatively quickly. While there may be debates to be had on more fundamental changes to auditor responsibilities, such wider changes can be complicated by potential unintended consequences which mean that they take much longer to agree and implement.

I would be happy to brief Lord Lawson and any other members of the Committee on the matters covered in this letter or any other matters arising from your inquiry if that would be useful.

28 October 2010

**Further supplementary memorandum by Mr Veron Soare, Executive Director, Professional Standards, ICAEW (ADT 9)**

I would like to comment on a number of the points that were made during the Committee hearing on Tuesday 9 November at which representatives of the supervisory community, including the Financial Reporting Council (FRC), gave evidence. As a Recognised Supervisory Body (RSB) for statutory audit under the Companies Act 2006, the ICAEW has a useful perspective to offer on the matters raised.

**Background**

As the Committee may be aware the current arrangements for audit supervision in the UK arose out of a 2002–03 Government Review commissioned by the then Secretary of State for Trade and Industry (Review of the Regulatory Regime of the Accountancy Profession). This Review concluded that the arrangements established under the Companies Act 1989 were fundamentally sound but that the system could be strengthened.
This led to the introduction of a revised supervisory framework (now part of the Companies Act 2006) whereby Recognised Supervisory Bodies (RSBs) such as ICAEW are subject to the oversight of the Professional Oversight Board (POB) and are also required to participate in independent arrangements for the monitoring of public interest audits and the investigation, for disciplinary purposes, of public interest cases. The latter arrangements are operated with ICAEW’s agreement via the Accountancy and Actuarial Discipline Board (AADB), the former via the Audit Inspection Unit (AIU), who along with POB are part of the FRC.

It should be noted that auditing standards, effectively the “rules” on how to conduct an audit, sit under the control of the Auditing Practices Board, also part of the FRC.

These arrangements are now mirrored to a very large extent in the EU’s Statutory Audit Directive. While in many respects the UK has led the way in the development of robust arrangements for the supervision of auditors, for good reason the EU Directive draws a clear distinction between those responsible for the day-to-day regulation of audit firms and those who provide oversight of this process. In our view placing regulatory functions within the remit of the FRC blurs the separation between regulation and oversight. It is with this in mind that we write to the Committee.

9 November Evidence Session

In their evidence session on 9 November the FRC noted that, as they do not register/licence the audit firms which the AIU inspects, they only have the “nuclear” option of recommending to a RSB the removal of a firm’s registration/licence. This is because under the terms of the Companies Act the AIU provides independent inspection which the RSBs then act upon. Under the Act, RSBs have a wide range of powers to take action against firms including removal of registration. All RSBs can fine a firm, place restrictions on the type of audit clients it can have, place conditions on how audit work is conducted and remove the right of individuals within the firm from being involved in audit.

With respect to reports made by the AIU to the Audit Registration Committee (ARC) of the ICAEW, these are closely reviewed and appropriate sanctions applied in accordance with the circumstances of each case. The AIU has never recommended that a firm’s registration be removed, or that an individual be prevented from undertaking audit work although it has made other recommendations for regulatory action. In all cases these have been taken up by the ARC and action taken against the firm or individual in question. In some cases the ARC has taken additional action to that requested by the AIU, such as restricting a firm from taking on new audit appointments, until the underlying matters have been dealt with—this may also require the firm to submit to an additional AIU inspection.

In passing it is worth noting that despite the most recent round of AIU reports on large firm audits raising issues requiring “significant improvement” and an increase in auditor scepticism, no request was made by the AIU to the ICAEW’s ARC to take any regulatory action against either a large firm or any individual auditor.

As we have stressed to the Committee in our previous submissions, it is important that recommendations on the future of audit regulation are evidence based. The AIU and POB are made aware of the ARC’s decisions that are based on AIU reports and they have never commented adversely on the decisions or the process used to reach them.

As far as the ICAEW is concerned, nothing presented by the FRC to date suggests that the Companies Act 2006 provisions are not working effectively. However, we recognise that the continuing success of the regime depends on clear lines of reporting between the AIU and the ARC.

With reference to the AADB, it is able to use any disciplinary sanction open to the ICAEW, including the power to impose unlimited fines and exclude from membership. This arrangement continues the powers enjoyed by the AADB’s predecessor body, the Joint Disciplinary Scheme (JDS). Like the JDS, the AADB independently investigates public interest cases against audit firms registered with the ICAEW and is designed to play a key role in maintaining confidence in the UK audit profession. However, despite accumulating a substantial caseload the AADB shows no evidence of an ability to meet the promises concerning speed and thoroughness of investigation made at its outset. Indeed, according to its website, since announcing its first investigation in 2005, the AADB has brought only two cases to a tribunal hearing. An independent review of the effectiveness of its work may now be timely.

During their evidence session the FRC also commented that it needed a wider range of sanctions against RSBs. Again we would advocate an evidence based approach here. The POB undertakes annual reviews of each RSB. Inevitably matters are discussed and recommendations made. As far as we are aware, all matters raised have been resolved to the satisfaction of the POB as evidenced by successive annual reports by the POB to the Secretary of State.
As the Committee is aware the European Commission is currently consulting on a number of these issues at a pan-European level including the possibility of an EU-wide audit licence, which would have a major impact on current licensing arrangements for audit firms carrying out audits of public interest entities. This has been a global crisis and reform proposals must be capable of implementation across international markets.
I would be happy to brief you further on any or all of these matters.

23 November 2010
I have pleasure in submitting written evidence to the Committee.

I was the chair of the Institute of Chartered Accountants in England and Wales’ (ICAEW) Competition and Choice working group set up under the then Department of Trade and Industry, which then evolved into the Financial Reporting Council’s (FRC) project on the same issue. I am a past member of the Governing Council of the ICAEW and an investor, an FSA registered fund manager. I am the Investment Management Association nominated representative on the Urgent Issues Task Force of the Accounting Standards Board (ASB). I have analysed banks in particular since 2006.

I would also be prepared to give oral evidence. I am writing solely in a personal capacity with no paid interest or other conflict of interest with the subject matter.

As the Committee is seeking evidence about the role of the auditor and risk, my evidence sets out and explains the context and purpose of the accounting and auditing provisions of the Companies Act. The Companies Act 2006 (previously the 1985 Act) has Section 837 which very simply defines the output expected of audited accounts as:

"the [audited] accounts must have been properly prepared, or only be defective in ways immaterial in determining whether the distribution [ie a dividend] is in breach of this Part of the Act. (Source: Palmer’s guide to Company Law 2006)."

The Act is seeking that accounts are sufficiently reliable so that companies will not pay dividends out of capital, such as when they are actually making losses. This objective is a stress test a sense check. However, audits have appeared to fail (clean opinions were given on banks about to collapse) because:

- the auditing standards give auditors the objective of auditing by the “accounting standards framework”. That falls short of setting out the full implications of S837
- when the “accounting framework” is IFRS (which for banks and listed companies has been the case since 2005), IFRS accounts cannot deliver that objective, because IFRS in parts positively overstates financial assets and profits. It has the wrong risk model
- overstating assets and false profits is almost bound to lead to companies, but particularly banks, getting out of control and misleading themselves as well misleading outsiders

This has happened because IFRS has wholly replaced the Accounting Rules that were in the Companies Act itself and had had proper legislative scrutiny. Section 837 is still intact and it is still the law but there has been no functional mechanism to deliver it.

The inconsistency between what accounting standards (IFRS) and auditing standards set out and what the Companies Act really requires was flagged by institutional investors in 2005 upon the launch of IFRS. The accountancy regulators dismissed those concerns. But since then IFRS has merely taken the self-referential compliance model already set by the auditing standards that bit further. So similar flaws have passed up the chain via IFRS to the directors and their business control systems as well.

Banks traded, priced credit and paid dividends when they weren’t really making the “profits” that they were showing and thought they were making. The banking crisis is largely due to faulty numbers. Post Enron accounting reforms have not worked as the medicine was the disease.

It is therefore encouraging that Parliament is looking at this matter in some detail.
**SUMMARY**

S1.1 This evidence covers two distinct areas; the role of auditors and the relevance of accounting/auditing standards in that role (to cover questions 5-9) and audit firm concentration (to cover questions 1-4). It sets out a case which explains why the audits of some banks have come under question from politicians due to their apparent failure to identify the true state of those banks that were on the brink of collapse. Or put another way, why auditors were the dogs that did not bark.

S1.2 Some banks were following capital destructive business models, essentially lending at below true cost, and in some cases having no capital at all. They were showing an accounting illusion of capital and profit, but they received unqualified audit opinions on their accounts, and paid dividends.

S1.3 Given that the accounting provisions of the Companies Act were established in 1879 explicitly to serve a banking solvency function and given that Parliament was assured in 2006 that the function of auditors of accounts had not changed, something has come adrift for questions on their role to be asked at all. In reading evidence recently given to the House of Commons Treasury Committee I conclude that neither the accountants, nor their regulators conveyed to that committee the true purpose of the statutory auditor. This evidence may explain why.

S1.4 Because of the way the law relating to auditors is constructed, the audits of banks should identify true solvency. The position that regulators should instead is false. Regulators did not have the resources or global proximity to the businesses, auditors did. The contractual purpose of the Companies Act auditor is to avoid management operating under or presenting an illusion, business is more dynamic than regulation.

S1.5 However the accounting standards introduced in 2005 can mask true solvency, and do not even purport to seek to show that. It is therefore my conclusion that there is an absolute incompatibility between Company Law and key parts of IFRS (the International Financial Reporting Standards of the IASB) that for banks means an absolute danger.

S1.6 IAS 39 (the accounting standard that deals with most of a bank’s balance sheet and profits) conflicts with the Accounting Rules of the Companies Act. It is therefore not surprising that the delivery of IFRS accounts and the audit thereof will be defective in comparison to what the Companies Act intends of both accounts and audits. Rather than functioning as a reliable basis for controlling and monitoring banks, inside and out, IFRS has had the dual effect of helping some of them to get out of control and obscuring that. The incompatibility is not merely against the intent and spirit of the law but is contrary to specific statutory provisions of the Companies Act itself.

S1.7 Because the UK’s accounting standards board (ASB) had set generally good standards whilst sitting below the Companies Act’s Statutory Accounting Rules there may have been a general presumption that IFRS was merely an internationalisation of what the ASB had done. But, what the ASB had done was properly restricted by the Statutory Accounting Rules set down by Parliament.

S1.8 However, IFRS did not merely replace UK Accounting Standards, it also replaced the Accounting Rules contained within the Companies Act that were consistent with the purpose of the law and drafted with legislative levels of scrutiny. IFRS has quite simply frustrated the delivery of the accounting model and audit that Parliament intended because IFRS is set without equivalent legislative scrutiny by a body with very different objectives. IFRS seeks to value companies at a point in time (“decision usefulness”) rather than ensure their safety going forwards (stewardship). IFRS also frustrates Section 386 which requires that companies by their books know where they are with reasonable accuracy at any time. That is difficult if the accounting standards do not achieve it.

S1.9 The way that the law is still structured, Sections 830–837 (Capital Maintenance), are still paramount outcomes, but complying with IFRS may well break that part of the law, despite being the expected method of delivery. Instead of a health check of a business, the model that part of false positives. Very dangerous indeed.

**BACKGROUND, THE YEAR 2008**

E1.1 I set out when and how I first concluded that there were severe technical problems in accounting and then auditing that have contributed to the banking crisis to the extent of being a primal cause.

E1.2 In early 2008, I produced a brief analysis of problems with banks and their accounts, and having sent that to HM Treasury I was immediately asked to meet officials in July 2008, where I ran a model (similar to that the FSA now has) past members of the Financial Crisis Team. I gave them my view that I thought that accounting standards were not only covering up problems in banks but were causative of them. Why cause? Because people plan and budget—and then monitor that—by numerical outcomes. If accounting standards produce a false profit as a numerical outcome, things will go awry right from the start.

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1 Answer to Justine Greening MP from Margaret Hodge MP, Minister, July 2006.
E1.3 That presentation was summarised by an official as the first time that anyone had “managed to explain [to them] what no one else had managed to explain”. At that stage only Northern Rock had collapsed, although Bradford & Bingley had had a failed rights issue. Investors were firstly blamed for being unsupportive of banks and there was a prevailing view that the pre-emption rights issue period was too long. In reality the market was suspecting that other banks too might be bust—and also need to be nationalised—but the numbers did not show it. Attention had been overly focussed on “liquidity” (asset/liability maturity profile) rather than capital solvency/adequacy (the amount by which assets exceed liabilities). All banks have a liquidity problem, that is their public benefit, they borrow short-term to lend long term. Liquidity matters most when people will not lend to what they suspect might be a bust bank (liabilities exceed assets). Banks were operating under and presenting an illusion.

E1.4 The official commented that speaking to long only investors (ie not short sellers) tended to show a convergence of interest with HM Government’s interest. I replied that it was because long investors also had diverse economic interests rather than narrow vested interests. I also commented that I thought that before long the government would also be an equity investor in more banks than merely Northern Rock. The team was impressive and quick on the uptake.

E1.5 My analysis was then, and still is, that problems have arisen quite simply due to changing accounting standards in January 2005. Checks and balances inherent in the accounting model replaced in 2005 were taken out and not compensated for: These changes not only affected regulated banks (ie deposit taking institutions) making loan advances, but also unregulated non-banks undertaking similar activity, such as Cattles plc (not regulated as a deposit taking bank—but making loans to customers by a doorstep collection model). It is difficult to blame faulty regulation where there wasn’t any (other than consumer protection regulation) in the case of Cattles which had existed since 1927.

E1.6 It is positive that of all regulators working in this area Lord Turner of the FSA has best articulated the issues that others have not. The accountancy regulators still don’t give a coherent explanation for things. They are embarrassed. Furthermore, standard setters resemble lobbyists, selling their standards rather than writing them properly. They don’t even do impact assessments.

THE FULL SCOPE OF THE LAW EXPLAINED IN MORE DETAIL

E1.7 The statutory requirement of auditing and accounts flows from the 1879 Companies Act, and followed the collapse of the City of Glasgow Bank in 1878, which had been a fraud. Before that when their commission was not compulsory, matters followed common law.

E1.8 The law is constructed such that the law is framing a private contract that is albeit compulsory. The parties are the company and the auditors. This differs from regulation, which is not contractual, the parties then are the regulated party and the regulator. An analogy is the legal requirement for a driver to have third party insurance. Whilst the government demands the contract, it is not a party to the contract. The audit though, is not insurance, but assurance, to detect and deal with risk and negligence, including fraud.

E1.9 The framework of the 1879 law is intact, and is now the 2006 Companies Act (previously the Companies Act 1985 and preceding acts, and is set out too in case law). Clauses particularly relevant to accounts and the audit and its purpose are:

1. The accounts that are published comply with the accounting framework (IAS accounts or Companies Act accounts) and give a “true and fair view” (ie a sufficient output). Section 393 (and the auditor opinion thereon, Section 495)(a) and 495(b).

2. The books of account that are kept privately at all times are suitable to inform the directors of where the business is at all times. Section 386 “adequate accounting records” (and the auditor opinion thereon, Section 498).

3. The firm link between the statutory audited public accounts and the legality of dividends declared off of those accounts. Sections 830, 836, 837. Sections 837(4) is wholly about the auditor duty in that regard. He must always conclude whether the accounts are suitable to be used for declaring a dividend even if his opinion is qualified. The statutory duty is so positive so as to require the auditor to report to shareholders on that matter over the heads of the directors if necessary S837(4).

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4 House of Lords, Caparo vs Dickman, 1990.
5 Also called “UK GAAP”. Through UK GAAP is Companies Act formats and rules, and then Accounting Standards Board Standards.
4 Section 532 prohibits the auditor from contracting with the company to limit liability. This appeared in 1929 as auditors had been contracting with the directors, or having provisions put into company articles to limit their, and/or directors’ liability. This remains subject to a modification in the 2006 Act under Section 534-538 allowing limitation to an amount that is “fair and reasonable in the circumstances”.

E2.0 The requirement in 1 above is about transparency. The requirements in 2 and 3 link both the public audited accounts and the private books of account with solvency. The Companies Act is very simply aiming to protect creditors from companies funding dividends and losses from creditors. Hidden losses in a bank will mean that it is taking in deposits to pay shareholders and managers, and hidden ongoing losses means it is making mispriced loans.

E2.1 The requirement in 4 was to prevent “take the money and run audits”, ie the statutory condition of having one was met, but the contractual efficacy was limited. Sections 534-538 were placed into the Companies Act in 2006 only after a conditional agreement with sceptical institutional investors (concerned then about poor quality audits of some public companies) that auditors would strive to adhere better to the intent of the Companies Act with respect to their statutory duties. The terms of that agreement encountered problems7 at the outset due to the problem set out below (E4.1).

STANDARDS FALLING SHORTH OF WHAT THE LAW DEMANDS AFTER JANUARY 2005

E2.2 The UK Companies Act Accounting Rules (“Accounting Rules”), and hence the audits thereof, were for banks in substance loan quality stress tests. The Companies Act positively requires this for dividend safety/capital maintenance to ensure that dividends are paid from firm, not transient or unstable asset values.

E2.3 However the requirements of the Act have not been backed up properly by functional standards since 2005. The accounting standards have failed to support the Act and the auditing standards then failed to pick it up also. But if the accounting standards regime is faulty, then to the extent that these can apply to how companies account perpetually throughout a year (as IAS 39 does), it is difficult to see how an auditing standard can fully correct it at the end of a year. Information drives behaviour at all times.

E2.4 The root of the accounting/auditing problem (and indeed the problem manifests before the auditor even starts work) is the change to International Financial Reporting Standards (previously called International Accounting Standards) in 2005. I will not generally refer in this evidence to the problems with “fair values” in the context of banks with trading books, but instead the “sister” of fair value, incurred loss provisioning (see in more detail later E3.5), also a part of the controversial standard IAS 39. That change took out the critical stress-test-for-dividend and capital maintenance purposes, to the extent of being wholly at odds with the intent of the Companies Act. It is possible to make a simple link between the lack of ongoing accounting failing to be a stress test from 2005 with regulators in 2010 rather late in the day having to do it instead. That is not what Parliament intended.

HIDING LOSSES BY NETTING OFF, IFRS REQUIRES IT, COMPANIES ACT RULES FORBID IT

E2.5 There is also another crucial test that fell away after IFRS was implemented in 2005. That is the test of not allowing values from one group of assets to cover up losses in others.8 The Accounting Rules forbid “netting off” different things, with a rise in one asset perhaps compensating for the fall in another, but IFRS permitted/required this so as to accommodate fair values of compound assets such as CDOs (collateralised debt obligations). Under IFRS what is valued and disclosed is the sum of the parts at a point in time. IFRS was not only not revealing of the underlying components nor their individual true condition or their risk of losing value, but it also did not even account for things that were already deteriorating.

E2.6 Under the Accounting Rules, it is forbidden in principle for the illusion of value to be created by essentially an insurance policy sitting on top of a pool of decaying assets (some CDO’s carried default protection, as either insurance or derivatives). However, the IFRS methodology served to replace primary and reliably audited information from banks themselves with secondary information from markets, hence inherently second-hand, that was reliant on other agencies, such as the credit rating firms. It has had the impact of delaying the accounting for losses inside CDOs that were often there from inception. Some CDO investments (which could be held on treasury books, banking books, or trading books) were approaching £1 billion in value. So covering up losses within that package is a serious matter.

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8 NAPF/Morley Fund Management, “Bringing Audit Back from the Brink” and “Undermining the Statutory Audit” 200-05.
E2.7 Under IFRS CDO’s were fair valued as a whole from 2005-2007 with virtually no disclosure of what they comprised. In the first quarter of 2008, it became widely understood that there were such poor loans in some CDO’s that the insurance in place was from a few and interconnected counterparties and hence that protection was also risk. Only then did the Financial Stability Forum (not the IASB) set a standard to disclose what assets CDO’s comprised and what their loss rates were, and the source of the insurance/derivative cover.

E2.8 From speaking with bank directors in 2007, 2008 and 2009, was is clear that the lack of public information was met by a lack of information on their part also. That is not surprising given the size of banks. Directors receive distilled information just like the public does. The problem was that complying with IFRS can distil information in such a way that does not match with business risk. Losses were occurring in 2006 that did not get accounted for until the first quarter of 2008. There was a mismatch between the real estate foreclosure notices in the USA and the transmission of these losses to the accounts of banks, though the losses were there. In the age of the internet, for modern accounting to delay loss recognition by at least 15 months is a remarkable phenomenon.

E2.9 Unlike IFRS being accepting of (and incentivising the production of) complex instruments valued as one thing, the Companies Act Accounting Rules are seeking to pull things apart to expose the fundamental parts. The accounting question is what is the cost of each item, and what is the diminution/risk to values of any of the parts.

E3.0 The difference between IFRS and the Accounting Rules for 2005-07 is stark. With the Accounting Rules any part of a CDO going down would show as a loss (and reduce profit, capital and dividend capacity), IFRS masks that, indeed the market value of the whole thing could be shown as going up (these were called by the IASB “day one gains”).

E3.1 Historic cost accounting (which IFRS has replaced in key places) can be disparaged by invoking the linguistic inference of a lack of modernity. One significant public benefit of historic cost accounting, is the simple fact that the impact of some things going down, cannot be masked by other things going up! Things held that are going down is business risk, things going up whilst not sold is merely opportunity. Under the Accounting Rules, insurance is at best a contingent asset, and a prudent view would require an auditor looking at the counterparty risk before even considering it having any accounting value.

E3.2 Other problems with IAS 39 included a total lack of business substance. It required banks to legally designate on an asset’s inception the accounting classification of either trading or to maturity or to treasury, irrevocably irrespective of the real business use of the asset. Given that IAS 39 gives trading assets profit for going up, in a rising market it incentivises designating assets as trading assets, leading to hoarding rather than selling. Yet commercially the term “trading” implies inventory, goods to be sold in the short run. Not only is the classification misleading, but, as with recent cocoa prices, prices might be high merely because banks were holding on to assets in a rising market due to other buyers being there, or a lack of liquidity due to hoarding. The Accounting Rules forbade taking a profit from merely holding assets, so such problems do not arise. With IAS 39, once a “designation” had occurred, directors and auditors were unable to change the accounting, even if they disagreed with it. It is easy to envisage how situations could get out of control in quite profound ways.

BANKS ARE THEIR NUMBERS

E3.3 Churchill referred to the architecture of buildings, in particular the Palace of Westminster, as shaping the behaviour of those in it. Accounting standards are directly analogous as forming the core architecture of the financial system. When an accounting standard enables a profit from building a house of cards people will tend to build them.

E3.4 Other than till money and office buildings, a bank exists as paper contracts and the business can only be described and controlled, by looking at numbers which pull of all of that together. A bank that gets it numbers wrong may “overtrade”, essentially self-finance, by taking in deposits and issuing its own paper whilst paying out too much as either; more bad loans, pay, taxes or dividends.

THE INCURRED LOSS LOAN PROVISIONING MODEL IN MORE DEPTH

E3.5 This critical problem can be summarised by comparing these extracts from the two standard systems (ie Companies Act accounts versus IFRS accounts).

IAS 39: incurred loss. BC 109 “For a loss to be incurred, an event that provides objective evidence of impairment must have occurred” and “Possible or expected future trends that may lead to a loss in the future (eg that unemployment will rise or a recession will occur) do not provide objective evidence of impairment.” (Chuck Prince the former CEO of Citigroup called this “Dancing until the music stops).
The Accounting Rules. Clause 19. “The amount of any item must be determined on a prudent basis….and in particular, only profits realised at the balance sheet date are to be included in the profit and loss account.” This was then interpreted by the British Bankers Association standard (“BBA-SORP”) for banks (franked by the ASB). “The balance sheet amount of advances should reflect any diminution of their ultimate realisable value below their cost.” And “To cover the impaired advances which will only be identified as such in the future, a general provision should be made.”

E3.6 The BBA-SORP/Accounting Rules test required a bank in valuing loans, and taking profit, and hence in pricing credit, to take a prudent view of the future, by taking past experience of lending and recessionary cycles. The loss from the test “any diminution” is proportional to the quality of the borrower and his collateral, and general provisions should reflect that. However, IFRS, positively forbids looking at the past or the future. The auditor of a bank operating that system as its provisioning model therefore really has nothing better to go on. And for those inside a bank the question “how are we really doing?” becomes a difficult one.

E3.7 This is an extract from Lord Turner’s letter to the Chancellor, on the Dunfermline Building Society which failed and needed to be bailed out. It indicates the problem with incurred loss provisioning, suggesting that the auditor (using IFRS) felt its loans were understated.

“In December 2007 as part of the ARROW work, the FSA discussed the Society with its auditors, who informed the FSA that overall the Society was well controlled and who suggested that the commercial loan loss provisions, given the benign market, may not have been entirely justified, ie may have been slightly higher than justified.”

E3.8 If one wished to invent a bank that would collapse, but appear profitable, even when audited, right up to the point of collapse, one could (with IFRS as the standard system):

(i) lend as much as possible.
(ii) take as little collateral as possible and charge a premium for that lending risk.
(iii) compete for marginal business to grow as fast as possible.
(iv) experience no losses in reported performance, indeed show growing profits and capital until the bank falls over.

E3.9 None of these things need to be malign, merely a product of group think, caused by rosy internal and externally audited numbers from assuming that these numbers are sustainable. This is accentuated if ones competitors are equally dysfunctional from doing the same things. Any business can sell goods at below cost, but obscuring that is precisely what IAS 39 accounting achieved for high risk lending by some banks.

E4.0 If accounting and auditing standards do not address the full scope of the law, then clearly audits will not deliver what is expected under the full scope of the law. The audit is intended as a check (a lookout) to then be a check (a brake). With IAS 39 both functions are ineffective.

THE 2006 ACT AND CORRECTING THE PROBLEMS WITH IMPLEMENTATION OF THE IAS REGULATION

E4.1 Other than auditor liability limitation which was new, all clauses mentioned in E1.9 by their 2006 Act references were carried forwards from the 1985 Act to the 2006 Act. However, Sections regarding the “true and fair view” were absent from 2005-09.

E4.2 The IAS Statutory Instrument (which implemented IFRS in the UK) excised the Companies Act Accounting Rules and deleted the applicability of UK Accounting Standards Board standards, for IFRS companies. However, the Statutory Instrument also excised the “true and fair view” objectives from the 1985 Companies Act for IFRS using companies, and that excision was also replicated for Companies Act (non-IFRS) accounts as well.

E4.3 Although “true and fair view” clauses were then put back by the Companies Act 2006, different parts of the new Act were invoked at different times, therefore these clauses were not operative from 2005-09. Given that the true and fair view is a backstop precisely when an accounting standard or its application might be defective, its absence corresponded with precisely the period that problems were in the banking sector due to just that.

E4.4 The problem of the result of the Statutory Instrument was identified by institutional investors and one large accounting firm, and then supported by politicians and then the other accounting firms, but not regulators. The essence of investor concern was the following:

10 SI 2004/2947.
(i) true and fair view as an overarching objective of Companies Act accounts is a backstop for precisely when accounting standards are defective or inadequate in the circumstances.

(ii) Company law has also never defined the true and fair view, merely set the context for it. However, IFRS defines true and fair view as not only the product of applying IFRS, but applying IFRS for the purposes set out in IFRS.

(iii) IFRS as to purpose, is not only not silent on dividend assurance and capital maintenance, but the IASB was opposed to the construct that audited accounts were for dividend assurance and capital maintenance for the benefit of creditors and members. The stated purpose of IFRS is “to be useful for users” instead.

(iv) IAS 39 was known by many to have been “the Enron standard” and it was not apparent that the IASB had fully appreciated its problems with it. Also IAS 39 was inherently inconsistent with dividend assurance and capital maintenance.

E4.5 A summary of the key changes from the above is set out in this table. The grey type is to demonstrate the various levels of confusion created after 2005.

<table>
<thead>
<tr>
<th>Position</th>
<th>Pre-2005 accounts of all companies</th>
<th>Companies Act accounts 2005-09</th>
<th>IFRS Accounts 2005-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>True and fair view override</td>
<td>Yes</td>
<td>No, or at best unclear.</td>
<td>No, and no evidence of it being used in a UK bank, (it was used in France).</td>
</tr>
<tr>
<td>Prudence as an overriding accounting rule?</td>
<td>Yes</td>
<td>Accounting Rules are intact, but the ASB put IAS 39 into FRS 26 (see below)</td>
<td>No. Imprudent provisioning was compulsory for banks (including banking subsidiaries), and this standard applied listed entities (their consolidated accounts) and for the individual company accounts of bank holding companies.</td>
</tr>
<tr>
<td>IAS 39 (with its incompatibilities.)</td>
<td>N/A</td>
<td>IAS 39 was incorporated into UK FRS 26, despite being inconsistent with the Accounting Rules of the Companies Act, (incurred loss provisioning, below).</td>
<td>Incurred loss provisioning. Forbids adjusting loans for inherent credit risk.</td>
</tr>
<tr>
<td>The BBA-SORP required loans to be carried at “not more than their ultimate realisable value below cost.”</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

All this meant that from January 2005 a bigger fog than usual descended around the banks’ accounts.

E4.6 However a fog in objectives was already in place around the auditing standards.

<table>
<thead>
<tr>
<th>Position</th>
<th>UK Auditing Standards to 2005</th>
<th>ISA from 2005#</th>
</tr>
</thead>
<tbody>
<tr>
<td>An auditing standard dealing with the matters in the 1985 Act equivalent to the 2006 Act of 836 and 837?</td>
<td>No. In some supplemental guidance, on a form of words when an auditor qualifies his opinion. But, this does not indicate the dividend test as a criteria for qualification, ie it does not direct auditing in that direction.</td>
<td>+</td>
</tr>
<tr>
<td>Materiality objective in auditing standards?</td>
<td>Accounting materiality [ie relevance for auditing purposes is: “Material in the context of the financial statements taken as a whole”*</td>
<td></td>
</tr>
</tbody>
</table>

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14 Soc Gen in 2008 overrode IFRS, to match the losses of unauthorised dealing, with the period in which the positions had been started. The IFRS treatment would have shown a profit for 2007, as the positions were in the money, with the losses being deferred until 2008.
Position | UK Auditing Standards to 2005 | ISA from 2005#
---|---|---
Fraud and error? Both are relevant to capital/dividend safety. | Auditing standards consistently emphasize the role of directors/managers to find fraud. This is somewhat odd as auditors use auditing standards not directors.

# ISA International Standards of Auditing.

* But, Section 837 does not restrict accounting materiality to this very general sounding criteria. Paying dividends out of capital (depleting reserves) by only £1 is a breach of the law (when and if reserves get that low). Company Law expect dividends to be what the company can bear and expects the accounts to reflect that. FSA banking regulatory capital is merely an additional constraint to that, essentially adding to share capital as the balance sheet grows. This omission therefore might lead auditors into believing that if their audit and the accounts comply with accounting standards and auditing standards, then they have achieved their objective and do not have to qualify their opinion. The auditing standards are therefore appearing to set a passive and reactive rather than an investigative objective.

E4.7 In contrast to that, Section 837 is very clearly expounded in HMRC material,\(^{15}\) it is an acid test, but it is surprisingly absent from much regulatory material, to the extent that even some regulators seem to have missed its significance in what they are regulating.\(^{16}\) What is most relevant is that Section 837 is entirely incompatible with “incurred loss” provisioning.

E4.8 Reasons for this acid test not being more clearly set out in auditing standards might include:

1. auditing practice is global. The USA does not have an equivalent acid test (in statute) for the auditors, hence the US profession is unlikely to wish to see it in international auditing or accounting standards.
2. the UK accounting profession might prefer it was not in the law. Any focus on it betrays the concept of “an expectation gap” as somewhat of a fig leaf.
3. external audit quality inspection processes established under self-regulation have been founded on auditing standards as the quality yardstick, rather than these more explicit parts of the law. “The inspection gap” then matches the expectations gap by inspecting “in accordance with standards”. It holds up the fig leaf.

But—as has happened—when accounting standards are faulty, there is no clear audit objective to follow either. The law requires the audited accounts to reflect the business condition, in numbers, and an assessment of proper control (Section 386), so that dividends can be paid, or withheld. Auditing standards are a fudge.

E4.9 The recent criticism of auditors arises despite much more audit regulation. Yet from 1879 to 2005, in the current and former sterling area, banks did not collapse systemically with no regulator and in places no lender of last resort. All of this area applied a similar accounting, reporting and governance system, the Companies Act.

CONCENTRATION AND REGULATION

E5.0 I believe that there has been an insidious problem with a “too few to fail” attitude within the regulatory environment itself.\(^{17}\) That has manifested in regulatory support for sheltering auditors from civil liability claims.\(^{18}\) It is a classic manifestation of regulatory capture.\(^{19}\)

E5.1 However, as we have seen there is a widespread recognition of the moral hazard of a “too big to fail” situation with banks. The same problem arises with audit firms. If poor auditing can lead to banks failing (as was held in cases in the UK in the 1990’s and 1980’s), then the combination of “too big to fail” (banks) and “too few to fail” (auditors) is a lethal combination.

LINKING THE TWO ISSUES ABOVE, STANDARDS AND CONCENTRATION

E5.2 Standards (accounting and auditing) are heavily influenced by the profession itself, a part of which has a vested interest in obscuring its statutory test of audit quality, which is an acid test, and replacing it with a far woollier one for public consumption and professional inspection. I have observed regulators not believing what Parliament intended, they then overlook it and hence themselves unknowingly subvert it. A significant part of the regulatory oversight system has very little grasp of the scope of the law as opposed to the standards.


\(^{16}\) FRC/FSA consultation July 2010 on matters arising from the results of inspections of bank audits. This does not mention the impact of potential overvaluations of assets found in the inspections with the impact on dividends.


\(^{18}\) FRC delegations to DTI in 2004/2005 to support a liability cap. Opposed by HM Treasury.

\(^{19}\) “Regulatory Capture” Stigler, Chicago, Nobel Prize 1982.
I have yet to see any evidence that the UK’s FRC uses information on successful auditor litigation (ie contractual failure) as a criteria for audit quality. It instead inspects according to (regulatory) standards with the lesser tests. It is checking false compliance, and driving a paradigm of “good” corporate governance on that model.

E5.3 Essentially Enron and the then collapse of Anderson was the tip of an iceberg that has unfortunately been hit twice. The lessons of that crisis were not learned and many of the remedies since have been quack medicine.

Risk and More Work on “Risk”—It Needs Numbers Not More Words

E5.4 Currently there is talk of auditors doing more on “risk”, and auditing risk statements. It is quite easy to see its attraction as both a distraction and a way of extracting more fees. The competitive advantage to accountants should be around numeracy. The risk to a bank is not getting money back having lent it. The key issue is getting the numbers right, and delivering as the law already requires but the standards have not delivered. Banks overstated numbers to one degree or other most probably from early 2006, or earlier in some cases, due to the problems with IFRS. That was the problem. More words and more fees around the more words are not going to address that. Other suggested remedies such “talking more to the FSA” will not help either party much if the auditor has not bottomed the numbers.

4 August 2010

Supplementary letter from Mr Timothy Bush (ADT 11)

I have pleasure in submitting written evidence to the Committee supplementing that I submitted on 4 August 2010.

I was the chair of the Institute of Chartered Accountants in England and Wales’ (ICAEW) Competition and Choice working group set up under the then Department of Trade and Industry, which then evolved into the Financial Reporting Council’s (FRC) project on the same issue. I am a past member of the Governing Council of the ICAEW and an investor, an FSA registered fund manager. I am the Investment Management Association nominated representative on the Urgent Issues Task Force of the Accounting Standards Board (ASB). I have analysed banks in particular since 2006.

The supplementary evidence covers:

1. (1) & (2) a memoranda relating to a standard setting committee to be held on 29th September 2010.
2. (3) a maths based summary of what is not audited with IFRS (for a bank—its prime risk in fact).

Investor Briefing Note

1. IFRS is imprudent (not allowing loan risk sensitive bad debt provisions—IAS 39).
2. The EU only required IFRS for the consolidated accounts of listed groups. Most EU states did not use IFRS in banking companies (ie banking companies used pre-IFRS prudent accounts).
3. Ireland and the UK (and Iceland, which is an EU affiliated EEA state) allowed IFRS for use in banking companies. This may result in significant problems in banking companies, by affecting capital, profits and behaviour:
   (i) understating risk by overstating loan values,
   (ii) understating the cost of lending, leading to risk mispricing and hidden capital destruction,
   (iii) creating artificial (temporary) profits, and pay and bonuses,
   (iv) even deferring losses when they do arise (by not classifying escalating payment rollovers as impaired debt),
   (v) overstating capital at the same time as hiding the ongoing destruction of it (frustrating whatever level of capital Basle I and II sets).

(Applying IFRS at only group level, where banking companies still produce proper prudent accounts, does not affect banking company margins, behaviour or capital, it may have a relatively minor impact on bonuses to the extent that these are based on group numbers).

4. The most systemic (non-investment) banking failures in the EU/EEA have been in the UK, Ireland and Iceland, those states where IFRS was used as the accounting system for banking companies. The USA used a similar model.
Northern Rock, HBOS, Bradford & Bingley, London Scottish Bank, Cattles plc (a non-bank), Allied Irish, Anglo Irish and Bank of Ireland, all collapsed, with similar symptoms, lower provisioning levels with seemingly higher (temporary) profitability. As did Landsbanki, Glitnir and Kaupthing.

5. IFRS were first used from 2005, from which point there is a distinct increase in the inflation of house prices in the UK and Ireland (source HM Land Registry UK, Ireland Financial Times, September 2010). Seemingly profitable banks (due to an accounting illusion) were attracting more and more credit to lend, and appearing to generate capital, increasing the capacity to lend, a Ponzi/pyramid effect.

6. However, the law in the UK and Ireland goes further than IFRS requires. Company Law requires accounts reliable for the purpose of creditor (and depositor protection). Some banks appear to have applied the law fully rather than IFRS-only, and not got into the same difficulty (or “fools paradise”).

7. Northern Rock used IFRS from 2004 (a year early, it failed approximately a year earlier than other banks, suggesting an unchecked (IFRS driven) “burn” time of 3–3\(^{1/2}\) years).

8. However, the law in the UK and Ireland goes further than IFRS requires. Company Law requires accounts reliable for the purpose of creditor (and depositor protection). Some banks appear to have applied the law fully rather than IFRS-only, and not got into the same difficulty (or “fools paradise”).

9. This paper for the UITF, to minute, will form a proposal be taken to the full Accounting Standards Board for 12 October 2010.

28 September 2010

UITF (Urgent Issues Task Force of the Accounting Standards Board), Memo for a Minute, 29 September 2010.

Company law individual accounts and IAS (IFRS) individual accounts

1.1 ICAEW/ICAS guidance on the law, under counsel opinion, states that prudence applies as a fundamental valuation objective for companies individual accounts, whether their accounts are Companies Act accounts or IAS Accounts.

1.2 The law post-IFRS is intact in the statute (and common law). The main relevant change to the Companies Act, for IAS individual accounts, was to require that the use of IAS accounts was stated in a note to the accounts. The preparation rules (“form and content”—for large and medium sized companies including banking and insurance companies) remained as Schedule IV to the Act. These rules include the fundamental valuation principles from the 4th Directive which includes prudence in valuing assets and liabilities.

1.3 The ICAEW guidance states that compliance with the Companies Act for the purposes of section 837(2) (capital maintenance and distributions) requires complying with the fundamental principles, notwithstanding IFRS requiring otherwise. Prudence may be overridden for accounts to give a true and fair view, but, prudence is still a matter for compliance with the Act. Hence, prudence must be applied in valuations and then the numerical impact of dis-applying it disclosed in the accounts so that the directors discharge their duties under Section 837(2) and prepare accounts properly. The audit opinion post-IFRS remained “two part”, and required a true and fair view in accordance with IAS (or Companies Act accounts) and compliance with the Companies Act.

1.4 However, the Financial Services Authority and Financial Reporting Council in a Discussion Paper (DP 10/3), dated June 2010, in observing valuation practice in some banks’ accounts states that “UK GAAP” (ie Companies Act accounts with FRS 26) does not require prudence. That statement it incorrect if it relates to company individual accounts. It does not accord with the ICAEW advice, indeed were it correct the UK would be in breach of the 4th Directive. The DP also states the same in the context of IAS accounts (using IAS 39), if that is in the context of individual company accounts, then again, that statement is inconsistent with company law.

1.5 There is a problem with FRS 26 which needs to be corrected with guidance for IAS 39. It would appear from the scale and frequency of bank failures in the UK and Ireland that risk has gone unaddressed in banking companies using FRS 26/IAS 39.

20 ICAEW/ICAS TECH 07/03 and TECH 02/07 (the final form of TECH 21/05)
21 TECH 07/03 para 6, 7 & 39, TECH 09 para 4.18
Capital, and profits, the problem when IFRS is used in companies especially banks

Basic position (compliance with the accounting rules of Company Law—IVth Schedule)

If a company is Net Assets N, Capital, C, and distributable profits D.

then, \( N = C + D \) (ie the balance sheet).

if D is paid as a dividend, then the position is \( (N - D) = C \)

Given that D is cash or borrowings, what remains as capital (residual net assets less cash, or with more gearing), must be sufficient for capital maintenance purposes (Section 830 to the Companies Act) to cover the capital. “N” is valued with sufficient hardness for that proposition.

Section 837(2) and (5) sets audited accounts quality to that numerical position + going concern. Profits are the increase in the company’s assets on that basis.

True and fair override (“prudence plus”)

If the True and Fair override is used to inflate the balance sheet by an amount “t”.

\( t \) is an imprudent addition (unrealised profit/revaluation reserve etc, or an omission of a loss).

Applying that to the above:

\[ N + t = C + D + t \]

If D is paid as a dividend, then the position is \( N - D + t = C + t \)

Capital is maintained. And capital ratios can be calculated. “t” is not distributable in law and is prevented from being distributed.

Pure form IFRS (“value is all—don’t worry about prudence”)

If \( t \) is not disclosed then \( N + t = T \)

and \( T = C + "D" \) (where \( t \) is not disclosed or audited)

\( t \) = the ability to over-lend (inflating capital), to overstate profit (bonuses and tax), dividends (depleting capital) and the ability to misprice credit and over-trade. A particular problem in banks and in contracting companies (overvaluing assets).

\( t \) = “to know what the capital or distributable reserves is a case of pin the tail on the donkey” = unaudited risk.

Memorandum by Independent Audit Limited (ADT 12)

1. Thank you for your invitation to give evidence to the Enquiry of the Select Committee on Economic Affairs into the above topic.

2. Independent Audit Limited provides clients with independent assurance and advice on matters relating to corporate governance, risk management and compliance assurance, ranging from board and audit committee effectiveness to the effectiveness and value for money of their external audits. We have expertise in financial statement auditing but do not undertake such audits ourselves.

3. Concentration of the audit market on the Big Four firms is most apparent in certain sectors, particularly listed companies and financial services organisations. The audit market for private companies, especially smaller ones, is very different, with much more competition, and is not addressed by this paper.

4. There has been no systematic evidence of audit failure relating to the recent financial crisis and in our view it is mistaken to seek to blame individual auditors for not having helped to prevent it. It is true that they did not seem to see it coming, but sadly they were not alone in this. Very few people saw the crash coming, and even those who did could not predict its timing. Auditors fell into the same trap as most of the rest of us, including those charged with economic policy and regulation of the financial services industry. And while it is true that audited accounts failed to draw attention to the stresses building up in the financial system, this is a failing not of individual audits but of the system within which audits are performed.

5. Criticism of auditors for their role in the financial crisis, or rather their absence of role in preventing it, seems largely to arise from a difference in expectations between those of the critics and those of the profession. Some of the critics seem to look to auditors to protect society from the ravages of capitalism, and their views, although usually expressed with eloquence and vigour, are perhaps better considered in a forum other than the present one.
6. A more significant, albeit sometimes less dramatically communicated, body of criticism originates from people who do not wish to change the nature of economic society but whose expectations are that audit will increase their understanding of management effectiveness, financial strength and business model resilience. The audit profession generally fails to meet these expectations and it is not immediately obvious to those outside the profession that this is because the expectations are fundamentally unreasonable. Once again, however, this is not the fault of individual auditors but of the system within which they have to operate.

7. The system of audit is characterised by a number of very distinctive features, which are to a large extent interdependent. These include:

7.1. “Clean” audit opinions have very low information value. Most of the words in them are standard boilerplate and are devoted to explaining what the auditor has not done and cannot be held responsible for.

7.2. The words in a clean audit opinion are usually identical regardless of the degree of risk in the financial statements and the extent of rigour in the audit. They contain nothing to identify a good audit that has licked poor accounts into shape so that they have come to deserve a clean opinion. A qualified audit opinion has higher information value than a clean opinion but is not evidence of a more rigorous audit.

7.3. The most significant piece of information in a clean audit opinion is the name of the audit firm. In the absence of any other information about audit quality, readers trust well-known brands.

7.4. Many investors show little interest in the technical relevance of the audit, instead acting as if much of the most useful thing to them is their ability to sue the audit firm for very large or even unlimited amounts in the event of the company’s accounts proving to have been misstated. This, together with a presumption of quality, leads them to favour the big brands.

7.5. The same predisposition can be seen in lenders, whose practice, if not their official policies, is often to require borrowers to appoint one of a short list of large audit firms. The evidence for this is largely anecdotal but there seems little reason to doubt that it occurs.

7.6. The widespread perception that investors and lenders favour the large audit firms discourages audit committees from appointing smaller firms. For an individual audit committee there is little to be gained by taking the risk of departing from the safe option.

7.7. In the same way, the widespread perception that the Financial Services Authority has a preference for large audit firms means that financial services organisations have a marked tendency to play safe. While the FSA has no official policy of favouring the large audit firms, it does little or nothing to dispel the widespread perception to the contrary, nor to encourage greater competition in this sector of the market.

7.8. Auditing standards impose a largely similar process on all audits. While the firms make brave marketing efforts to differentiate their audit services, underneath the decorative trappings each must employ much the same approach as required by the various professional and regulatory bodies who govern their practices.

7.9. The economic model of the profession is that a small number of partners profit from work carried out by a much larger number of employees. A high proportion of an audit firm’s staff are trainee or recently qualified accountants. They have knowledge of accounting standards and audit process but little experience of business and even less of management. Rules aimed at increasing the public’s perception of auditor independence have had the side-effect of restricting auditors’ wider experience.

7.10. Auditing standards reflect this state of affairs and are translated by the audit firms into methodologies which can be completed by inexperienced staff under the supervision of a smaller number of experienced auditors. The process required by auditing standards is one which places a very high premium on the completion of satisfactory documentation as evidence that an audit has been completed and this is reflected in the firms’ and the regulators’ approaches to quality assurance.

7.11. Documentation tends to become an end in itself (an assertion supported by academic as well as much anecdotal evidence) and is not necessarily well correlated with what constitutes an effective audit.

7.12. The purpose of a financial statements audit is defined by law and regulation in very circumscribed terms, being to give an opinion on whether the financial statements give a true and fair view and comply with accounting standards. Much of the public expectation of audit lies beyond this tightly defined and largely historical purpose, and is therefore doomed to disappointment unless auditors choose to go beyond their remit. From the individual auditor’s point of view there are few good reasons to do so, and many very good reasons not to. Liability is the most obvious one, but it is also the case that while audit firms are very well equipped to examine compliance they are much less well equipped to form a view on the subjective and sensitive topics that lie outside the financial statements remit. This is especially the case where the opinions have to do with uncertain future events of which a global liquidity crisis is the most extreme recent example.
7.13. Financial statements are essentially backward-looking and contain only limited information about other matters for which there is public demand. Information about the risks inherent in a business model, for example, is largely forward-looking, and to the extent that it is to be found in an annual report it will be in the narrative section which is not subject to audit.

7.14. Accounting standards have become much more complex and prescriptive. Although enthusiasts and the uninformed pronounce that IFRS is principles-based rather than rules-based, this assertion defies common sense. No statement of principles should be measured in thousands of pages.

7.15. IFRS can introduce a high degree of subjectivity into financial statements through accounting procedures that sometimes require a great deal of estimation, so audit judgement is required in relation to detailed calculations. However, the self-referential declaration that a true and fair view is achieved through compliance with these standards serves to reduce professional judgement in relation to the overall picture. Whether the accounts are “right” is reduced to compliance with the rules.

7.16. Regulators and lawyers generally attach considerable importance to documentary evidence of compliance with standards. Audit firms seek defence in documentary evidence of completion of audit steps or by reference to accounting standards which relieve them of responsibility for outcomes. Not unreasonably, there is a very strong defensive motivation to avoid taking positions which can be only unreliably defended by reference to subjective notions such as “right and wrong”, “true and fair” or “professional judgement”.

7.17. An increasing proportion of time spent by auditors is spent on checking compliance with the increasingly voluminous accounting standards and documenting the audit process. This contributes to the cost of audit without necessarily providing a great deal of real value.

7.18. Knowledge of how these complex standards are elsewhere applied is a commercial asset to audit firms, and one which increases in value with scale. Larger firms have much more valuable knowledge of practice, as well as the capacity to commit more resources to specialist technical roles. Any new entrant to the audit market would need to invest very considerable amounts in acquiring this knowledge and developing technical expertise.

7.19. The increasing burden of regulation on audit firms and the commercial benefit of scale in accounting expertise together create a strong rationale for yet further consolidation in the audit sector, while discouraging fragmentation and increased competition. The reason consolidation is rarely seen in practice is that, as private partnerships, audit firms are usually reluctant to give up their independence.

7.20. It is sometimes argued that increased competition could be introduced through forced fragmentation—breaking up the large firms. This would be immensely difficult to do within the existing system (for example, how do you break up a large UK firm into pieces that can function effectively without also breaking up its international network, which is not within the UK’s power?). And given that all the other pressures within the system are for scale and consolidation, it is not self-evident that forced fragmentation would have a net beneficial outcome.

7.21. Audit firms compete very vigorously when audits are put out for tender. However, for what are usually good reasons this happens only rarely. A change of auditors might bring a fresh point of view but it also brings ignorance, and there is some evidence that the temporary disadvantage of the latter outweighs the equally temporary advantage of the former. In years when there is no tender, the fact that there is limited market competition is largely irrelevant since price is set by negotiation, usually using the previous year’s fee as a reference point.

7.22. When an audit is put out for tender, the audit firms will compete vigorously on price and on quality of service to management, but not in practice on the quality of audit. Because of the role of auditing standards and regulation, their differentiation over the quality of the audit service is restricted to peripheral matters and “froth” which clients usually disregard.

7.23. Some aspects of service to management are disguised as contributors to audit quality. The most significant of these is the large, well-integrated international network. This is something that multinational clients appreciate, since it simplifies the management of the audit process and gives access to useful resources that can be deployed when and wherever the need arises, within the constraints of the auditor independence rules. It would in fact be perfectly possible to conduct a quality audit of a multinational company without such resources but this would be contrary to the presumptions of auditing standards, the economic interests of the international networks of audit firms and the convenience of management. Instead, the presumed need to have such a network is allowed to remain a very significant barrier to entry into the large company audit market.
8. This is far from an exhaustive list of distinguishing features of audit market, but it is enough to show the nature of the systemic problem with audit. Auditing and accounting standards; the business model of audit firms; the liability regime; the individual interests of investors, lenders, management and audit committees; these and other features all work together to give us an system which favours consolidation and discourages innovation and competition, and whose output is increasingly what might be labelled as “compliance” with a reporting regime which meets the public’s expectations to only a partial extent.

9. The audit partners and staff who work in this system are, with only rare exceptions, conscientious, diligent and highly skilled professionals who seek to make the system work, and are rewarded for doing so. It is no criticism of them to observe that the system fails to achieve what those outside the system would like it to achieve. In fact, criticising auditors or individual audits undertaken within the present system distracts attention from the real issue, which is the inadequacies of the system.

10. Of the separate features of the system summarised above, there is no single one which dictates its overall character, nor is there a clear-cut chain of cause-and-effect. The different features fit together and support each other, and the system functions as a whole. Consequently, it is hard to see how incremental adjustment to individual features will succeed in making significant change to the system. Reform of the liability system and control of restrictions in bank covenants are probably the most immediately helpful things that could be done, but even these are removal of barriers rather than positive inducements to change.

11. Moreover, there is a long history of unsuccessful attempts to improve the situation from within. For example, the “expectations gap” between what the public want and what auditors do has been around for as long as auditors can remember. Despite the profession’s heroic efforts to educate the public to want less, the gap remains. And attempts to improve regulation by doing more of the same have made things better in some respects and worse in others.

12. The regulation of audit and accounting is increasingly international and the features of the audit system described above are broadly similar in all major jurisdictions. This provides a further constraint on the UK’s ability to achieve significant change through adjustment of the present system. So while it might be tempting to suggest, for example, that matters could be improved by a transformation of audit regulation, this would be at least a lifetime’s work if it had to be done on the international stage.

13. When the system of audit is looked at in the round in this way, if leads to the conclusion that if, as a society, we wish to see audit move away from compliance and contribute more to economic stability by increasing public understanding of and confidence in matters such as the quality of management and the sustainability of business models, and if we wish to see a market which encourages rather than discourages new entrants and innovation, we must consider radical options that could be implemented in the UK without needing international agreement. For example, any or all of the following:

13.1. Leave the financial statement audit regime largely untouched and consistent with international practice, thus avoiding getting drawn into international dispute. Meanwhile, in recognition of the fact that the expectations gap relates largely to qualitative and forward-looking information, develop the requirements for narrative reporting by UK listed companies and other public interest entities, with a view to reducing, if not closing, the gap. This narrative reporting should be audited, but not by the financial statement auditor. The audit’s output should be a long-form report giving a qualitative commentary, rather than a “yes or no” opinion. Liability should be much restricted to encourage effective communication around difficult issues for which there is often no clearly right or wrong answer. Regulation should focus on ensuring that the quality of this review was apparent through the content of the report. This framework would create a new market in which innovation and specialist smaller firms would be able to flourish, so long as the visible quality of their work justified it.

13.2. Remove the statutory requirement for companies to have a financial statements audit and instead increase the requirements for boards to explain how they have ensured that they are giving a good statement of account to their shareholders. One of the problems with audit is that the duty of auditors is to report to the shareholders on the board’s statement of account but they are in practice appointed and overseen by the board (the principal/agent problem). Without a statutory audit to muddy the waters, shareholders should increase their emphasis on the accountability of directors. In many cases, this could be expected to result in boards choosing to appoint auditors for their own protection. Auditors would thus be appointed by the beneficiaries of their work, who would also be those best placed to monitor its quality. If investors felt strongly enough about it, they could form a shareholders’ committee to appoint and manage auditors on behalf of all shareholders (with audit fees to be paid by the company and reported in the same way as dividends, and liability negotiated under contract). This proposal would have the additional benefit of mitigating the consequences if a large audit firm were to withdraw from the market.
13.3. Distinguish the audit of consolidated accounts for shareholders from the local audits of statutory accounts of subsidiaries, by prohibiting the group auditor from acting as the auditor of all but the most material subsidiaries. This would have two benefits: it would remove a barrier to entry by luring away the perceived need to have a well-integrated international network, and it would force the auditor to address a multinational company’s financial reporting by reference to how well it is managed in the context of the risks arising from its business model, rather than on its compliance with accounting standards around the world.

14. This is far from a complete review of the wide range of topics covered in your request for evidence, but we hope it is sufficient to make the case that improving our system of audit will not be achieved by tweaking it. It has been tweaked at regular intervals for decades and the outcome is always to make the present system work better on its own terms. If we wish to make it work well on different terms, terms which are better fitted to the present needs of society, then we need to be willing to think outside the present system.

24 September 2010

Memorandum by Mr Stephen Kingsley (ADT 13)

This note offers views on some of the issues raised in the Call for Evidence published by the Select Committee.

1.1 A little background. Four firms currently dominate the auditing business globally and, between them, would appear to have over 250,000 employees dedicated more or less exclusively to audit and assurance, generating approximately $46 billion in fees. These figures are based on data drawn from the firms’ websites. Auditing is a thus big and costly business. Unquestionably, stakeholders in the corporate sector, whether investors, lenders, employees, tax authorities or regulators, need to be able to rely on the financial information that they receive. So, when analysts and others look at financial information provided by corporates, they need to believe that what they are looking at is complete, accurate and fairly presented. The notion that an outside expert has examined this information with these criteria in mind ought to give them the comfort which they seek. The question is—does it? Put another way—we all want to see truth and fairness in corporate reporting, that they receive. So, when analysts and others look at financial information provided by corporates, they need to believe that what they are looking at is complete, accurate and fairly presented. The notion that an outside expert has examined this information with these criteria in mind ought to give them the comfort which they seek. The question is—does it? Put another way—we all want to see truth and fairness in corporate reporting,

2.1 What is the purpose of auditing? Statutory auditing seems to have become formalised in early English company legislation which, by creating joint stock companies, recognised the separation of management and ownership of businesses, and allowed external capital to be provided by people who would have no direct line of sight to the business that they were funding. To compensate for this, the concept of the mandatory statutory audit emerged as way of providing assurance to shareholders as to the truth and fairness of management’s account of the way in which their money had been put to use. This concept has been developed over the years so that we now have reports and accounts, accounting principles, and a persistent attempt to create some global consistency in the way companies account and report on their operations so as to mirror the globalisation of the market for corporate capital. The statutory auditor has played a key role in this process and, almost everywhere, is a mandatory element in the corporate reporting process.

2.2 Indeed, their role and responsibility has been widened as the reach of regulation has itself widened. For instance, financial institutions have detailed regulatory reporting responsibilities which often require the intervention of external auditors. Furthermore, the supervisors often rely on external auditors to perform inspections.

2.3 There are, or arguably should be, stakeholders in the audit process other than shareholders and regulators. A case could be made for the formal stakeholder group to include lenders, creditors, employees and the tax authorities.

3.1 Does auditing meet these needs? Does the status quo drive companies and their auditors to do the right things? External auditing involves the transfer of responsibility for the accuracy and completeness of financial information from management to an independent expert. But the transfer is not complete, as a quick scan of a typical audit report will confirm. The extent to which responsibility is transferred and, therefore, the extent of auditor liability for errors and omissions, is a grey area. From time to time, this gets to be tested in the courts. Most often, however, it is settled behind closed doors—which means that the uncertainty persists. There is also uncertainty about who is entitled to rely on information signed off by statutory auditors. The result is confusing—both for the audit firms and for stakeholders.

3.2 As accounting and reporting rules have proliferated, compliance with these requirements has become both technical and challenging. Managements understandably consult with the auditors on such matters since they are the experts. Equally, it should be understood that this is accounting and not auditing—and there is a big
difference. Two problems arise. First, there a clear potential for conflict here since the auditor now “owns” the answer rather than checking it. Secondly, the burden of compliance with these requirements is such that the balance between ensuring compliance and “real” auditing is now likely to be wrong.

3.3 Where management has put together a comprehensive and accurate set of financial information and where “there is nothing to hide”, external auditing is relatively straightforward and is unlikely to add a much value. External auditors are really needed when management does have something to hide, and where the truth has either been massaged or masked. Unfortunately, auditors are near-defenceless where management is intent on deceit and is sufficiently competent to cover its tracks. Indeed, the extensive caveats in their contracts and their reports tend to support this.

3.4 Management may feel that the auditor can and should be blamed when accounting and reporting issues surface. We should remember that it is management’s responsibility to prepare financial information—as audit reports make very clear—so management really needs to be fixed with the responsibility of any material errors, particularly if these are deliberate. The very existence of the external auditor helps to blur responsibility for external reporting.

3.5 Corporate accidents—frauds and insolvencies—often result in assertions that the audit “went wrong”, and thus lead to action against the auditors, mainly because they have deep pockets. When this happens, audit firms act as de facto insurance companies and yet, ex ante, do not operate like insurers. If they did, they would likely be much more differentiated about the audits that they did, the scope of their work, and what they charged.

3.6 The result of all of this is the so-called “expectation gap”. This is the difference between what auditors think they do and what outsiders think auditing means—and the debate about it has been going on for at least the last four decades. If anything, the gap has increased over that time.

4.1 Perhaps the concept of auditing is flawed and should be debated? Some of the preceding arguments might suggest that the concept of auditing is inherently flawed and that the perhaps 150 year-old experiment with statutory auditing should be closely examined. Why has this debate not taken place, despite the unsatisfactory status quo? External auditing provides a valuable “tick in the box” for all kinds of users—analysts, rating agencies, shareholders, bankers, trade creditors and tax authorities to name but a few. Changing what has become a globally accepted regime would require agreement from the key jurisdictions (US, EU, Japan)—and that is unlikely to happen any sooner than the emergence of a contender to challenge the domination of the Big Four. Instead, much of the debate around statutory auditing tries to deal with two different problems—the lack of competition to the Big Four and auditor liability. Whilst it might be interesting to introduce more firms into the global auditing game, I doubt that it would change the dynamics that I have described. In any case, given the enormous barriers to entry, introducing a new competitor would be a real challenge. As for auditor liability, lack of limitation clearly concentrates the mind and does not seem to, of itself, have led to the collapse of any major firm—including Arthur Andersen. At best, it seems to be a peripheral part of the problem.

4.2 Issues of competition. It is received wisdom that competition is a “good thing”. It should ensure that customers get fair prices, high quality goods and services, and benefits from innovation. On the face of it, the market in statutory auditing of large corporates is a four-firm oligopoly. As a result, there is only one company in the FTSE100 which is not audited by the four firm group. Others can comment better than I on whether customers are damaged in consequence. It is clear, however, that it will be really difficult to widen market access. There seem to be a number of simple reasons for this:

(1) Audits change hands very infrequently.

(2) Much of the selection process is in the hands of Big 4 alumni who, apart from anything else, are possibly loath to deal with what they see as an unknown quantity.

(3) An enforced break-up of the Big $ is likely to prove practically very challenging.

(4) The aspirant firms, of which there are perhaps one or two, have neither the experience, personnel or footprint to deal with many of the complex international companies.

4.3 It may therefore be more pragmatic to “accept” the oligopoly and to introduce some new thinking into the way it operates.
What can be done to improve the status quo? Here are three ideas:

**IDEA #1**

5.1 The culmination of an auditor’s work is the audit report. Whilst audits may be a mandatory requirement for listed companies and regulated financial firms in most jurisdictions, the wording of the audit report is something which is largely left up to the profession. This, in my view, has a number of undesirable consequences:

(a) The length and complexity of wording of the reports has increased.
(b) The reports contain somewhat arcane phrases like “true and fair” (in the UK) and “presents fairly” (in the US) the precise meaning of which is not clear to most readers and which has all too often had to be tested in the courts.
(c) It leads to “box ticking”.
(d) The gap between what we all think auditors do and what they think they do is allowed to persist.

5.2 It is worth focussing on this last point about reporting. The latest manifestation of the problem is in the report by Mr Valukas on the demise of Lehman. One easy step that could be taken to increase usefulness and close the expectations gap starts by recognising that auditing is a public service and that what auditors say about their work is a matter of public interest. It should follow that users, via the relevant authorities, should state what they want auditors to say in their reports. What the reports could say about the accounts might include comments about:

1. Accuracy and completeness.
2. Compliance with applicable accounting and reporting standards.
3. Whether they “make sense”.

5.3 This last point is both new and key. Accounting and reporting standards have been, and will continue to be, arbitrated by exploiting loopholes or inconsistencies. Indeed, the larger the rulebooks, the likelier this is to happen. This is not to say that this happens all the time or that everyone does it, but it does happen. It can lead to accounts being technically compliant but nevertheless not making much sense in terms of reflecting reality. Insisting that auditors say whether or not the accounts make sense would lead to better balance between the application and application of judgement, and should serve to make their work much more useful.

5.4 As is inevitable with any system founded in statute, and in line with developments in other areas of society, external auditing has become increasingly based on rules rather than principles, reducing the need to apply judgement and experience, to the possible detriment of quality.

5.5 There is a further point here. Standards governing both accounting and reporting have, particularly over the last few years, become more and more complex. The process of standard setting, whilst not controlled by the large accounting firms, is certainly capable of being influenced by them. The increasing complexity seems to have led to a position where, for many companies, the accounts are becoming incomprehensible to most readers. Perhaps worse yet, some of the more recent developments in accounting standards are controversial and seem to have unintended consequences—fair value accounting comes easily to mind in this context. This suggests a rethink and perhaps a move back towards simplicity.

**IDEA #2**

5.6 Accounting is, in some senses, the reconciliation between corporate imperative and economic reality. The auditor’s role in this process is to ensure that this reconciliation is fair and follows the rules. Managements, quite understandably, sometimes get caught on the wrong side of this reconciliation and seek to take evasive action. Part of the answer may be to make more serious the consequences of being detected. There continues to be a significant blurring of the line between the respective responsibilities of management and auditor. It is normally the case that an auditor stands little or no chance in the face of management intent on deceit. If this position is accepted, then the response needs to be a more rigorous and unambiguous treatment of managements who deceive.

**IDEA #3**

5.7 There are some fundamental differences between auditing and everything else that the firms do. This is because auditing should not be about advice; it should exclusively be about an objective assessment of someone else’s work. Moreover, the real client is not the enterprise being audited or its management; it is the external stakeholder group—shareholders, creditors, regulators and so on. The audit committee is an attempt to enfranchise this group but is unlikely to do so effectively. In a very real sense, auditing is a public service
and the organisations that deliver such a service need a culture which corresponds. The rest of what the firms
do is, for the most part, not like this, and requires a different culture. Managing these two cultures within the
same organisation is, in my view, a serious challenge and one which, if not handled properly, creates the risk
of conflicts of interest. This in turn can dilute the healthy scepticism with which auditing should be conducted
and the consequent willingness to deliver “bad news”. This line of argument might point towards the
mandating of “audit only” firms.

THE AUTHOR

6.1 Stephen Kingsley worked in the financial services practice of Arthur Andersen for thirty years, latterly as
head of the firm’s global practice. He is currently a senior managing director in the London office of FTI
Consulting, a global expert services firm. He is also a non-executive director of the Co-operative Financial
Services Group. The views expressed herein are those of the author.

September 2010

Examination of Witnesses

Witnesses: Mr Jonathan Hayward, [Independent Audit], Mr Stephen Kingsley, [FTI Consulting], Dr
Gunnar Niels, [Oxera], and Mr Timothy Bush.

Q83 The Chairman: Gentlemen, good afternoon and
welcome to the Committee. Before we start hearing
evidence, as I was unable to attend our first meeting
I just wanted to make a declaration of interest, which
I think probably applies to most people, as a director
of a number of companies, all of which are listed in the
Register of Members’ Interests. All of those
companies are audited by members of the accountancy profession. I think that is a blanket
cover.

This week’s witnesses are consultants. Three of those
who are with us this afternoon have already
contributed written evidence and the fourth, Dr
Niels, is from Oxera, which has published influential
reports such as Competition and Choice in the UK
Audit Market. They may be a bit livelier than last
week’s spokesmen for the professional associations.
We shall wait to see.

I will take the first question and then pass to my right.
I am taking the chair today in the absence of Lord
MacGregor, Chairman of the Committee. Copies of
any other Members’ interests have already been
declared and are shown in the Register of Interests.
Two Members of this Committee, Lord Currie and
Baroness Kingsmill, are not taking part in this
inquiry.

You are all very welcome and thanks to those of you
who have already supplied written evidence. I would
be grateful if you could kindly speak loudly and
clearly as this session is being webcast, and for the
benefit of the shorthand writer. When we reach the
questions we will be happy, in order to save time, to
take silence from the other three of you as agreement
with the first to speak, but if you disagree please do
not hesitate to say so.

Would any of the four of you like to make an opening
statement? If not we will go straight to questions.

Dr Niels: Just very briefly, if I may. It’s a pleasure to
be here. As you have mentioned already, I directed
Oxera’s work for the FRC and the DTI and also the
study we did later for the European Commission. I’m
hoping to help the Committee this afternoon with
insights on the topics covered by those studies,
competition and choice, in particular the
microdynamics of how competition and choice in the
audit market work. I’m probably less well placed to
comment on some of the other topics that you cover
in the inquiry.

Q84 The Chairman: Thank you. I will take the first
question and then I will pass to my right and we’ll go
round the table. The question I would like to ask you
is—and I see this sitting on the board of a number of
companies—there seems to be a view that only the
mega audit firms with huge background knowledge
and deep competencies are really able to audit
companies, say in the FTSE 350. Do you consider
that is overblown? I think it would be very helpful to
the Committee if you could let us have your views
on that.

Mr Hayward: I think it is overblown, certainly, and I
can answer it in two parts. Within the FTSE 350 there
are some relatively straightforward companies.
Property companies are a case in point. Even FTSE
100 property companies are, as organisations,
relatively small. They may have huge balance sheets,
but in terms of the number of people they employ and
the amount of activity that goes on they are not big
organisations. They tend to be largely domestic.
Medium-sized audit firms have plenty of experience
of auditing property companies; they would be able
to audit those companies. However, no audit
committee chairman of a FTSE property company
that I know of is particularly interested in changing
to a medium-sized audit firm because there is lots of
downside and no upside for an audit committee in
doing that. That example is the easy one. If any
companies were going to change it could be those, but
they don’t.
Less obvious are the multinational companies with more complex businesses, where again, I think, the dependence on a large international network is overstated. It arises because of the presumption, which is now embedded in the system of auditing, that a multinational audit will be done by auditing all the separate statutory entities around the world and adding up the results. That was a very good way of doing an audit when accounts were written down and then sent by steamship to head office in London, but in days when companies run an SAP system that manages data all over the world it’s obsolete. Companies need to manage the way they operate globally in a different sort of way and it is perfectly possible to audit a company by working through the way in which it manages and evaluating whether or not it actually has a decent grip on the information within the business. That would be perfectly possible and it would mean that a different resource model could be employed. You would require fewer but much more expert auditors. It’s only the fact of doing statutory audits all over the world which means that you require lots of statutory auditors in all jurisdictions. You then end up with a situation where having those auditors available to management is very useful to management because it’s a resource pool that is available for them to call on when required.

So what we have now is a system that works quite well. It suits the audit firms, it suits the management and it usually gets the right answer, but it is not the only way in which you could audit a large multinational company and other ways do not require those resources.

Mr Bush: I am slightly concerned that the regulatory regime itself might overly identify with the larger firms and therefore by default squeeze out some of the competencies that are in smaller firms. Certainly when I qualified there was effectively a Big 10 and some firms that were quite small specialised in certain aspects of insurance; my firm I trained with, Ernst & Whinney, audited very large banks. I think there is a regulatory sense that big is best and I have an example that I think is quite interesting of a small firm in Belfast that I don’t think was subject to a very strict regulatory regime that is effectively forcing auditors to follow standards even if they disagree with them. So I think that there are some issues between the best way of delivering what the law requires and what some of the standards are giving. That is a bit of problem.

Dr Niels: On that question of the mega audit firms, 90% of the audit committee chairs that we surveyed thought that the mid-tier firms were perfectly technically capable, but if you then look at the three main products that in essence audit firms offer to the companies that they audit there are three aspects and on each of these three the Big Four have perceived or real advantages over the rest of the market. The first one is the technical audit itself where it is often perceived that, especially for the larger companies, you do need the international coverage, the depth and the sector knowledge, so they are better placed than the smaller firms. The second aspect is the value added services over and above the audit itself. That is a service highly valued by the audit committee chair and by senior management, and again the perception is that the Big Four are better placed, capable of providing those services. And then the third one is, of course, the reputational advantages of having a Big Four as your auditor, which you have discussed already at previous meetings. Again, that is where the Big Four have this advantage over the smaller firms.

The Chairman: Mr Kingsley, did you want to add anything else?

Mr Kingsley: No. I shall adopt your silence protocol, on this one anyway.

Q85 Lord Lawson of Blaby: My greatest concern in this area is over the auditing of banks, to which I know that Mr Bush in particular has given a lot of thought. Reflecting on what we’ve been through with the banking meltdown, it has been discovered that banks were either taking excessive risks or they were taking risks they didn’t understand or they were taking risks that they thought they had laid off, either through securitisation or through insurance and in fact they hadn’t. It was a complete mess and it has been a major cause of the difficulties that the world economy and the British economy are in at the present time—not the only cause, but a major one. So I have some questions and I think your answers will be very helpful to us.

The auditors were the dog, or one of the dogs, that didn’t bark. Was this because they were unaware of the problems that I’ve just mentioned? If so, what have you to say about that? Were they aware of them but they were not required by law to make anything of it? Did they nevertheless privately warn the management and the boards of these banks of their concerns, even though they were not required to do anything on paper or publicly? If these auditors who were disquieted warned the board and the management and they didn’t feel that the board and the management were taking sufficient notice of what they were saying, did they say to the regulatory body,
for example, “I’m worried about this practice that’s going on. You might like to look at it”? If not, why not? Did confidentiality, as it were, trump the wider public interest? I’m sorry to ask so many questions but they’re all interconnected. Finally, what changes, if any, would you think would be sensible in the public interest to enable auditors in future to be a dog that does bark?

**Mr Bush:** To answer the question on whether they spoke to regulators, all I’m aware of is that I think in the Banking Act there was a requirement for auditors to have a conversation with the regulators. I think that was the 1987 Banking Act.

**Lord Lawson of Blaby:** It was. It’s the Act I introduced. That’s right. That’s why I’m particularly interested in it. I hoped something would come of it but it doesn’t seem that it did.

**Mr Bush:** I think it disappeared from the Financial Services and Markets Act 2000. That said, I think that the biggest factor has been the loss of prudence in accounting standards. The principle of prudence was put in the law to protect the creditors so that when a company makes a distribution, or basically operates, the creditors aren’t left with a bag of poor assets and therefore every asset should be valued on a reduce-to-cash basis. There are several problems with IFRS; I’ll give just two in respect of prudence. First of all it has a bad debt provisioning model that is backward looking. It only requires provisioning for loans that have already shown an “impairment event”, which is a bit of jargon in the standards. It doesn’t allow you to take a forward assessment of risk and say on an historical basis, “Customers like that won’t pay X amount and therefore we reduce our loans by that much”. Therefore there is an inbuilt imprudence in the bad debt provisioning model. It went into the standard in 2003 at the last minute and then became operative within the UK and Ireland from 2005 onwards.

The same standard has also excluded the general presumption to assess and disclose contingent liabilities. So you have a double problem within that standard of assets that may be over valued and then revert to the mean. Also, not disclosing contingent liabilities is a particular problem if you have had securitisations where, say in the case of some banks, you had make good clauses between the bank and the securitised vehicle, therefore if the loans in the securitised vehicle went bad the bank had to put good assets in. That’s effectively a margin call. My understanding is that one bank that failed, initially with a liquidity problem, then had very large margin calls drawn against its securitised vehicles and I cannot find a contingent liability note in those accounts. If you look at the website you can find the word “contingent” in the directors’ remuneration report but it does not appear in the note to the accounts. So I think there is a deficiency in that standard.

That is pretty serious in itself because you’re dealing with over-valued risk on one hand and possible cash outflows on the other. I believe that accounts that miss these things out or overstate assets are falsely giving boards the green light, because it’s not just the process of getting the accounts signed off, it’s the due diligence and the work that goes into producing a set of accounts and then the board understanding their risks from reading those accounts as they sign them off. I believe that these deficiencies are a major factor in the banks that failed within the UK and Ireland. I say the UK and Ireland because the UK and Ireland is a common standards area.

By a bank failure, I categorise that as a bank that had lost 100% or more of what it had last claimed to have had as share capital and distributable reserves. There are at least eight banks that lost more than 100% of their capital, which is almost unheard of in modern times. In each case the bad debt provisioning is a major factor. I can add a ninth bank, which is an Icelandic bank operating in the UK, and for all of them the bad debt provisioning level sinks; for some of them it absolutely plunges. To reduce bad debt provisions by just 1% of the balance sheet basically increases the capital base by 20%. Certainly within Ireland you can see the lending capacity of the Irish banks taking off as the bad debt provisions are going down. The problem then gives a circular macroeconomic effect: there is more money in the economy, the collateral looks good because house prices are going up, but as we all know in the long run asset prices tend to mean revert. So I believe that that was a major factor.

IFRS, International Financial Reporting Standards, came via the EU but the EU only required them to be applied for group accounts. The UK and Ireland were relatively unique in allowing them to be used in banking companies themselves, therefore there is the possibility of absolutely no risk assessment whatsoever if companies are using that standard within banking companies. The French are using French GAAP for banking companies and banking holding companies and you can see from looking at their accounts that they are making prudential provisions. Sorry, it is a rather long answer, Lord Lawson.

**Q86 Lord Lawson of Blaby:** It is an extremely helpful answer. It is a very serious problem and you have obviously very thoroughly thought about it and made a number of interesting suggestions. I think, Chairman, it might be helpful if we could have a short note—I know you have written about them in various places—summarising the changes that you
propose should be put in place. That would be extremely helpful to us.

May I ask one last quick question? You mentioned a lot of things; all of them seemed to me to make very good sense. One thing you didn’t mention was mark-to-market accounting. Do you feel that that needs to be re-examined?

Mr Bush: Mark-to-market is quite difficult. We always had mark-to-market accounting for the most liquid positions on dealing books of stockbrokers. It’s the best way of accounting for what they do. Very liquid positions were accounted for on a mark-to-market basis I think from the early 1980s, possibly the late 1970s. What happened with IFRS was that the general presumption that you shouldn’t mark anything other than the most liquid positions to market was again relaxed to create a general presumption that you could almost value anything, not only on a market basis, which creates a problem if you have a very large volume because if you start cornering the market you can make the price of the asset go up. The EU Intervention Board used to do that and the Bank of England have done it with quantitative easing. So the problem is if you allow that as a method of recognising profit, you can make your own profit by just cornering the market. UK GAAP required a block discount if you had large holdings.

Secondly, there are a group of assets where you are allowed to mark to model, so not even marking to a market but effectively trying to guess what a market does, which I think is quite difficult because it’s very difficult for any one player to estimate what the total demand in a market is. You actually need to know how much everybody else is holding to even begin to plan. I believe that that aspect of IFRS was fairly well regulated outside of the territory of the United Kingdom because I think it was seen as a serious problem. I think it was more of a problem in the United States and it was certainly a problem in certain parts of Europe but, as we know, one major UK bank went and bought a Dutch bank where that balance sheet effectively collapsed shortly after the acquisition. So I think mark-to-market is a bit of a mixed bag. I’ve been looking at how the standards have been applied in different territories and how that has panned out.

If I may add, in my short note I think what I’m going to say is we need UK GAAP back. London is a financial services centre because it has competitive advantage in a legal framework and a trustworthy information framework of accounting standards. For some reason we decided to go for an international model that is potentially a race to the bottom and I do not see the sense in the United Kingdom giving up sovereignty of accounting standards. It’s as simple as that.

Q87 Lord Forsyth of Drumlean: My question is for Mr Bush as well and I think he may have touched on the answer at the end there. First of all, your paper is absolutely devastating. We had an earlier inquiry where we looked into the financial crisis and one of the questions that remained hovering in the air was: why did the auditors not pick this up? Why did these very clever non-executive directors not see it coming? The first part of the question was should we go back to GAAP, which you have already answered. The second part of the question is, given your analysis, which really explains why particular banks got into particular difficulties and gives a reason and points to the failures in the accounting system, why is this not a bigger issue? Why is this not a great raging debate and why is nothing being done about it? What are the forces that are preventing this being addressed, given that we are now some way out from the crisis and there has been endless analysis about it?

Mr Bush: It’s an extremely arcane area and it’s very difficult to start a conversation on the subject. Very often people will just freeze if you even start to mention it. Dare I say it, it’s a bit like Murder on the Orient Express. If you start to find who was involved there are an awful lot of people that had their go in it. It seems to have crossed various Departments of Government; various regulators seem to have signed up to it. Dare I say it, IFRS was really an idea from round about the year 2000 and I think it was a bit of a gimmick. I think it sounded good to have international standards. It sounds good, like having one model of international law it sounds good, but I think it has failed at the practical level.

I think it has also failed politically, because in my view the difficult things that have been left out of the accounting standards have been left out because they didn’t suit the American accounting profession. Things like assessing risk and assessing contingent liabilities are things that the American accounting profession didn’t want to address and that seems to have been the most malign factor in some of the standards in particular being poor.

What I found interesting in looking at the law over the years is that company law, through being connected to the DTI investigations department, had worked out all the ruses that people had got up to over 100 years and safeguards were put into the legislation. What happened in 2005 was all of those safeguards were taken out in one go. The fact this is a crisis that has been largely caused by accounting is good news because I think we can regain our faith in human beings. Most people were not stupid or greedy, they were just doing what they were told to do. I think it would be good if the narrative can move on from greedy bankers and whatever to putting the system right and accepting that people have failings but basically if you allow a banker to produce a paper profit, they will.
Lord Forsyth of Drumlean: So, go back to Old Kent Road, start again?
Mr Bush: Absolutely, yes.
Mr Kingsley: I just wanted to maybe present a slightly different view to Mr Bush's. I have been a bank audit practitioner for many years; I now sit on a board of a financial institution as a non-executive. The thing that strikes me about what has happened to accounting standards over the last 35 years is that they have become extremely complicated but they seem to be set and framed in a way that is divorced from reality. Taking fair value accounting as a very good example of that, the standard setters, almost using economic principles rather than principles of prudence and reasonable reporting, have come up with a set of standards that companies, banking companies in particular, are required to adopt. The profession has almost slavishly had to follow the guidance that has been given through these accounting standards, almost right or wrong. And so, when I was a kid there was a great store set on the truth and fairness of accounts, which could be roughly translated as, “Do these accounts make sense?” That seems to have gone out of the window—roughly translated as, “Do these accounts make sense?” That seems to have gone out of the window.

As to your dog barking, I found that intriguing. I think if we get to the stage where we have to rely on the external auditors to flag fundamental issues in banking institutions, I think we’re in a bad place. You may be shocked by that, but I think the problem is much deeper than that and you are almost asking the wrong question, as it were, because they reflect an expectation gap as to what external auditors are really capable of doing.

Q88 Lord Lawson of Blaby: Let me make clear, I did not say—
Mr Kingsley: No, I am not criticising.
Lord Lawson of Blaby: No, I am just clarifying, and you’re perfectly entitled to criticise anyway. I was not suggesting, for a moment that the only failure—if there was a failure—was on the part of the auditor. I don’t think there is any way in which auditors should bear the whole burden of reducing systemic risk, or whatever you like to call it. The question is whether auditors have a role to play. It seems, from what Mr Bush said, that he accepts that auditors could play—with the sort of changes that he was advocating—a useful role, even though, of course, there is no question that they can bear the whole burden of improving the system.

Mr Kingsley: I think you’re absolutely right, which sounds strange given what I have just said. I think the issue is that auditors are spending far too much time on trying to deal with accounting standards, disclosure issues, and all that kind of detailed stuff, and are not stepping back and seeing the wood for the trees. By which I mean that if the auditors of some of the more unbalanced banks in this country, in terms of management or balance sheet or risk, had stood back and looked at the business, looked at the people who were running at it, looked at the degree of oversight provided by the finance function, by the compliance function, by the risk function, by the NED, and so on, they might have thought, “Well, wait a minute, this thing is going to go wrong”. Now you can say exactly the same about the supervisors, you could say the same about the analysts, but the auditors are pretty close, they’re in there and they can see it—not every day but pretty regularly—and they can see, because they’re there over a long period of time, how it is that risks and balance sheets and businesses are evolving. The truth I think is that for some of our banking institutions, the size and complexity got away from the capability of management process and systems to cope and identifying that is something that I think the auditors could and should have contributed to.

Q89 Lord Tugendhat: May I ask two questions? The first is that it has been said, by a number of people, that non-executives of banks did not always understand very clearly the complexity and the underlying principles of what the business was engaged in. To what extent do you think that accusation could be levelled at auditors? Of course these are highly trained people; of course they have a considerable technical knowledge of the technical subjects they are dealing with, but to what extent do you think that sometimes they were quite simply out of their depth in understanding the implications of some of the activities that they were looking at?
Mr Kingsley: Sorry, I don’t mean to monopolise the conversation. There is no doubt, I think, that you’re right. Because if management was out of their depths then either the auditors had to second guess them or they were just as, if you like, blind as their audit client.

Q90 Lord Tugendhat: Another thing that has arisen, when one looks at some of the banks that got into trouble—the Royal Bank of Scotland, Northern Rock, Lehman Brothers, and I suspect Anglo Irish would come into this category—you have the phenomenon of a very strong chief executive; a very dominant character. We have seen, in some of the banks I have mentioned, these people who have
dominated their colleagues—both executive and non-executive. To what extent do you think we’ve seen the phenomenon of the very dominant chief executive dominating the auditors as well?

Mr Kingsley: If you like I can monopolise the conversation. I don’t think you can run a financial institution effectively without a lot of balance around the place, particularly in the boardroom and particularly in the executive group. By which I mean that there are people in the executive group who are charged with running the business—delivering profit and value to shareholders—and there needs to be a group that provides some challenge and oversight internally, and that is the finance function, the risk function, the compliance function and the internal audit function. If those functions are either not present in the executive committee room, or they’re not listened to, or they aren’t up to the challenges of the particular institution, then the management of that institution will become unbalanced. The reason that is important, and why that is different in banking from most other industries, is that banking is a very agile industry. It’s a virtual industry with virtual products and it can expand, both in terms of size and in terms of complexity, very quickly. If you compare it to a supermarket chain, if I want to double the size of a Tesco or a Sainsbury’s, it’s going to take me a long time to do that. Even if I could get the planning permission it would take me a long time. If I want to double the size of a bank balance sheet it’s not going to take me very long, provided I can acquire the capital to allow me to do it.

That, combined with the virtuality of the products that they sell—most banking products are accounting entries wrapped up in a legal contract, which is why they can be so complex—means that a bank is capable of great complexity and capable of great agility, which makes it all the more important that there is challenge in the boardroom; not just between the non-executives and the executives, but within the executive group. If the challenge isn’t there within the executive group then the effectiveness of the external governance will likely be lost.

Dr Niels: A brief related point. In our study there were basically two sectors that stood out as particularly complex to audit, which were insurance and banking. It was, I think, common knowledge that in banking there were only three of the four audit firms that do audit banks, so in the banking sector that reduced choice by one. In addition you then have the special rules on conflict. So you have a banking relationship, so that firm cannot also be your auditor or you can’t audit that bank. So in banks the whole problem of choice has always been even worse, if you like, than in many other sectors.

Mr Hayward: If I may just come back. I think Lord Tugendhat has identified one of the fundamental weaknesses of corporate governance, in relation to

the dominant chief executive. It’s not fashionable to say so but my experience of corporate governance, which is now the field in which I work—10 years ago I was a bank auditor but now I work in corporate governance—is that it is to a very large extent dependent on the extent to which the management wish to make it work. If the chief executive does not want corporate governance to work, it’s very difficult for non-executives to do anything other than acquiesce or fire him. A chief executive is able to be dominant because he is successful, almost always. They’re not always bullies; sometimes they are very subtly dominant and, therefore, being successful, can be extremely difficult for non-executives to deal with. I don’t think there is a very easy way around that. It is a fundamental weakness in corporate governance. I raise it now because sometimes you hear corporate governance being talked about by regulators, for example, as if it were self-regulation.

The expectations of corporate governance for preventing corporate disaster are very high. I don’t think that corporate governance is always up to meeting the expectations that are placed upon it. Sometimes they are, and corporate governance can make a good situation better, but one of the ingredients necessary to make corporate governance as good as it can be is a good dose of humility on the part of the chief executive. Not very many chief executives get to that position by practising humility, so there are some real human problems in here and we should be careful how much we expect from it.

Q91 Lord Best: What about corporate governance being proved, and would the power of a dominant chief executive be moderated if we had a different system of appointment of external auditors? Could we strengthen the independence of those auditors from either the management or the board? I’m thinking particularly about the change that I know exists in America, where it’s a statutory requirement for major companies for the audit committee to appoint the auditor. Would that help in the UK and, indeed, in the EU? Mr Hayward: I doubt it. In practice in this country, the audit committee would have a veto on the appointment of auditors. In practice, in America, the audit committee requires the management to do the leg work on managing the process of selection of auditors. In either case, both management and audit committee are involved. Where the formal responsibility lies I don’t see as making an immense amount of difference.

Dr Niels: Just to add to that, my impression is that the audit committee clearly has a role and is playing a good role, and management also has a role in inputting into that. The other side of the choice could
be to give more of a role to the investors themselves. So, for example, the appointment of the auditor could be made a more prominent item at the AGM, or there could be more ongoing discussion or questions from the investors to the audit committees about a choice of auditor.

Q92 The Chairman: Mr Hayward, were you suggesting that, in the US, the non-executives would expect the management to do most of the leg work, as you put it, to recommend the choice of auditor but that isn’t the case in the UK?
Mr Hayward: No, that is the case here. The difference is that in the US it is formally the audit committee that makes the appointment.
The Chairman: But that’s a formality?
Mr Hayward: It’s a formality, yes.
Mr Bush: Right, can I just—

Q93 Lord Lipsey: Mr Bush, I hope this question will be such as to enable you to come in with whatever you were going to say. Another way of skinning the cat might be to insist that the firm changes auditors every five or seven years, or if you weren’t going to be that draconian you could insist that it at least puts audit out to tender every five or seven years. Do you think that would help the situation? And are the costs involved so high that we should, nevertheless, rule it out?
Mr Hayward: The problem you have to deal with here is that you have, on the one hand, a presumption that longevity reduces objectivity, which might or might not be a valid presumption. On the other hand, you have the distinct probability that newness will bring ignorance. So you have to choose between the possibility of impaired objectivity versus the great likelihood of reduced competence through ignorance. The only academic research I’m aware of on this comes from Italy, about 10 years ago, where they did a study of audit rotation; Italy being one country where they do require mandatory audit rotation. That 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.
Mr Hayward: Can I add, I think this audit independence issue coming from the US is slightly addressing the issue in the wrong way. In America, the role of the finance director doesn’t exist. They have the chief financial officer and they’re very much lower down the food chain than the chief executive. Certainly, when I was in practice the finance director was the key, and the test of auditor independence was whether the finance director had captured the auditors, rather than the chief executive had captured the auditors. Therefore, this is a debate about auditor independence from a regime where the chief executive is all. There is nuance, of who’s captured who, which I don’t think is necessarily picked up. I think the risk to the public, and the shareholders, is if the chief executive has captured the finance director and then the finance director has also captured the auditors, and it seems to me you need that level of failure. But generally, within the UK, I don’t think that audit independence is a significant issue.
Mr Bush: On the question of rotation, there are clearly switching costs and there is investment required, in time and money, for a new audit firm to get to know the company. That can take several years in some cases and, indeed, in the early years things may go wrong. Therefore, perhaps one question to ask the firms themselves is: you already have rules on audit partner rotation and practices on mandatory audit partner rotation. You could ask them how that is working. Has that already produced systems where you can, internally within the firm, overcome switching costs? Are there systems in place that things can be handed over to the new auditor quite easily? So it may well be, if that is the case, that the transition to mandatory audit firm rotation is not that big a step change.

Q94 Lord Lipsey: I take the point that research suggests there may be audit failure in the early years. However, you also need to ask whether there could not also be audit success in the early years. That is to say, a new firm comes in and it spots something that has been going on for years, which is dangerous to the company. You could have both an increase in failure and an increase in success, and then you’d have a difficult judgement: whether it was worth paying the price of the former for the latter.
Mr Hayward: That is a possibility. But there are very few instances of accounts being restated following a change of auditors, which suggests that there are not really material discoveries of the sort that you suggest.

Q95 Lord Hollick: We have seen suggestion that there is very little to choose between one audit firm and another. They have to comply with the IFRS, so therefore they have little discretion. They are technically competent—we hope—so price is possibly the only thing upon which they compete. Is there any evidence that if you change auditor there is a saving for the company?
Mr Hayward: If I may, I think they compete on two things at an audit tender—and remember audit tenders happen very infrequently, so you only get market competition between audit firms at very infrequent intervals. When they do they compete, it is on two things: one is price and the other is the quality of service, which is service to management.
Q96 Lord Hollick: Which, I think we've seen from some of the papers presented today, could lead to a position of conflict, where the auditor has already provided advice and is then auditing the advice it has provided.

Mr Kingsley: With respect, I think it is a bit worse than that. Auditors find it, I suspect, very difficult to maintain what is almost a schizophrenic position, in that on the one side they are responsible to the users of the accounts—primarily the shareholders—but on the other side the people that they relate to every day is the management. Therein lies, I think, a difficulty. I think what is curious to me is that there is a big variation. We talked about the differences of different firms. There is one difference, which is that some firms can take anything up to £1.10 in non-audit fees for every £1 in audit fees, and others are taking 25 pence. Given the size of the firms, relative to each other, which means they are relatively similar, this isn’t a statistical aberration. There is something going on here, in terms of internal rules and guidelines or possibly some firms not being very good at cross-selling their services. I don’t know which it is but it is curious, nevertheless.

Dr Niels: There is evidence that the greater the concentration in the sector and the less the switching the higher the audit fees are. I think it is worth distinguishing between two types of competition concern, so one is a narrower concern about: this is a concentrated market, is there price competition, quality competition, between the Big Four? It’s the kind of concern that you would expect the OFT or the Competition Commission to look at. Of course the two are not unrelated but there is a wider concern about choice, as such, and the systemic implications of this lack of choice. That is perhaps less to do with the audit fees which, at the end of the day, are a small percentage of a company’s costs.

Q97 Lord Forsyth of Drumlean: I wonder if we could pursue this idea of the alignment of the auditors with the board or the top management team, and I wonder what you think about the ideas that have been put forward by Joshua Ronen, the professor of accounting at the New York Stern School of Business, of having some kind of financial statements insurance approach—which I must say was a completely new idea to me—which does have the advantage of at least aligning the shareholders’ interests with the auditors’. I don’t know what your view is on that.

Mr Kingsley: Can I take that? I have always been fascinated by it. I came across this concept about 15 years ago. It’s been around for a while, believe it or not, although being arcane it has probably been buried under a lot of cobwebs. I think it is interesting, in the sense that when something goes wrong in an audit the audit firm becomes an insurer. Yet it doesn’t act like an insurer in the work that it does particularly. It doesn’t set its fee levels in relation to risk by way of example, which is what an insurance company would do.

If you track back and think of what the accounts are and who is responsible for them, they are management’s accounts. You read the audit report, that’s what the audit report says, “These are management’s accounts”.

The rules and regulations, in particular the law, are very explicit in laying responsibility on management for producing the right numbers, with requisite punishment if they don’t. That I think that would start a chain of thinking which might lead you down to say, “Well, maybe we don’t need mandatory audits of companies where there is external capital participation, where there are shareholders, et cetera. In those circumstances, you would go down a number of steps, one of which would be, “Okay, if management doesn’t necessarily need external audit they do need internal audit”. I think that’s almost a sine qua non.

You then have to establish very clear events of claim and responsibility, so that you know what kind of insurance policy you’re writing, and obviously you can still permit management to have external audit because they can elect to do so. Obviously they would then have to justify those costs to their shareholders, but they could still do it, and then you have an insurance policy of some kind. I suspect the pool of money, in terms of audit fees, would fund quite a decent policy. I’ve never looked at it and I’m not equipped to look at it, but it certainly is something that is worth exploring.

Mr Bush: That is very interesting because, about six years ago there was a debate about auditor liability. Some investors looked into this and in 1929 there was a proposal from Scottish Widows that they were going to insure financial accounts, rather than the accountants doing it. Then in fact the accountants decided to offer unlimited liability as their trade-off. I think they worked out that if the insurers did it, the insurers would end up employing the auditors; therefore, the auditors decided that it was a better proposition to go for a model that tried to avoid problems developing, as a fire alarm rather than fire assurance. I think, is the way of putting it. I think it is an interesting proposition. My understanding is that the core statutory proposition is that, because a company has unlimited liability, there is the risk of inherent corruption of whoever is running it defrauding the creditors, and that is right at the root of the law, which is why, other than some of the very small companies that have been exempted, most companies in Europe now do need statutory audits to protect the creditors, irrespective of whether they are listed or not. I’m not sure whether the insurance
companies could provide that, but they probably could.

**Q98 Lord Smith of Clifton:** Do audit firms still “low ball”—that is to say, cross subsidise—on their charges for audit work, in anticipation of additional and perhaps higher fees they expect to receive from their audit clients for non-audit work; or is this a thing of the past? You did say, just now, that the ratio between the audit income as opposed to the non-audit income varies. Could we have your comments on that, please?

**Mr Bush:** I believe it is a thing of the past. In fact, I think that the change in the regulatory and the accounting standards framework has been very profitable for the firms. I think they probably don’t need to cross-subsidise or low ball in the way that they were, and I think that the accounting regulatory regime has basically worked that problem out of the system. That’s my view.

**Mr Hayward:** That has been largely my experience also.

**Q99 Lord Lawson of Blaby:** Leaving aside the cross-subsidisation problem there is also a kind of conflict of interest, which I was referred to by one of our witnesses, in terms of the management versus shareholders’ interests conflicting to some extent. Do any of you feel that there is a conflict of interest problem to some extent, when an accounting firm will both be the external auditor and do advisory work for the same company or, alternatively, doing external and internal audit? Do any of you feel that there might be some sense in saying, “You can’t do that”; saying, “You can either be the auditor or the advisor” to a particular firm? They can obviously do advisory work for other firms but not for the same one.

**Mr Hayward:** I have a rather unfashionable view on this: I think there is certainly an issue of perception but I think the perception is not particularly grounded in the reality. I have seen some excellent audits done by audit partners, who provide lots of extra services to their clients, but they were intent on helping that client do the right thing and do it well. I have seen very second-rate audits done by audit partners who had no advisory work and weren’t very interested in the client. The attitude of the auditors is much more important than any number, or ratio, that you put on the non-audit fees. This is a human issue not a simple mechanical one of, “If I get 75% of your audit fees and non-audit fees, I’m okay, and if I get 125% I’m corrupted”. It doesn’t work like that.

**Lord Lawson of Blaby:** Could we hear whether any of the witnesses take a different view, or whether you all agree with what has just been said?

**Mr Kingsley:** I take a different view despite the fact I’ve known Jonathan for a long time. I think it is an issue of culture and it depends—there’s almost a question that underlies the question you’ve posed which is: what are audits for? What do we expect from these processes? If you take the view that public auditing is a public good, it’s a public service, then I find it difficult to see how you can have a culture of public service sitting side by side with a culture of strong commercialism, as it were. Not that commercialism and the public service are necessarily incompatible, but I think that the culture of auditing, if it was seen as a service to the public and not as a service to companies and management, would lead you quite clearly down a path of saying, “Firms that do auditing shouldn’t do other stuff”. So the question in my mind comes back to saying, “What do we expect of audits and auditors?"

**Dr Niels:** Yes, in a way that would be not a demand side role, that if you audit a firm, you can’t provide that company with consultancy services. You can also look at it from the supply side, which is you have to be an audit-only firm and I think that is a question that hasn’t been debated as much as the demand side restrictions. I think it is worth thinking about.

**Mr Hayward:** But it is a very difficult question, because what lies behind that is the question of what you want an audit to accomplish. If we make it completely independent, then you’re saying, management do their own thing and the auditor comes along afterwards and passes judgement on whether it’s acceptable or not. That is an entirely separate, distinct and potentially negative role. Alternatively, you have the role that auditors currently occupy at its best, which is a “right first time” role, to ensure that companies get their accounts into a condition where they can deserve a clean audit opinion. The majority of companies do get clean audit opinions and that doesn’t mean that the auditors are biased. A lot of those will have had a great deal of negotiation behind the scenes to get them to that stage, and that is a useful audit output that I wouldn’t want to dismiss. I think if we are going to have that sort of audit, the right first time sort, then doing advisory work can improve the auditor’s ability to do it, because he has a better understanding of the business and of the motivations and pressures of management. It places a great deal of importance on the attitude of the auditors and the culture of the firm. If you go to the other extreme and have it as an entirely independent thing, you’re now into a different situation. You are going to have a more confrontational relationship with management, which will not necessarily produce a better audit, in fact. So I think there’s a very basic distinction here between two fundamentally different approaches to audit.
Lord Best: Lord Lawson was making the point or asking the question whether or not internal audit as well as external audit could or should be in the hands of the same auditors, or whether one should prohibit the same firm doing the internal audit operation. Would you go so far as to say that you wouldn’t worry about that either?

Mr Hayward: I would argue differently on theoretical and practical grounds. On a theoretical basis, I could make a good case for saying they could be done by one firm. If you had no internal audit function, then the external auditor would do more work. It would look very similar to internal audit work. In practice, if I'm a non-executive director, I would like more than one source of assurance, and I think it would be very foolish of me as a non-executive director to put all my eggs in one assurance basket.

The Chairman: I think Mr Bush wanted to say something on this issue.

Mr Bush: Could I just add one quick comment on this? I think one area where I would have concern is tax and tax compliance, because 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, because you can be pretty sure the chief executive won't necessarily understand it and the problem will linger for quite a long time. So I think I would distinguish tax as a particular area.

Lord Lipsey: I want to just follow in, if I might, on the point I was trying to raise, because I think you used a good phrase in saying there are human issues involved, but the trouble is that doesn’t necessarily cut the way of your argument. I mean, the human issue involved is if you are the auditor partner and you know that your firm has twice as much consultancy work to take—in extreme cases, they have audit work coming out of the firm—is that not going to change the nature of your relationship with the finance director and his staff? Now, you may say that might lead to—I think you just did—a better audit, because you are so keen to get on with him well that it leads to a better audit, but going back to the perception issue, I wouldn’t think it would be perceived as a better audit if it was done between two people who are big chums, because the human perception was that they were in each other’s pockets.

Mr Hayward: Indeed, and I think the reality of this is very complex, and I think as far as perception is concerned, it is probably a lost cause. The public will look at the simple appearances. If the purpose of an audit is to increase the public confidence in the financial statements, then there's not much point in trying to fight this battle.

Mr Kingsley: Can I just go back to Lord Lawson's point on internal audit, because I think a company that outsources its internal audit hook, line and sinker is making a mistake, because like any outsourcer, you need to keep control of the relationship and direct the work that is being done. If the company gets itself into a situation where it doesn’t have anybody who is doing that, then the value of internal audit has diminished significantly. There is a very big difference, at least in my view, between internal and external auditing. Internal auditing, and particularly the leadership of it, ought to be almost part of the management team and provide the kind of challenge to decisions that are being taken on a recurrent basis that an external auditor simply can’t do.

The Chairman: While we’re on the subject of internal audit, do you think it should be mandatory for listed companies?

Mr Kingsley: I think if you want the insurance route, for certain. For me, it’s a management decision, because it’s essential for the management group to have a function that is overseeing the quality of processing, what the CFO is doing and what his group is doing. By and large, I would say the answer is probably yes, but it would depend a little bit on complexity.

Lord Lipsey: Can I just ask the following? It’s become clear, certainly in the financial services, that both the external audit—which has been described in various not particularly flattering ways by you gentlemen—and the internal audit failed to look at and address the real issue, which was risk and judgement around risk. Do you think the recommendations made by Sir David Walker around the risk committee are that the right way to address the risks in the financial services, and is that another role for accounting firms to play a part in? Should those be made mandatory? Should they be externally advised? Coming back to your question about the quality and diversity of assurance, it seems to me that’s a most important part of the framework going forward for ensuring we don’t get into the same mess again.
Mr Kingsley: I think that’s right, Lord Hollick, but whilst the auditors can play a role here, the power of the Walker recommendations goes back to something that I said earlier, which is around the balance in the board and the amount of challenge and oversight that’s provided internally and externally. Walker was about balance, challenge and competence for the most part, and I think many of his recommendations are absolutely spot on, and if they are implemented in full, we hopefully will see fewer recurrences of what we have seen in the last three or four years. It will happen again, but hopefully it won’t happen with the same force. The auditor’s role in those circumstances I think is to provide oversight as to whether what has been done to implement the recommendations has been done to effect rather than to help in the implementation, if you see what I mean.

Mr Hayward: I think you happen to have touched on a very important point here with internal audit, and I find it very pleasing that you have put it on your agenda, because it’s unusual to find internal audit mentioned very much. It’s hardly mentioned. Walker mentions internal audit about four times and always to its disadvantage compared to risk management. Internal audit is only mentioned in the UK Corporate Governance Code as one of the things that the audit committee has to look at. There is no real regulatory emphasis on the importance of internal audit, and I think that is something that could usefully be corrected.

Q105 Lord Tugendhat: The FRC’s Market Participants Group was established in 2006, I think, and it has published several reports. Do you think it has had any effect at all, or how would you assess its impact?

Mr Bush: Can I come in? I think it’s in an invidious position. I think it’s very difficult for any regulator to effectively change the shape of the market. I’m not aware of a market being able to unpick an oligopoly, so in terms of competition, if there’s a perceived oligopoly, I think it’s one of the reserve powers of Government and politicians to resolve. I was chairman of a working party for about six months on this issue, and it’s a very good way of losing friends.

Q106 Lord Tugendhat: Can I approach it from another point of view? The Market Participants Group has a preference for market-led rather than regulatory action. I do too, lots of people have a preference for market-led, but I think we’ve established both in this discussion and in the other ones we’ve had that the market doesn’t lead in this area, because for all the reasons that you have gone over and others have, the way that auditors are appointed is not proving very susceptible to market forces. So market-led doesn’t get us anywhere. Is there a case therefore for regulatory action in order to widen the market, and if so, how would you see that working? Secondly, it may not be a very probable thing, but suppose one of the auditors was to decide to jack it in, if one of the auditors was to decide that they were going to withdraw from a particular area of business, wouldn’t that require perhaps regulatory intervention to try to maintain even the level of competition that we have?

Mr Bush: There is a structural problem with auditing that doesn’t seem to exist in other professions. If I take architecture, the law, in all of those, a group of people can pull away and set up as a boutique. The independence rules of auditing mean that you can’t. I think, have more than one client who is more than 10% of fee revenues. It’s very difficult to get seed corn client base to be able to break away. Advertising agencies can do, almost every other industry can have breakaway people, but auditing seems to be one area where your staff get locked in and the client base gets locked in. I think that’s why market solutions don’t work, and I think there’s nothing to stop the whole profession just becoming one firm, if it wanted to.

Dr Niels: To be fair to the Market Participants Group, I think yes, market-led, but what it focused on was trying to remove certain regulatory obstacles as well to liberalise the market and facilitate market movement, such as the growth of the mid-tier firms, which hasn’t happened. It’s very difficult. One factor is indeed the factor that Tim mentioned, but it requires a lot of investment for mid-tier firm and gradual growth to become a significant player. That’s very difficult. It will take a long time. On the other hand, we had a Big Eight 21 years ago and Big Six 13 years ago. There is no reason why in principle you couldn’t have a market with six players or eight players who have that required minimum scale. But we arrived here through some idiosyncratic processes, including the approval of mergers by the competition authorities in the past, which with hindsight were perhaps not such a good idea, in particular the six to five merger, the Pricewaterhouse/Coopers & Lybrand merger. With hindsight, the European Commission said, “Okay, we allow the six to five merger, but we wouldn’t allow a five to four merger”. Well, five to four happened naturally through market forces and we are where we are, but is not a particular reason to try to get back to a situation where you have six or eight firms, because then that’s probably the main way of avoiding the problem currently of lack of choice, which leads to systemic risk, if indeed one of the Big Four were to go out of the market, as you mentioned.

Q107 Lord Lawson: Very briefly, please, on the audit dimension to the banking disaster, which I readily admit is not the only dimension, but it’s the only one
that is relevant to our inquiry, do any of you have any doubts and concerns about VAR and how it operated in practice, and if so, what should be done about it?  

**Mr Kingsley:** The trouble with VAR is it’s economically extremely elegant and very persuasive in the way that it attempts to model what happened in the past, produces a curve of outcomes and therefore creates an expectation of what might happen in the future, and that is where I think the problem is. There are two issues. One is that in order to understand what happened in the past, we need to go back a long way, and the models that were used to drive VAR generally did not do that. So they didn’t capture some of the worst things that happened in the markets in the past. Secondly, it caused management to err in two bits of thinking: one is they could almost predict what was going to happen in the future, but secondly, there’s something very beguiling about numbers. If you can reduce something to numbers, like risk, you think you have it licked. You think that you have it under control.

**Lord Lawson:** It’s the illusion of certainty.  

**Mr Kingsley:** Yes, and I think that is the biggest problem, so management would be presented with VAR numbers. They’d see, “Tomorrow we’re at risk of £25 million. Tick” and the fact that it might be £125 million because of some black swan or whatever it happens to be wasn’t today’s problem, it became tomorrow’s problem. So it’s the illusion of certainty, as you absolutely put it.

**Q108 Lord Lawson:** So what’s the solution?  

**Mr Kingsley:** The solution is to use VAR as part of a more balanced approach to the management of risk, of which judgement and common sense ought to play a large part, and I suspect didn’t in some institutions.

**Q109 Lord Lawson:** Do auditors have a role here?  

**Mr Kingsley:** I think they have a role in observing the quality of decision-making that is being made. It’s back to standing back and looking at the quality of the institution. One of the problems about being an auditor is that you’re only as good as your client, at the end of the day.

**Q110 Lord Forsyth of Drumlean:** Sorry to interrupt, but isn’t the issue that if there’s a shedload of money to be made, then common sense and this balanced approach goes out the window and the auditors are thinking, “Well, if we stand up against this, we’re going to get fired”?  

**Mr Kingsley:** That applies to a number of issues that have appeared as a result of the credit crisis, including the idea of macro-prudential supervision, which has exactly the same problem attached.

**Lord Forsyth of Drumlean:** Your answer to Lord Lawson’s point is not much help.

**Mr Kingsley:** No, not that in that sense. I had forgotten the human factor, but that’s not fair. I shall double back. If in the boardroom there were voices of challenge through the CRO, the chief risk officer, through the internal audit function, through even the finance function, that said, “Look, these risks are oversized compared to our capacity to control them, and the balance between risk reward and capital that we’re now facing isn’t a safe one” then if that discussion takes place in a balanced way, you might not get, if you like, the greed overtaking the rationality. So your question runs to the core of some of the things that went wrong three and four years ago, and the need to introduce more balance into financial institution decision-making.

**Mr Bush:** My former chairman, the late Alistair Ross Goobey, had a very simple test as to whether there was an economic problem. It was the number of cranes he could see from his office in the City. Whatever the value at risk formulas are doing, I used to say, if there were two free newspapers outside the tube station in the morning, and when one is called The Daily Deal it is definitely indicating a bubble. Just talking to estate agents who are telling you that people are going through a sealed bid process is definitely a sign that there’s going to be a bubble. So I think there are definitely more empirical factors out there that you can use to apply in a commonsense way, rather than some quite complicated mathematical theory that might work in biological systems, but I don’t think it necessarily works in financial markets.

**Q111 Lord Best:** Assuming that it would be a good thing to have wider choice in the audit market, what would be the one thing that each of you would suggest to achieve that?  

**Dr Niels:** I think the option of structural separation is worth exploring more than has been so far. Structural separation can be done in two ways. One is to have audit-only firms and the rest. The other one is more a break up of the Big Four audit firms into smaller, but still large, audit firms. I’m not advocating that at all as a solution, but I’m saying that that is worth considering.

**Mr Hayward:** In the paper that I submitted as written evidence, I outlined how this is a very systemic problem, there are all sorts of things that work together to give you a system that works quite well on its own terms. Unfortunately, those terms don’t meet the expectations of those of us who are not auditors. But the problem with a systemic failure like that is that you don’t fix it very easily by adjusting one single thing. So I think you can either do something outside it, the Florence Nightingale approach, ignore the War Office’s approach to nursing and enlist The Times to create an entirely independent system alongside it.
That’s one approach when you have a systemic failure. The other approach is to do something dramatic that is such a shock to the system. A major audit firm failing would be a shock of that sort, but I wouldn’t recommend it. I think the single shock that could be voluntarily imposed, that might have the most advantageous effects, would be to prevent group auditors from being the auditors of statutory subsidiaries around the world, because that would force them to adopt a different business model for the audit of large multi-national groups, and that different business model would increase the opportunities for smaller audit firms.

Mr Bush: I agree with Jonathan on that absolutely. There’s a distinction between being a director of a holding company and being a director of each company group, and I think one interesting example of a bank that was quite successful with that model was HSBC, which operates a pure holding company model. What Jonathan says I think might focus people’s minds on which bit of the group has the risk, because I believe—I perhaps shouldn’t say in this Committee—you can combine retail banking and investment banking under the same brand, provided you have proper firewalls between the retail bit of the bank and the investment bit of the bank.

Lord Lawson: No, I am just observing, sorry. Sotto voce, firewalls are fine in theory, but they don’t work in practice.

The Chairman: Lord Tugendhat.

Q112 Lord Tugendhat: In an earlier meeting, we were talking about the French system, where they have joint audits. As a result of that, the Big Four have a significantly lower proportion of the total French market than is the case in many other countries. Now, obviously that would be a regulatory intervention and I imagine that in the first instance it would add to audit costs, but if it is believed—and I say if it is believed—that it would be desirable to have a widening of choice, would this be an appropriate way to bring on new talent, as it were?

Dr Niels: I had the impression that when you discussed it at the previous hearing there was a slightly negative view on that option.

Lord Tugendhat: Yes.

Dr Niels: I think I have been more positive about that option. Certainly, yes, it adds to the cost, but it is a good way for the mid-tier audit firms to get to know the companies, the bigger companies, to build a corporate CV, if you like, and then gradually gain more business. That is I think precisely the reason why in France the issue of concentration is slightly less marked than in the rest of the world.

The Chairman: Mr Kingsley, did you want to add anything else?

Mr Kingsley: No, I don’t.

Q113 Lord Best: There was one suggestion to the House of Lords in Question Time on 14 October that the Audit Commission’s future might be as the fifth major audit firm entering the corporate sector and giving others a run for their money. Did that idea appeal to anybody?

Mr Hayward: Personally, I would prefer the Audit Commission to carry on doing what it has been doing rather well up until now.1

The Chairman: Gentlemen, thank you all very much for your contributions this afternoon. You have given us some very clear advice and views, and we’re very grateful to you all.

1 Note by witness: If corporate clients are currently unwilling to choose, for example, Grant Thornton as their external auditor, it is hard to see why they should be more keen to appoint the Audit Commission. The fact that the Audit Commission exists is not in itself sufficient to overcome the barriers to entry in this market.

Supplementary memorandum by Mr Jonathan Hayward, Independent Audit Limited (ADT 14)

Following the Committee session at which I gave evidence, I would like to make one point regarding financial statements insurance.

While this is at first sight an interesting and potentially attractive idea, I am not convinced that it would work in this country. What follows is expressed somewhat tentatively, since I am not a lawyer, but if the Committee were to consider pursuing the idea of financial statements insurance then I would suggest that you first obtain proper legal advice on this point.

The idea of financial statements originates from the USA where the system of law and regulation is directed and maintaining an orderly secondary market. The purpose of financial statements in that jurisdiction is primarily to enable secondary market transactions to take place at well-informed prices, which facilitates litigation against companies whose accounts are misstated since litigants need only show that they suffered loss through dealing at a price which was based on incorrect information. In this country, the legal framework for corporate reporting is based on the idea of accountability to shareholders, and as a general rule legal action by shareholders against directors and auditors arises when the company itself has suffered loss.

Claims against companies in the UK because unsatisfactory information has affected dealing prices in the secondary market are extremely rare.
I understand, however, that it is such claims that underpin the idea of financial statements insurance. So if financial statements insurance were to be introduced into this country, making it effective would necessitate a change in the legal framework to enable investors to bring claims much more easily against companies whose accounts were misstated.

This would be a significant change which would be viewed by many as a severely retrograde step.

29 October 2010

Supplementary memorandum by Mr Timothy Bush (ADT 15)

ACCOUNTING ISSUES AT STAKE

1. Prudence (not overvaluing assets), loss visibility, no hidden gearing and being alert to contingent liabilities. These all underpin the creditor protection purpose of accounts and the audit. These things are also essential for directors and auditors to assess whether the business is a going concern, and for directors to understand where their businesses are at.

These things are required for the law to function (the capital maintenance clauses in the Companies Act) but are not delivered by IFRS (or the erroneously copied FRS 26 which directly clashes with Company Law). These things do form the foundation of “UK GAAP”.

PERVASIVE VESTED INTERESTS (“RULE OF STANDARDS” RATHER THAN THE RULE OF LAW).

2. Since Johnson Matthey (UK, and earlier in the USA), auditing/accounting standard setters have been populated by people with professional expertise in auditor liability defence. The pendulum has therefore swung too far towards protecting auditors, at the expense of directors, creditors, shareholders and the wider public.

3. Auditors have benefited from complexity of accounting standards, not just their protective/scope limiting characteristics. Bankers too benefited from the uptick in profits.

BRITAIN CANNOT WAIT FOR THE INTERNATIONAL ACCOUNTING STANDARDS BOARD OR THE EU TO FIX PROBLEMS

4. The timescale is slow. The EU is weak on this area, and not united, nor does it have same priorities. Other parts of EU have “dual boards” with non-IFRS accounts for director/creditor assurance (eg Germany). The EU Commission seems to be a “soft touch” for Big 4 lobbying.

5. IASB in seeking to converge with the USA is up against the full force of the liability limitation tactics of the Big 4 USA and the pervasive power interests there. The biggest funders of the IASB were the Big 4 and the largest US investment banks. IAS 39 was written essentially in-house at Citigroup, the harmful bad debt provisioning model came from Big 4 USA.

6. Britain has got itself into position of “over adopting” IFRS (in companies and banking companies), caught between the worst aspects of the EU and the USA.

SOLUTION AND CONTAINMENT OF PROBLEM

(i) UK must halt compulsory extension of IFRS as was proposed by (recently stepped down—12 October 2010) chair of UK Accounting Standards Board.

(ii) The Department of Business must work with Accounting Standards Board to fix the clashes: between IFRS and the capital maintenance clauses of the Companies Act, and the problem of FRS 26, which clashes with both the capital maintenance clauses and the Companies Act accounting rules.

(iii) UK GAAP must be brought back to its pre-2005 condition. Each accounting and auditing standard should have a statement that it complies with the letter and spirit of the intent of Company Law, so as to avoid clandestine auditor liability limitation tactics (whether omissions or commissions).

27 October 2010
Further supplementary evidence from Mr Timothy Bush (ADT 16)

CATEGORISATION OF BANKING FAILURES BY ACCOUNTING ISSUE

<table>
<thead>
<tr>
<th>Accounting Problem</th>
<th>Treasury Assets collapsing</th>
<th>Banking Books collapsing</th>
<th>Trading Books collapsing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad debt provisioning insufficient to protect creditors and very growth expansionary</td>
<td></td>
<td>Fatalities (&gt;100% of capital lost)</td>
<td></td>
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<tr>
<td>* lack of contingent liability assessment (“make good” clauses in securitisations).</td>
<td></td>
<td>Allied Irish Bank</td>
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<td>Anglo Irish Bank</td>
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<td>Bank of Ireland</td>
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<td></td>
<td>Bradford &amp; Bingley*</td>
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<td>Cattles (non bank lender)</td>
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<td>HBOS (Bank of Scotland)</td>
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<td>London Scottish Bank</td>
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<td>Northern Rock*</td>
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<td></td>
<td>Near miss (rescued): Alliance &amp; Leicester plc Dunfermline BS and several other building societies</td>
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<tr>
<td>Mark to market gains covering up losses (Collateralised Debt Obligations), then met by mark to market downswing</td>
<td>Most banks exposed. HSBC had MtM losses at one point approaching £20bn (these then substantially reversed).</td>
<td>Bankruptcy/nationalisation and/or forced dilution. Massive loss of capital and contraction. In case of RBS/Lloyds-HBOS/B&amp;B/Northern Rock nationalisation. London Scottish in administration. Tremendous market dislocation.</td>
<td></td>
</tr>
<tr>
<td>Impact</td>
<td>Market rise and then panic. Regulatory forbearance needed. Tremendous market dislocation.</td>
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<tr>
<td>Auditors</td>
<td></td>
<td>PWC</td>
<td>E&amp;Y Netherlands ABN AMRO</td>
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<tr>
<td>Auditors of failed banks</td>
<td></td>
<td>Bank of Ireland, Cattles, Northern Rock</td>
<td>AMRO</td>
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<td>KPMG</td>
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<td>Allied Irish, HBOS, London Scottish, Bradford &amp; Bingley</td>
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<td>Anglo Irish</td>
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<tr>
<td>Auditors of “victim” banks/survivors (victim meaning acquired collapsing banks)</td>
<td>KPMG</td>
<td>PWC</td>
<td>Deloitte</td>
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<td>HSBC</td>
<td>Lloyds</td>
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<td>Barclays</td>
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Further supplementary memorandum by Mr Timothy Bush (ADT 19)

Technical addendum from Timothy Bush, to support evidence of 26 October 2010, given the evidence given 9 November by the FSA and FRC which is contradictory in two places.

1. Mr Haddrill stated that, prior to IFRS (2005), there was no UK standard on derivatives. That is incorrect. There is a UK standard, FRS 13 (1998) which is actually entitled “Derivatives and other financial instruments”.

Also, UK standard FRS 5 (1994) deals with securitisations (as well as off balance sheet transactions), see the attached notes on both standards on the ASB website.

http://www.frc.org.uk/asb/technical/standards/pub0106.html
http://www.frc.org.uk/asb/technical/standards/pub0100.html

Further, and superior to that, are the Accounting Preparation Rules of the Companies Act itself. Part 2, Section A, 17-21 are the overarching accounting principles that must be adhered to.
Para 19 (a) requires prudence (and no unrealised profits).

Para 77 (3) is a catch-all contingent liability clause.

All of this was then pulled together by the bank specific standard (SORP) from the British and Irish Bankers Association (attached) dated 1997 (and regularly revised). Page 51 et seq is the derivative section.

Mr Hadrill refers to prudence still being in the regulatory system, which seems to accept that it is no longer in the accounting system.

That does not work if, the company is not regulated (eg Cattles, which lent, but did not take deposits), nor does it work if the regulator is not alert, or themselves misled. The statutory purpose of Companies Act accounts is a stewardship function, irrespective of whether the company is regulated or not.

2. Further, on bad debt provisions, Mr Thorpe of the FSA stated correctly, that IFRS [by 2013 at the earliest] will move to an “expected loss” basis (forward looking) of bad debt provisioning.

However, he stated that the “incurred loss” model of IFRS was the same as had been in the UK for 30 years. That is in my opinion not correct.

IFRS has excised the general presumption of prudence (above) as a valuation method, and replaced the British and Irish Bankers' Association SORP. Para 9 of page 5 of the BBA SORP deals with both specific and general bad debt provisions. It set an aspirational goal for the carrying value of loans set out as:

“Although specific and general provisions are computed separately, they are in effect components of the same provision. In total the specific and general components of a bank’s provisions for bad and doubtful advances should represent the aggregate amount by which the bank considers it necessary to write down its impaired advances in order to state them at their expected ultimate net realisable value.”—(UK GAAP)

IFRS (IAS 39) requires provisioning on the basis of evidence of default (ie the customer is already not paying), rather than forward looking. It is highly qualified compared to UK GAAP. A PWC paper “joining the dots” which summarises this as: “IAS 39 specifically states that losses that are expected as a result of future events, ‘no matter how likely’, are not recognised.”

The FSA's own discussion paper on the implementation of IFRS (04/17, October 2004) “Implications of a change of Accounting Framework”, para 2.42, says:

“General provisions under UK GAAP are provisions for losses that have been incurred but not yet individually identified. There is no equivalent concept under IAS 39, but the standard does permit companies to assess impairment “individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant”—(IAS 39.64 as at 31 March 2004).”

www.fsa.gov.uk/pubs/cp/cp04_17.pdf

Although superficially, the FSA seems to have used similar language to UK GAAP, the word “incurred”, the FSA paper itself reveals that the definition that sits beneath is, both qualified and very different. The use of the term “permit” a provision, is clearly restrictive. The UK GAAP position is aspirational, requiring general provisions and for the total amount to be the expected realisable value.

From reviewing the accounts UK and Irish ordinary lending banks which collapsed, it can be seen that general provisions disclosed in the accounts either fall under IFRS, or disappear altogether.

The benefit of the audited statutory accounts of a company is for the body of members, to protect the capital, from hidden losses for the benefit of the members and hence the creditors. In my opinion, the accounting standard (IAS 39) does not meet that function in concept, or practice. Further to that, the FSA as a regulator seems to have assented to that deficiency.

The implication of this is that the regulatory interest in statutory audits—regulation has traditionally free-ridden off the contractually audited accounts for the benefit of the members—has intruded to the extent of being a part of a train of events that has then undermined the interest of the members, and then of the creditors.

11 November 2010

Not published here.
Auditors: Market Concentration and their Role: Evidence

Further supplementary memorandum by Mr Timothy Bush (ADT 17)

FURTHER REMARKS ON THE SESSION DATED 25 JANUARY 2011, AS REQUESTED BY LORD MCGREGOR, Q540–547

Dear Lord McGregor

I am pleased to be asked to give my remarks. I have watched, or read the transcripts of, every session including this session with Mr Davey, Mr Carter and Mr Hoban.

I am happy to stand behind all of my evidence to date. I treat the Committee as I would a Court, the whole truth, not selective bits or half truths. I took all of my evidence from prime information and the primacy of law rather than hearsay. In this submission I have included prime law in appendices.

I noted with great interest that Mr Hoban did say that regulation should start from the accounting numbers Q531. He is correct, and that is precisely what happened. The FSA regulated from IFRS numbers.

The FSA took (imprudent and unreliable) IFRS statutory accounting numbers from banks and made regulatory adjustments (Basle) to that. The problem was that those adjustments were also imprudent and therefore did not negate the impact of IFRS where the banks were in difficulty (running faulty/risky business models). I believe that these adjustments in some cases merely amplified the problem.

The French banks did not use IFRS, they used already prudent French GAAP, and then the regulator made regulatory adjustments (Basle) to it. However, those adjustments were only imprudent to the extent there was already a problem in those banks, but there was no problem to amplify.

The difference between French GAAP + Basle and IFRS + Basle is that the poor regulation in itself does not necessarily mess up the running of the business. The regulator may regulate less efficiently, whatever that means, but the business itself is running on the correct ratios/KPIs if it is using prudent GAAP in first instance. Basically the directors, managers and shareholders can see what is properly going on in terms of proper business economics, even if the regulator then puts himself in the dark a bit. However, if you use IFRS numbers to run the business you may well get lost, and then run the wrong model, but appear profitable, with all the wrong ratios and KPIs.

In maths, as an analogy, the regulation and the accounting are not commutative, like division and subtraction you get a different answer depending on the order of things. If an IFRS using business has a “softness factor” in it due to imprudent accounting, regulation cannot re-harden it.

Those banks that failed due to bad debts (rather than the investment banking/Lehman crisis) tended to be former Buildings Societies (B&B, NR, HBOS and divisions of it such as Birmingham Midshires). I presume, and I did observe this from some analyst meetings, they seemed to be too dependent on IFRS, ie they were only running one set of books. Those lending banks that survived, HSBC-UK, Barclays-UK, NatWest and Lloyds-TSB, the former clearers, seem to have used a form of UK GAAP before applying IFRS (ie two sets of books, with the right ratios/KPIs). So did Abbey/Santander which essentially ignored IFRS. It is fairly easy to see why there was a systemic problem.

31 January, 2011

General Comments

Neither the BIS nor the Treasury minister addressed in Q540–547 (or elsewhere) that the law requires statutory accounts for the purpose of conducting the business of the AGM properly. That is a prudential purpose, a discipline, so that shareholders and directors know where their business is truthfully at. For banks at risk the audited IFRS numbers were unreliable for that purpose; profits were exaggerated and dividends and bonuses were paid out of unreal or reversible soft profits, for the banks to then collapse shortly afterwards, depleted of capital.

Mr Carter hits the nail on the head without perhaps realising it (Q547), “the losses were immensely greater than all the bonuses and dividends that the banks had paid”, this is precisely due to the gearing of a bank. False profits may be paid out or retained. Any false retained profit is false capital, and that multiplied > 20 times—in gearing up—gives (false) over-lending capacity. Over-lending will be to more marginal borrowers. Eventual losses will be large, more than merely the already false capital will emerge as losses. Legally safe dividends are a function of safe reserves left behind ex-dividend.
I dispute that there is no evidence on IFRS versus UK GAAP and banking problems (Mr Davey Q546). Lord Turner highlighted IFRS as a problem (a whole speech to ICAEW in February 2010 about “illusory profits”). There is also counterfactual evidence. No French bank came anywhere near collapsing, they kept prudent French GAAP for the accounts of banking companies, meaning normal financial governance (self-control) operated properly in first instance alongside prudential regulation (state intervention). The problem is not merely regulators getting it wrong after the fact, they do not run the business. The problem is a business doing the wrong thing but thinking it is on the right track. Banks are run on key ratios from the accounts.

I can understand why BIS is defensive (and I can see this whenever “prudence” or “law” is raised). BIS legislated to allow the use of IFRS for banking companies. This was in part because the FSA, which had used UK GAAP for prudential banking regulation, signed off on IFRS for use for prudential banking regulation, whilst appearing to miss some of the major changes with IFRS, most notably:

— the impact of the IFRS mark-up-to-market or model without the BBA SORP moderating it (Mr Carter does seem to acknowledge allude to this omission in Q544 where he says “with the benefit of hindsight” when referring to the loss of the BBA SORP),

— the impact of IFRS on bank profit and loss accounts. The FSA only adjusted the balance sheet for its identified IFRS impact, not profits, but IFRS has a disproportionate effect on profits due to gearing, this can easily increase “profits” by >20%, even more where there is increased risk, and

— the impact of the IFRS bad debt provisioning model on balance sheets, particularly where there was very high risk lending (eg HBOS, Northern Rock, Bradford & Bingley). The FSA reversed out the deficient IFRS defined “incurred provision” to substitute it with a one-year—expected loss in the balance sheet. But, one-year-expected loss itself was also deficient, as shareholders in any limited liability company may walk away when total foreseeable losses exceed capital. One year expected loss was not much better than “incurred loss”. It too rode with the boom, as it was also evidence based, rather than commonsense economics.

In short, the FSA missed that prudential banking regulation did not work with IFRS. The FRC (under BIS) seems to have missed the dysfunctional impact on governance, pay and profits, of IFRS. The Treasury allowed IFRS for Building Societies. The Big-4 sought a global model (Mr Halliday-E&Y said so).

Q540–547—To give some structure to my remarks, as it all interlinks, I have ordered this under four subjects that were covered in Q540–547. The subjects are:

— prudence/losses/realisation, “UK GAAP” versus IFRS;

— law/legality of IFRS as a preparation method (which the IASB/EU decided);

— audit purpose and the output standard (which Parliament decides); and

— going concern/expectation gap/“snap shot” balance sheets.

All of the subjects interlink with going concern. Going concern requires reliable accounts, and vice versa. The law is structured so that AGM’s can function (essentially on the nod) with a one year ahead view based on a truthful and reliable audited account of true condition, statutory accounts.

1. Prudence and IFRS and UK GAAP (Mr Carter, Mr Davey and Mr Hoban’s answers Q540)

I see a good deal of implying equivalence of IFRS and pre-2005 UK GAAP. However, I have attached the Accounting Rules (“the Rules”) from the Companies Act statutory instrument (“UK GAAP”) as Appendix A for the benefit of the Committee. The Rules give prudence a statutory bearing.

The law requiring prudence, Rule 19, is unequivocal, it is a must. I agree that one might not agree on the precise amount of it, calculating most things is subjective. But prudence is directionally clear.

Mr Carter’s evidence, Q544 states correctly that prudence was not defined in statute. However, the required accounting outcome from applying prudence is set out in objective form in statute as Section 830–837 of the Companies Act which links the audited accounts to the distributability of reserves. As assets back all reserves, including those left behind ex-div, I think it self-evident that asset values should be prudent and reliable rather than soft or speculative. Rule 32 (1) specifically requires bank loans to be carried at net realisable value where lower than cost. In other words its recoverable amount. Rule 19 sits over Rule 32, ie UK GAAP in law is a prudent estimate of net realisable value.
Also, Rule 19 (b) requires negative post balance sheet changes to be adjusted. Mr Hoban’s evidence though stated that balance sheets are a “snap shot”. Rules 19, and 32 are forward looking beyond being a snap shot, they adjust things by requiring judgments. The same goes for inventory provisions. By definition any inventory left at the balance sheet date is goods not sold, inventory provisions are for goods not likely to be sold. That is a judgment.

IFRS is more “snap shot” and evidential, and not the same as UK GAAP. I therefore wholly disagree with Mr Davey’s comments and Mr Carter’s then agreement with his minister (Q540). The FRC paper on auditor “scepticism” is in my opinion its way of resolving the prudence/IFRS problem without overtly admitting it. It is worthy of note that that BIS (nor the FRC) does not refer to scepticism in the context of the FRC’s (excellent) auditing standard on going concern (see later).

1.1 Architecture of IFRS standards and the force of law (Mr Carter and Mr Davey’s answers on IFRS and prudence, Q544)

The answers here were incomplete or muddled. Each EU-IAS (EU endorsed IFRS) Standard is an EU legal instrument, ie the law. IAS 1 is the general “mother” standard of IFRS. However, its principles/rules, are excluded for areas where the subject matter is covered in another standard. For bank loans IAS 39 is sovereign. Furthermore, IAS 1 does not contain the word prudence at all, nor a synonym. What Mr Carter describes in his evidence as prudence in the “the Framework” (Q544) is not only irrelevant as IAS 39 is sovereign, but “the Framework” is not endorsed by the EU. The EU has quite remarkably incorporated something into law that is definitively cross referencing to something that is outside of the law. (Further, the IASB is currently changing its “Framework” to exclude mention of prudence from even “the Framework”, ie neutrality instead).

But more simply than all of that, IAS 39 has to exclude prudence. It is impossible to have mark-up-to-market—as in IAS 39—with prudence operative in IAS 39 itself, or from anywhere else in IFRS, whether IAS 1 or “the Framework”, as prudence would counteract it.

IAS 39 (para 59) states “losses expected as a result of future events, no matter how likely are not recognised”. It then goes on to give in AG 90, as an example in practice, that even substantial credit risk from the death of borrowers, who have not died before the balance sheet date does not require provisioning. That exclusion of inevitable loss cannot possibly encompass the “net realisable value” test of Rule 32 in the Companies Act Accounting Rules (UK GAAP).

Further, IAS 39, para 59, has the rather weasel words, “observable data that comes to the attention of the holder of the asset”. “Coming to the attention of” is a qualifying term, a safe harbour sanctioning accounting that is missing things, but it is also a perverse incentive not to even look. The wording “holder of the asset” also seems to exclude things coming to the attention of the auditors. That to me is a limitation of scope, “I see no ships”. Company Law is worded to avoid any definitive frame of reference. Truth is truth. The auditing issue should be digging sufficiently to get at it.

1.2 Mark to market (again on UK GAAP and IFRS having been similar Q544)

The Company Law Accounting Rules, Para 32, is drafted such that “net realisable value” might be the lower of cost or market value, where there is a market.

But the term “realisable value” is not defined restrictively to be a market value (as with IAS 39). UK GAAP is able to deal with the paradox of “price” and “value” and take a recoverable amount rather than a distressed price. IFRS was not able to, IFRS required “market” or a model of a market when markets were distressed. The EU then had to suspend part of EU-IAS 39 in Q4 2008. That is not an equality with UK GAAP in my view. Different rules, different authority/sovereignty.

1.3 “UK GAAP was an incurred loss model” (various evidence)

Several bits of evidence have claimed an equality of IFRS and UK GAAP for bank bad debts, due to UK GAAP also being “an incurred loss model”. I think that this is a well rehearsed wordplay on the indefinite article “an”. The Companies Act Accounting Rules are not incurred loss, it is prudent net realisable value.

The BBA SORP, is not saying what IAS 39 does, nor is it a legal instrument able to override the Companies Act Rules. My understanding is that the BBA SORP was worded to exclude recessionary forecast in provisioning, such as Spanish economic cycle provisioning, the ultimate end of the spectrum of “expected” loss. The BBA SORP was not excluding such losses as might be expected by making 120% mortgage loans to people of poor credit standing. If there is a spectrum from incurred loss to expected loss, IFRS is at one extreme, Spanish economic cycle provisioning at the other, and “UK GAAP” (Companies Act Rules, including the SORP) was somewhere between.
Indeed, Old Mutual plc, which has banking business (audited by KPMG), stated in its IFRS conversion statement that it used UK GAAP’s expected loss model.

Additionally, under IFRS, the Group has moved to an “incurred loss” provisioning model within its banking segment. Under UK GAAP, the Group utilised an “expected loss” provisioning model.

http://www2.oldmutual.com/ifrs/release/06/d/default.asp

Another example of the clear difference on transition to IFRS, the Nationwide Building Society, Annual Report and Accounts, 2006 stated:

“52j The net impact of more stringent evidence testing required by IFRS has resulted in a decrease in the carrying value of loan provisions of £86.0 million.”

2. The legality/conformity of IFRS with the purpose of accounts (Mr Davey’ specific answer Q544)

Mr Davey, was asked specifically about my evidence. But he seems to misunderstand the question around “conformity of law”. I was not saying IFRS is “illegal” which is how Mr Davey has answered the question.

Law is law and IFRS is law. But one part of law can clash with other law. Statute can clash with other statute or common law. The issue is not IFRS being “illegal” the issue is law not working. Tax law is notorious for inconsistency, and hence creating overlap or loopholes.

The purpose of audited accounts set out in IFRS and also the purpose against which the EU assesses an IFRS for adoption does not accord with the purpose of accounts set out in UK Company Law, which is corporate financial governance (“stewardship”). The purpose in English Law is set out in the Caparo case which describes the statutory position (see Appendix 3):

(i) audited accounts protect the company (such detecting frauds and not paying dividends out of capital, Companies Act 2006 Section 830–837, which is a statutory articulation of the common law), and

(ii) audited accounts inform the members at the AGM for the AGM to properly hold the directors to account and pay them properly for performance (even though this is retrospective, it takes reliable profits (and ratios) to do it).

This law “concatenates-pyramids”, ie if a if company owned by another company pays a dividend, then the above model applies. eg HBOS plc’s board (as shareholder) could rely on the audited accounts of Bank of Scotland when Bank of Scotland declared its 2007 dividend, and paid it up to HBOS plc in February 2008. Bank of Scotland has now had had > £28 billion injected into it but the y/e 2007 accounts had justified a final dividend of £1.2 billion off capital and reserves of £18 billion. The accounts were not at all reliable for the AGM (nor the acquisition by Lloyds), nor had they been for expanding lending. Total losses since the 2007 Accounts were signed off have been £30 billion.

IFRS has a very vague stated purpose (see Appendix 4). IFRS is concerned with ill-defined “users” for an ill-defined purpose which is “to be useful for users”. It is an inconsequential definition. It came from the litigation conscious USA. (See going concern later).

Usually if statute clashes with common law statute wins, or if statute clashes with statute the latter statute wins by the doctrine of constructive repeal. However, the purpose of accounts in English law, is expressly not overridden by the EU Regulation under Article 5. The EU and the Department of Business confirmed this prior to the adoption of IFRS. However, IFRS in practice frustrates delivery of Section 830–837. This is evidenced clearly by the bad debt provisioning model not being prudent or mark to market accounting not addressing net realisable amounts. It is directionally wrong to be prudent.

In summary there was no functional mechanism to deliver the law, as the law is at cross purposes. This incompatibility can be seen in the ICAEW/ICAS legal advice on applying IFRS with Company Law. From 1982 to 2005, the ICAEW guidance on distributable reserves was three to four pages. Under IFRS it is > 120 pages and increasingly confused. It is clear from reading it, that one leg of the law (Sections 830–837) requires prudence, whilst IAS 39 is imprudent. I question whether the BIS Minister was made aware of that. I am happy to supply it to the Committee.

However, there is a legal problem with UK-Eire FRS 26 as part of “UK GAAP” (ie not part of IFRS). ASB standards are not law, and must conform with the law or state their deviation from it so that the impact is shown nevertheless. I cannot see how the paragraphs in FRS 26 which have been copied straight from IAS 39 can possibly conform with the Companies Act Accounting Rules. In that case, this is not a clash of law, the inferior body (the Accounting Standards Board) is contravening the law of Rules 19 and 32.
3. **Going concern and “expectation gap”**

Lord Hollick had asked about auditors needing to be more sceptical on going concern (Q531) and Lord Forsyth on the risk of carrying 40 times gearing (Q537).

I was perturbed by what Mr Davey said about there being an inevitable “expectation gap” with auditors when he was asked about going concern. I would also refer him and the Committee to the Barings plc and Baring Futures Singapore cases. They tend to betray any expectation gap (both were settled under English Law). I do not know what “literature” he refers to on “expectation gap” but if any of it is from the USA, it may well not accord with English law. US auditors contract essentially for reporting for the market, not for the company. The “market” can be ambivalent on going concern.

Going concern is the economic phenomenon of the company being able to stand on its own two feet, ie shareholders are funding it, are standing behind it and will continue to do so. Members have the prerogative to wind up a solvent company, and administrators insolvent ones. New equity will only be forthcoming when it is economically beneficial to put new money in. Shareholders will not rationally do if their new subscription is firstly funding excessive losses.

IFRS leaves out losses and included unrealised and unrealisable profits. (Q 546, Lord Lawson, hits the nail on the head, so does Mr Carter, Q547). IFRS accounts in my opinion can be unsuitable for assessing whether a company is a going concern or for raising new capital.

Further I note that KPMG’s evidence on going concern was not consistent with the UK and Irish auditing standard ISA 570 that it claimed to be quoting from. ISA 570 does not allow a general presumption about the availability of capital whether debt or equity regardless of source or circumstances (KPMG supplementary evidence) when an auditor signs off the accounts. That would be illogical given that the audited accounts are supposed to be reliable enough for shareholders to take money out, as a final dividend. Shareholders vote on final dividends, based on the audited accounts after all.

Further, the KPMG statement “regardless of source” is at odds with the pre-emption regime in this country. Shareholders have first refusal, and to exercise that right without being misled they require accounts that are true and fair, ie they are not being kept in the dark about hidden losses and/or loss making trends.

Requiring new capital to be injected is fair to satisfy the going concern presumption if it is flagged to shareholders—the members—that new capital is required, such as with a co-terminous underwritten rights issue. In such a case the auditor opinion, and also the prospectus, should still look at the sufficiency of these additional capital resources at least a year ahead. (Or, for a subsidiary that requires support, binding parent company support).

The FRC/APB auditing standard ISA 570 on going concern is strong, and is aiming to correct IFRS. It sets out quite clearly that [probable] future losses/asset write downs are a going concern risk, they are a loss of capital. But, there is no operative accounting standard with IFRS (or FRS 26) to pick that up.

For a group holding company to be a going concern, the subsidiaries need to be going concerns, but some subsidiaries may rely on parent support. The only way to properly assess whether a group holding company is a going concern (and not being stressed by some subsidiaries) is if the group and the subsidiaries prepare prudent accounts. IFRS has upset that model, even in respect of the mandatory EU requirement for consolidated group accounts.

**STRUCTURE OF STANDARD SETTING IN THIS COUNTRY POST IFRS**

I also submit, as it has not come out in evidence, that UK GAAP (the Accounting Standards Board element) was able to react to new issues within weeks (following the Dearing Review of 1988 any issue could be fast tracked). The IASB takes up to three years even when there is a known problem eg incurred loss and the EU can take two or more years on top of that after that.

“**LEGALITY**”

In particular I note your question to Mr Davey Q544 which referred to my evidence. I believe that the minister took your question about “conformity with the law” to mean “was IFRS illegal?”

However that matter is bad law/clash of laws.

IFRS as an EU legally sanctioned preparation method (under the option to use imprudent IFRS), versus the capital maintenance/solvency clauses of the Companies Act as an output requirement dependent on prudence. A clash of law in itself is not illegal, and that is how Mr Davey correctly responded. But he did not address the conflict of laws.
Further, he did not answer your actual question which was the conformity of accounts prepared under the “statutory instrument”, ie the detailed Accounting Rules for Companies Act accounts “UK GAAP”, with the capital maintenance/solvency clauses of the Companies Act.

However, the specific problem with “UK GAAP” in your question is that FRS 26 (the Accounting Standards Board copy of IAS 39) does not accord with the Accounting Rules. The ASB is supposed to set accounting standards in accordance with the Companies Act in both senses, complying with the Accounting Rules (input) and the capital maintenance/solvency clauses (output).

This is not a matter of UK law clashing with EU law but is a matter of FRS 26 as a UK standard not conforming with UK law; neither the Accounting Rules of UK GAAP nor the capital maintenance/solvency clauses. The ASB thus unnecessarily copied the EU/UK law mismatch to create a UK/UK mismatch (and Eire/Eire).

Bank directors applying IFRS (IFRS using companies) or FRS 26 (non-IFRS using companies) may not comply with Sections 830–837, the capital maintenance/solvency requirements. If that is so they will not have discharged their solvency obligations, but they may very well think that they have, as may their auditors and everyone else.

Rather than being a counter to IFRS, like French GAAP was, FRS 26 made UK GAAP equally bad, Hobson’s choice.

**Further supplementary memorandum by Mr Timothy Bush (ADT 18)**

**THE CLASH OF OBJECTIVES IFRS VERSUS COMPANY LAW, AND PROBLEMS IN IMPLEMENTATION OF THE LAW**

<table>
<thead>
<tr>
<th>Function and purpose</th>
<th>Accounting System</th>
<th>IFRS (a derogation from preparing Companies Act accounts under EU law, IAS Regulation)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial corporate governance (Companies Act obligations)</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Transparency for accountability to members</td>
<td>Yes (requires prudence, and a judgmental forward view, dealing with on or off balance sheet risk)</td>
<td>(not only leaving risk off balance sheet, but may be hiding risk even if on balance sheet (e.g. MTM, loan losses)</td>
</tr>
<tr>
<td>Discharge of capital solvency obligations of the company and directors</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Market compliance (since 2005 - single market in financial services)</td>
<td>Pre-2005, market information resulted from Companies Act accounts plus additional Stock Exchange Listing requirements</td>
<td></td>
</tr>
</tbody>
</table>

**Comment**

If the accounting system is not discharging the directors’ duties, then the auditing of that system will not either. The members’ interest is not protected by exaggerated profits or hidden risk and hidden losses. (The director still have these duties, but applying IFRS is not discharging it).
The “True and Fair” Problem—Limitation of Scope with IFRS

1. DTI (now BIS) advice was that notwithstanding IFRS, UK statutory accounts should still discharge solvency obligations.

2. However, the IFRS enabling law (DTI 2004 for 2005 commencement) was drafted “true and fair (fairly presents) in accordance” with IFRS. IFRS defines “fairly presents” as following IFRS standards (or where not a standard, what is in “the Framework”) the problem is that the Framework is in its objects is excluding things needed for discharge of solvency obligations. IAS 39 in particular is at odds with solvency discharge.

3. There was a problem of structure; of law frustrating law, and standards themselves entirely at odds with the law and in cases directionally wrong (eg leaving out losses).

4. To solve the law problem, investors’ lawyers came up with an opinion questioning the form in which IFRS had been incorporated in UK law. This led to revisions in the Companies Act 2006, but these were only operative from April 2009. (See Hansard debate below).

5. However, even with the law adjusted to allow overriding IFRS, beyond the limited terms IFRS itself allows, there are no accounting standards to deliver the law. Some IFRS are directionally at odds with discharge of solvency obligations. Further, the FSA had used UK GAAP as the basis for prudential returns, and substituted IFRS in its place. (See ICAEW Audit Quality Forum below on the mismatch).

HANSARD—Debate of the Company Law Bill 2006

Hansard 13 July 2006, there further probing amendments to extract whether the new true and fair view clauses were enough, but it clearly describes concerns with a “tick box” regime.

Justine Greening (Putney)

These probing amendments seek clarification of the concept of “true and fair”. One thing the Bill does is move the auditing profession increasingly to a tick-box approach to auditing whereby, if accounting and auditing standards are fulfilled, the accounts and the business of the audit, as well as the accountants, are, by definition, deemed to be successful. I understand that, nevertheless, the concept of “true and fair” still underpins financial statements.

We are moving increasingly to an IAS basis for international companies, and IAS 1 includes the concept of fair presentation, which is not exactly the same, potentially, as “true and fair”. I understand that when this has been debated at European Union level, “true and fair” has predominated over even “fair presentation”. Again, it would be helpful to get clarification from the Minister that, irrespective of the fact that all accounting and auditing standards might have been followed, the accounts that emerge from that process must give a true and fair view of the financial position of the company at the date of those accounts. That must predominate, and I would be grateful if she gave the Committee that assurance.

ICAEW—Audit Purpose, Audit Quality Forum (March 2006), recognises that accounting standards headed in different direction to the law http://www.icaew.com/~/media/Files/Technical/Audit-and-assurance/audit-quality/audit-quality-forum/meeting-notes-2006/july-2006-audit-purpose.ashx

“The purpose of the statutory audit, as set out in law, reflects the stewardship role and is backed up by case law.”

“... The group believes that further consideration of the potential differences between International Financial Reporting Standards as a reporting framework and the purpose of the audit under the current UK legal framework (and future framework) by an appropriate forum would be helpful in understanding these differences and what the likely implications may be.”

Solution (TB comment) In an era of “following standards”, it is absolutely hazardous to have a regime of standards that absolutely frustrate the discharge of solvency obligations and fiduciary obligations to the members and creditors. There needs to be a statutory basis to put the basic Companies Act Accounting Rules back into operation to allow law to function. (Directors of large groups will not be getting reliable subsidiary accounts either to show their directors’ discharge).
2. Output Standard

Company law transparency (for members) and discharge of solvency obligations
Extant in law, but, IFRS does not deliver to that standard (directly clashes in places).
Also, FRS 26* (ASB copy copy of IAS 39) does not deliver to that standard either, and it is inconsistent with the Companies Act Accounting Rules it is inferior to in law (ie it is replicating the clash that IFRS also has with the law).
TUESDAY 2 NOVEMBER 2010

Memorandum by BDO LLP (ADT 19)

1. INTRODUCTION

We are writing in response to your call for evidence on “Auditors: market concentration and their role”.

We welcome your enquiry. The role of audit is, and needs to continue to be, key in the operation of capital markets which enjoy the confidence of investors. However, we believe that there are substantial issues relating to market concentration, to the conduct and scope of audit and to the underlying financial reporting framework which could potentially threaten the stability of those markets, and which thus require urgent attention. We believe your enquiry presents a unique opportunity, in this rapidly changing business environment, to re-examine the role of audit, its conduct and market structure, and the financial reporting to which it relates, afresh, with a view to setting a course for the future which is fit for purpose.

Our conclusions are set out below. Detailed responses to your individual questions numbered 1 to 14, are set out as an appendix.

2. CONCLUSIONS

2.1. Market concentration has led to a small number of firms having a very dominant position in the market. There is no evidence to support that this dominance affects the quality of auditing. There is evidence that it tends to increase price.

2.2. This market dominance is self-reinforcing in an industry where size is taken as a proxy for quality. There is a need for further examination of what quality in auditing actually means.

2.3. Domestic and international investors want more choice in the audit market, as do other market participants, including companies themselves.

2.4. There are steps that government and other market participants can take to encourage competition, albeit that firms themselves will have to make substantial investment to compete in the market for the largest public companies.

2.5. There is a case for consideration of direct shareholder engagement in the audit appointment and review process for public companies.

2.6. Many UK companies currently subject to audit requirements need not be so, saving considerable expense at little risk, for example by increasing audit exemption limits and abolishing the requirement for separate audits of subsidiary companies.

2.7. The role of formal financial reporting (and thus of audit) is diminishing in the public company arena as annual accounts (the primary focus of the audit) become increasingly peripheral in shareholder communications.

2.8. Financial reporting itself has become overly complex, reducing its value to users of accounts, despite its greatly increased volume. A process of review and deconstruction is required, based on users’ practical needs, both domestically and internationally so that accounting standards continue to converge worldwide, but not by default to the most complicated answer available.

2.9. There is a tendency to confuse the purpose of audit, which is a precise statutory requirement, with assurance more generally (of which audit is an example). There is a growing demand for assurance over the identification and management of risk in, for example, large financial institutions. This is a legitimate demand, but not one that should be confused with audit.
2.10. The reduction in a statutory requirement for so many companies to be subject to audit, and the demand for wider assurance relating to, for example, risk or to communications with shareholders other than annual accounts, will produce a need for a tiered structure of assurance to be developed to meet users’ needs, appropriate to the size and complexity of businesses.

2.11. We do consider that there is merit in the suggestion that, for public companies the section of the accounts which deals with critical judgements be required to make reference to matters which are the subject of discussion between the auditors and the Audit Committee.

23 September 2010

APPENDIX

RESPONSES TO INDIVIDUAL QUESTIONS

Question 1: Why did auditing become so concentrated on four global firms?

Concentration amongst the largest auditing firms started in earnest in the mid 1980s and was largely complete by 1990, at which stage there were six firms remaining, which now constitute the four largest industry participants.

The driving force behind these transactions was the “merger mania” of the 1980s, which resulted in the largest companies in the world being smaller in number, but larger in individual size. Sheer size itself therefore became an important component in being able to demonstrate that global coverage was available in depth, in order that the needs of the largest clients could be satisfied.

At the same time other firms, such as ourselves, were concentrating on improving their international networks to enable them to compete, by entering into arrangements with the larger independent firms in each jurisdiction.

The outcome of this wave of activity was market concentration in a relatively small number of firms, but there remained a sufficient number of market participants such that no particular firm dominated, nor was choice restricted to one or two service providers in most instances.

In 1997 Price Waterhouse and Coopers & Lybrand merged. The rationale for this merger was that the two firms feared being left adrift by the four other largest firms. The competition authorities, both in the UK and internationally, examined this transaction, but to the surprise of many, allowed it to proceed. It remains difficult to see how this merger was in the public interest, given that it resulted in an immediate 42% market share for PWC.1

The subsequent collapse of Andersen and that firm’s absorption by Deloitte, again cleared by competition authorities in the UK, led to the current position where the four largest firms in the market hold an entirely dominant position.

The sheer scale of these firms does give them an enormous advantage in auditing the largest public companies. This is a consequence of the scale of resource that they have and thus of perception of quality. It has also created a kudos around their success which has become self reinforcing—for example the mere use of the name “Big 4” is excluding in itself.

In reality other firms, such as ourselves, have ambition and have a dedication to quality which results in substantial investments in people, in service quality and in building international networks of real resilience. These should reassure the investor community of real alternatives to the largest firms.

It is also important to note that the actions taken by the largest firms in creating such enormous practices cannot now be replicated by others—there are simply not suitable merger candidates around the world to provide the stimulus to growth by acquisition that the largest firms enjoyed. The finance needed by individual partnerships to invest in creating similar sized businesses in each jurisdiction around the globe is prohibitive, even if the resources were available, and this is a powerful inhibitor to other firms to challenge the very largest firms in size terms. The market for audit services is unlikely to grow significantly and therefore any real change in concentration is unlikely to be achieved through normal market mechanisms alone.

1 Oxera, Competition and Choice in the UK Audit Market, 2006.
Question 2: Does a lack of competition mean clients are charged excessive fees?

There is a lack of comprehensive research on the effect of the lack of competition in the UK audit market on audit pricing, but what there is does suggest a direct relationship.

The Oxera Report on “Competition and Choice in the UK Audit Market” published in April 2006, indicated that the “Big 4” audit firms charged higher audit fees on average than other firms, and quoted a differential of 18%.

A research paper, published after the merger activity had completed, demonstrated that the fees charged by the less expensive of the two merger partners increased to be equivalent to that of the more expensive merger partner over a short period.

Research by the London School of Economics estimated a reduction of about 7% in audit fees of UK Listed and private companies were there to be a 10% reduction in the market share of the four largest firms.

Question 3: Does a narrow field of competition affect objectivity of advice provided?

Question 4: Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

We have seen no evidence to suggest that the objectivity of advice has been affected by the current lack of competition in the audit market in the UK.

The level of objectivity, or otherwise, in auditing is difficult to assess, as inevitably its only expression is in the outcome of individual audits, and is consequently largely a matter of conjecture.

Question 5: What is the role of auditors and should it be changed?

The role of auditors has been determined by statute and, in essence, has remained unchanged over a very long period, albeit it has been extended through other regulation. The 2006 Companies Act makes clear that the auditor’s primary function is to report on the company’s annual accounts. In so doing he or she is required to opine on the truth and fairness of the profit and loss account and balance sheet of the company or group, and additionally to state whether the directors’ report is consistent with the accounts. There may also be, in certain circumstances, separate reporting on a corporate governance statement and there are various other matters on which he or she must report, such as for example, the existence of adequate accounting records.

The focus of the audit is therefore very much on the annual accounts.

It is also relevant that the auditor’s report is addressed to the members of the company and specifically not to any other stakeholders in the business.

We believe this remains appropriate for the majority of UK companies, but that there are specific requirements for reform, both to ease the costs and administrative burdens on companies and also to strengthen responsible reporting and governance.

Audits are for the benefit of the shareholders of any company. We do believe that there is scope to look again at the threshold requirement for an audit. Broadly companies turning over more than £6.5 million per annum require auditing. We believe that raising this threshold to £10 million will remove a significant number of companies from what is increasingly an onerous requirement. This would not preclude third party financiers being able to ask for form of assurance, as part of the terms of lending, and thus needn’t be seen to erode confidence where there are indications of significant risk for stakeholders other than shareholders. Such a form of assurance could be similar in scale and scope to an audit, but could be more tightly focussed on the specific needs of the user. We do not contemplate it being set in scope by statute.

We also believe that the requirement for audited accounts to be prepared for subsidiaries (where those accounts are consolidated into the accounts of another company) could be abolished. A significant part of the audit cost and burden for medium and larger businesses relates to the requirement to have them audited to the same degree as stand-alone businesses, irrespective of the relative importance of the subsidiary to the group of which it forms part. In relation to this proposal most third party financing of groups of companies are cross-guaranteed, such that the level of risk in this proposal should be negligible. Again companies could contract for special purpose assurance where stakeholders require it, and, of course, that assurance need not be provided by the primary group auditor.


By contrast, however, we do believe there is a significant element of the private sector UK economy where audit is not fulfilling the purpose for which it was designed. The largest public companies no longer use annual financial statements as the main conduit for communicating with their shareholders. Developments in financial reporting over recent years, and notably the introduction of International Financial Reporting Standards (“IFRS”), together with the increasing sophistication in investor relations by companies and their advisors, have led to an increase in direct investor briefing and of dialogue between directors and shareholders. Indeed this has been encouraged by proponents of better corporate governance.

One of the consequences of this development is that the preparation of annual financial statements, and by extension their audit, has become a somewhat dry and compliance driven exercise. Financial statements of larger companies are now very difficult to understand and even more difficult to interpret. Their sheer complexity has made them a barrier to communication.

Consequently major communications between companies and shareholders are not subject to the rigours of an assurance process and directors are free to, within reasonable bounds, communicate to the marketplace using figures that may suit their objectives, and which will not be rooted in Generally Accepted Accounting Practice (“GAAP”). The use of non-GAAP measures is widespread and undermines comparability between companies, as well as introducing uncertainty over their provenance.

It is beyond the scope of this enquiry to examine the financial reporting framework and the various GAAPs that are in existence (or planned), but we strongly believe this is an area that needs to be re-examined, in the hope that annual accounts will once again become an effective means of shareholder communication. This is largely a matter of determining what information users are actually interested in and of providing comparability and balance.

However, in the interim, we do believe that, for particular public interest entities, including the larger financial institutions, there is a good case for requiring assurance to extend to information contained within analyst briefings and other market communications. This might further extend to an examination of risk and its management for those financial institutions and, potentially, for very large and complex businesses.

We believe that there is as yet no proven case for mandating assurance over the existence and management of risk outside the largest public companies.

Such a response needs to be scaleable and appropriate. For example, it would not be applicable to most privately owned companies and should not be onerous for smaller public companies, such as to deter entrepreneurial companies from equity markets. For the very largest, and for regulated businesses, it could involve reporting to a range of stakeholders. Such an extension of responsibility would require a re-examination of audit liability, so that risk became proportionate with reward. We can foresee a tiered approach to assurance being developed, meeting the needs of different markets, and building on the work already undertaken in this area (for example: ICAEW: Alternative to Audit, 2009).

Question 6: Were auditors sufficiently sceptical when auditing banks in the run up to the financial crisis of 2008? If not was the lack of competition in auditing a contributory factor?

We are not auditors to any of the major banks in the United Kingdom, and will therefore restrict ourselves to comments which are perhaps of more general application.

This issue of “scepticism” in auditing has recently been raised by both the Financial Reporting Council and the Financial Services Authority in their recent paper dealing with the role of audit and the banking crisis. Reference is also made to a lack of professional scepticism in the report of the Audit Inspection Unit (“AIU”) of the Financial Reporting Council (“FRC”) issued in July 2010. It is difficult to gauge the underlying evidence that there is a lack of such scepticism, but it does seem to rest, in so far as we understand the AIU report, on the same firm making different judgements about a similar set of circumstances. The recycling of this apparent lack of scepticism into the debate on auditing banks smacks of a rather knee jerk reaction to the auditor’s position in the banking crisis.

The Treasury Select Committee Report on the banking crisis acknowledged that auditors did do their job, but that their duties, as currently stipulated, were largely irrelevant to the crisis. If, for example, an institution is funding long term assets with short term borrowing and that is being correctly reported in annual accounts, then users of those accounts should be capable of determining that was the case. Assuming that there was no evidence at the time of viability risk in the short term, it is difficult to see how auditors could have flagged up the issue that, whilst the accounts were right, what they showed was that the business was not a very bright one to be in, should short term credit dry up. These sorts of judgements are the ones that investors and analysts in particular, should be making on the basis of the evidence that is made available to them. Similarly, regulators

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4 Financial Services Authority & Financial Reporting Council, Enhancing the auditor’s contribution to Prudential Regulation, 2010.

have that evidence for the protection of depositors. It may well be that the very complexity of financial reporting is masking the key messages that accounts should deliver. It is for users to make investment and other decisions. It is the auditors’ responsibility to make sure the required information is fairly stated.

Question 7: What if anything could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

As we have suggested above complex financial institutions are particularly difficult to understand adequately from the perspective of annual accounts. They are not easily dissectible by segmental reporting, as many industrial businesses are, because of the size and nature of their operations and the variety of the underlying transactions. In particular this makes it difficult to determine where risk arises and, unless volunteered, how it has been addressed. This seems to us to be primarily a financial reporting issue, rather than an audit issue.

We would commend the suggestion contained in the paper from the Financial Services Faculty of the Institute of Chartered Accountants in England and Wales ("ICAEW"), published in June 2010, that banks confirm that they have dealt with areas of judgement discussed with their auditors, and that these are set out in disclosures related to critical accounting estimates and judgements. Whilst there are always shades and tints that can be applied by management to disclosures, which are a matter for discussion and judgement with auditors, the inclusion or not of these areas is a matter of fact and one on which auditors can report if they are not satisfied. The judgement must, however, remain those of the directors and be within their report and accounts and not form part of the audit report. There would be merit in considering the extension of this idea to public companies more generally.

Question 8: How much information should bank auditors share with the supervisory authorities and vice versa?

There has been a decrease in the amount of dialogue between regulators and auditors of financial institutions over recent years, which has not been helpful, but has largely been a function of the regulatory framework. Both the joint paper on prudential regulation by the FSA and the FRC and the ICAEW publication referred to above support greater interaction between regulators and auditors. We support this development.

Question 9: If need be, how could incentives provide objective and, in some cases unwelcome, advice to clients be strengthened?

The only sanction available to auditors, other than resignation, is to modify their report through qualification or inclusion of an emphasis of matter. This is very much the “nuclear option” and therefore is not proposed lightly. There are normally a whole range of discussion issues relating to the treatment and presentation of items in the annual accounts, as far as public companies are concerned, that are the subject of a difference of view or nuance between management and the company’s auditors. Inevitably these are dealt with through a process of negotiation whereby the most important of these are dealt with by the Audit Committee, should they not be resolved earlier.

As suggested in our response to question seven above, these could form part of the discussion in the annual accounts relating to critical accounting estimates and judgements. Whilst it could be argued that reference in the annual report to matters discussed by the auditors with the Audit Committee might lead to a drive by financial management, in particular, to restrict those matters discussed at the Audit Committee, we believe that it could be an effective tool and one that auditors would be robust enough to make good use of and which investors would be reassured by.

Question 10: Do conflicts of interest arise between audit and consultancy roles, if so, how should they be avoided or mitigated?

The ethical standards, issued by the Auditing Practices Board, have provided an environment where auditor independence is regulated and where fewer non-audit services are being provided to audit clients than was hitherto the case. This position is sometimes distorted by the unfortunate way in which annual accounts disclose fees for non-audit services, which can cause confusion. There are a number of services which are effectively extensions of the audit (such as reporting on bank covenants) but which do not appear to be at all related in the way that they are disclosed. This is currently being considered by the Auditing Practices Board.

For private companies, and in particular those where there is no real public interest element, the implication of restricting further non-audit services would be to increase the number of suppliers and to put upwards pressure on pricing. This does not seem welcome in the absence of any evidence of independence failure.

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6 ICAEW, Financial Services Faculty, Audit of Banks: Lessons from the Crisis, June 2010.
For larger, public interest companies the anecdotal evidence from chief financial officers is that it is always easier to ask a firm other than the auditors to carry out additional work, because of the independence considerations and the consequent need for an extended dialogue with the Audit Committee. The latter are there, at least in part, to ensure that independence is in place and, when the general direction of travel is to increase the level of governance and the standing of Audit Committees, it seems unfortunate to take over part of their role through legislation or regulation.

We suspect that more conflict arises from a desire to retain the audit appointment, than from the provision of other services. This highlights the anomalous position that auditors work for shareholders but are, in effect, judged by management. For public companies this could suggest some intervention is required in the auditor appointment and review process. Both mandatory audit firm rotation and “quota” limits on client numbers seem to us to be directly anti-competitive. Direct shareholder representation in the appointment and review process would be welcome and would seem an appropriate response to both national and international investor concerns over audit choice.

Question 11: Should more competition be introduced into auditing? If so how?

More competition in the market for many of the audit of the largest companies is desirable. The Oxera report demonstrates concern amongst companies with the lack of auditor choice, particularly in the largest companies. The US Government Accountability Office (“GAO”) estimated that half of those companies who felt they had a choice of three or fewer auditors felt they had insufficient choice. Domestic and international investors want more choice. Companies themselves wants more choice, but the potential market opportunity is inhibited, as we have referred to above, by the practical difficulty for market entrants in being able to invest sufficiently to enter the market and hold sensible market share.

This will be particularly exacerbated if one of the four largest firms were to exit the market for any particular reason. Such a situation could lead to high risk companies being unable to find a suitable auditor, independence rules becoming inoperable and price increasing (which Oxera considered might be in the region of 14%). Such a scenario would have a disproportionately higher effect on competition and concentration than previous mergers or withdrawals from the market. There has been no international consensus on liability reform, rendering it largely inoperable, leaving failure of one of the firms as a distinct possibility. Alternatively, suggestions have been made that audit firms be effectively treated as being “too big to fail” and thus get support through some other manner. This seems particularly unfortunate in the light of the recent banking crisis, and we believe that a contingency plan should be put in place to cover the eventuality of the failure of one of the largest firms, which might include short-term measures to direct a widening of supply, to avoid a further significant increase in market concentration. As a global issue, this would need a high degree of consensus amongst major economies.

The FRC’s Market Participants Group (“MPG”) reports produced since Oxera have sought to produce recommendations for increasing choice in the audit market, reducing the risk of a firm leaving the market and mitigating uncertainty and disruption that might arise as a consequence. Whilst there has been a number of useful initiatives in a number of areas (such as the introduction of the Audit Firm Governance Code in January 2010 and the publication by the FRC of the Audit Quality Framework), the impact of all this on competition and choice has been and will continue to be negligible without real action. For example, the FRC’S Guidance to Audit Committees, issued in October 2008, included a number of detailed recommendations. The MPG found that, from 129 reports subsequently published, only 29 companies addressed information on frequency of audit tenders, 49 provided information on the tenure of the current auditor and just seven included reference to competition considerations and the consequent need for an extended dialogue with the Audit Committee. The latter are there, at least in part, to ensure that independence is in place and, when the general direction of travel is to increase the level of governance and the standing of Audit Committees, it seems unfortunate to take over part of their role through legislation or regulation.

This failure to engage suggests to us that some more evidence of market concentration and their role to the risks of auditor withdrawal from the market. Both mandatory audit firm rotation and “quota” limits on client numbers seem to us to be directly anti-competitive. Direct shareholder representation in the appointment and review process would be welcome and would seem an appropriate response to both national and international investor concerns over audit choice.

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The pre-eminence of the four largest firms is largely based on continually reinforced market views which equate size with quality. The audit market is one where quality is ill defined and therefore difficult to benchmark.

This myth is reinforced by the language that is used by virtually all market participants. The use of the terms “Big 4” and “Mid-Tier” are in themselves unhelpful. We would encourage all market participants, including Government and its related bodies, to use the phrase “major firms” to cover any that participate in the audit of public interest entities. That term at least does not preclude “promotion” and “relegation” in the normal commercial to and fro. This should lead on to the elimination of overtly anti-competitive actions, such as the much reported inclusion of “Big 4” only clauses in banking agreements.

7 GAO, Audits of Public Companies, 2008.
The domination of the “Big 4” firms of the four largest firms is replicated in the public sector. We believe Government should encourage wider market participation and should start doing this “at home”.

Without these signals it is difficult to see how firms other than the four largest will be encouraged to make the sort of investments, at considerable short-term financial cost, to ensure that there is a competitive position that is acceptable going forward. External financing and ownership models are unlikely to be effective. The payback period on such investment is likely to be too long term to attract external investors.

Question 12: Should the role of internal auditors be enhanced and how should they interact with external auditors?

The role of the internal audit is one that can only be approached on a company by company basis. The different complexity, control and business environments and sizes of companies will be determinants of what they require to ensure that they have the necessary assurance. It would be wrong to mandate a level of internal audit work from outside any company.

External auditors have been, and are, encouraged to make use of the work of internal auditors and we do not believe that any changes are needed to the current guidance in this area.

Question 13: Should the role of Audit Committees be enhanced?

Audit Committees have become an important element of the way Boards of public interest entities work and, often, appear to have taken over a higher level of responsibility from the Board as a whole, than perhaps they should have done. In particular we do not believe that Audit Committees should also be responsible for risk (and nor do we necessarily think separate risk committees are a good idea). Risk is the flip side of the coin of opportunity and is therefore a facet of every aspect of every business. This seems to us to be a matter for the whole Board.

For many public companies in the UK, largely outside the FTSE 350 the real issue is whether the Audit Committee gets sufficient support from the Board. By and large they will have one independent non-executive director with appropriate experience, who will be the chair and who, in practice, has to largely deal with all matters that are reserved for the Committee. Where there is other than an excellent relationship between the Chair of the Audit Committee, the Finance Director and the Chairman, the audit chair can be a difficult one on which to sit.

Question 14: Is the auditing profession well placed to promote improvement in corporate governance?

The quality of corporate governance in any company is more closely related to the culture of that company than it is to the governance procedures it has in place. However there are best practices in governance. Auditors, because of their relationships with a number of companies, are in a good position to advise on best practice and this would seem a natural thing for them to do, although it is a service that might best be sourced by other than one’s own auditors, in that at least partially one would be advising on the governance of one’s own relationship, and would potentially lead to the appearance at least of independence being compromised.

Memorandum by Grant Thornton UK LLP (ADT 20)

1.1 We welcome the opportunity to respond to the call for evidence.

1.2 Grant Thornton UK LLP is a leading financial and business adviser operating from 28 offices. Led by 215 partners and employing nearly 4,000 of the profession’s brightest minds, we provide personalised assurance, tax and specialist advisory services to over 40,000 individuals, privately-held businesses and public interest entities.

1.3 Specifically in respect of public interest entities:

— we audit 271 companies listed in the UK of which 186 are on AIM and 85 on main market;⁹
— we work with one in six of the FTSE 100 in providing non-audit services;
— we audit 25 local authorities as a chosen supplier to the Audit Commission including Manchester City Council and three London Borough Councils;
— we are also a leading assurance provider to the National Audit Office; and
— we publish the FTSE 350 Corporate Governance Survey.

We are a member firm of Grant Thornton International Ltd, one of the world’s leading international organisations of independently owned and managed accounting and consulting firms. Clients of member firms can access the knowledge and experience of more than 2,500 partners and 30,000 professional staff in over 100 countries and consistently receive a distinctive, high-quality and personalised service, wherever they choose to do business.

Given our capabilities in the public interest sphere, we believe we are well placed to provide the Select Committee with our perspective on market concentration and the role of the auditor.

We believe the questions posed by the Committee fall into two broad categories (i) market concentration and (ii) lessons from the financial crisis on the role of the auditor and we summarise our main comments on these two areas below:

2. Market Concentration

We are not aware of any evidence that the presence of four large firms has led to excessive fees being charged or had an adverse effect on audit quality in the markets that we serve. The current audit market structure is not viable in the long term, because the failure of another large firm would leave the market with too few firms and could lead to the exit of other firms. Market confidence would be significantly dented and the resulting market structure could create the further moral hazard that the remaining firms are perceived to be “too big to fail”. This would reduce price competition and lessen the pressure to maintain audit quality.

If this is accepted as a premise, in view of the international structures within which we and the other large audit firms operate, and absent global regulatory intervention, the only viable solution is forcibly to drive greater competition and choice as a medium term contingency plan. If one of the largest firms failed under the current market structure, an orderly transition would be difficult to effect and it is unlikely that people with requisite skills would choose to move to the next largest firms such as Grant Thornton and BDO, for example, because of differentials in partner remuneration.

The soft touch initiatives promoted by the FRC have demonstrably not worked. While there is no “silver bullet”, we believe that regulatory intervention could achieve meaningful changes in the structure of the audit market to widen and deepen participation beyond just four firms over, say, a five year period.

For this reason, we are calling for the following:

- a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest; in the first instance this might be as auditors of subsidiaries within large, public listed groups;
- placing tapered limits on the market share of firms measured by the number of appointments held over, say, a five year period, monitored by representatives from regulators and investors;
- prohibition of contractual restrictions that prevent companies from appointing firms other than the four largest for audit and/or related services.

There are helpful lessons which could be learned from the UK public sector audit market, where there is less institutional prejudice, audit quality is high and where there is a widespread view that audited entities receive value for money. In this market, independent appointments bodies monitor audit appointments, audit quality, value for money and tenders.

The ultimate aim should be, within the medium term, to create a vibrant, competitive but sustainable market for large listed company audits since healthy competition is a long term driver of both innovation and quality. Both capital markets and audit quality would benefit in the long term were a more level playing field to exist between firms which are part of global networks.

There is widespread concern that four dominant firms are too few, and in particular that the market is unduly exposed to systemic risk from the collapse of another large firm. This has led to studies on audit market concentration in a number of jurisdictions, including the UK, the EU and the US. We understand that in Japan following the withdrawal of one of four largest audit firms, the regulators were forced to step in and oversee the creation of a new audit firm and effect a transfer of audits. This demonstrates that this is a tangible rather than purely an academic risk.

Grant Thornton has a successful and well regarded business model and is now widely seen as the leading firm in the privately-held business and small listed company sectors. We are part of Grant Thornton International, a global organisation, which is responding to the market demand for more choice and has
encouraged significant investment in its member firms. In terms of audit services, the global breadth and depth of our resources now means that Grant Thornton International member firms have the capability today to audit most large listed companies around the world. What holds us back is a misguided belief that big is better. The pervasive use of the term Big 4 inadvertently perpetuates the belief that there are only four global audit players with the capability to audit large listed companies. Despite the increasing evidence from independent audit inspections, the term Big 4 continues to be used as a short-cut for quality and it is this IBM effect (the perception of there being no recognisable upside to appointing a non-Big 4 firm but considerable perceived downside risk for individuals who make appointments) which remains the biggest barrier to entry for us in this market.

3. The Role of the Auditor

3.1 We are proud of the role that audit plays in underpinning capital markets by providing investors and potential investors with confidence in the reported performance of quoted companies. We do, however, recognise the risk of the perception gap; the difference between what investors may believe an audit delivers compared with what is actually delivered. We would suspect that any perceived shortcomings in auditing in relation to the financial crisis are more likely to have arisen as a result of the current limitations on what constitutes an audit as opposed to failures to perform those tasks that presently are required as part of an audit.

3.2 The Policy and Regulatory Group (“PRG”) which represents the six largest UK firms on public policy issues, and which we chair, has made the following recommendations to the FRC:

— a publication to be prepared by the ICAEW to raise awareness of what a modern audit entails and how auditors discharge their duties to ensure audited financial statements give a true and fair view;
— the establishment by the FRC of a working group, including preparers, investors, auditors and BIS, to develop a framework which would enable large listed companies to provide enhanced and more relevant disclosures in areas such as the business model, risks, and management estimates and judgments; in due course these enhanced disclosures might encompass controls reporting and sustainability;
— the establishment of a further group to develop a framework for the provision of assurance reports on these enhanced disclosures.

We have also urged the FRC and BIS to consider safe harbour provisions for preparers and auditors who publish enhanced disclosures and assurance statements diligently.

3.3 As a member of the ICAEW Financial Services Faculty, we support the Faculty’s June 2010 Report on an enhanced role for the auditors of banks. Among the key policy proposals it contains are:

— more frequent bilateral and trilateral meetings between the prudential supervisor and audit firms on both generic pressure points within the sector and bank specific matters;
— specific, targeted reports to the supervisor by bank auditors, or another audit firm, on regulatory returns, control activities and governance;
— views on how to establish a coherent framework which would enable banks to provide high quality disclosures on matters such as more detailed explanation of the business model and identification of key risks, a detailed going concern statement, a capital statement and benchmarking. These disclosures would be reported on by an auditor.

3.4 Should, as has been proposed, a further working group be established to develop a framework for provision of assurance reports on the enhanced disclosures, then this could be designed in such a way to permit the involvement of a firm other than the statutory auditor to opine on these disclosures. We see no reason why the provision of this opinion need be restricted to the largest four firms and could see this as a possible method for delivering the benefits of multiple auditors to stakeholders, companies and audit firms seeking a foothold in the large listed market.

3.5 On the following pages we provide brief answers to the questions raised by the Committee. In the interests of brevity, we have grouped some questions together and provided one response which addresses all the questions in that group.

3.6 We commend the Committee for its interest in these vital areas of auditor concentration and the role of the auditor.

24 September 2010
APPENDIX

4. Responses to Individual Questions

Question 1: Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

4.1 At the end of the 1980s, following a period of radical change and significant growth in the profession as well as a series of mergers and acquisitions, the market started to refer, for the first time, to a Big 8. Grant Thornton made a decision to focus on owner-managed businesses, as that segment of the market where we could legitimately claim to be the leader. Following the advent of the Big 8 firms by the late 1980s, subsequent mergers within this group resulted in a Big 6 by 1989 and it was the combination of Price Waterhouse with Coopers and Lybrand in 1998 followed by the demise of Arthur Andersen in 2001 that saw six become four.

4.2 Grant Thornton has the global breadth and depth of resources to audit all but the very largest of the listed companies around the world. We believe that it is a common misconception that there are only four global audit players with the capability to audit large companies. In the large listed market, the biggest barrier to entry we face is not economies of scale but the relative strength of the brand names of the Big 4. This culminates in the IBM effect whereby few audit committees want to risk appointing a firm without such an established strong brand for fear of personal criticism for being out of step with market thinking. The point at which economies of scale would prove a bar to our competing is very high, perhaps the upper reaches of the FTSE 100. If there were genuine opportunities to grow our presence in the large listed market, we would invest further in this market.

4.3 The significant differentials in partner incomes between the four largest firms and the next largest firms is a likely barrier to the partners from a collapsed firm joining such a firm, instead they would seek to join one of the three remaining largest firms leading to an audit market concentrated on just three large firms. This would create a further moral hazard to the detriment of capital markets since these three firms might be considered de facto to be too big to fail. To date, the soft-touch initiatives promoted by the FRC have demonstrably not worked, hence we are calling for direct intervention forcibly to drive greater competition and choice in the large listed audit market which we are confident would at least maintain audit quality.

4.4 We submit that in order to protect capital markets from the inevitable chaos that would descend were four to become three, policy makers and regulators should give serious consideration to the case for regulatory intervention. The firm’s current medium term strategy is to provide large corporates with advisory services in sectors where we can demonstrate credibility with a view to showcasing the global capabilities of our organisation such that we will in the future be invited as genuine contenders to tender for the provision of audit services.

4.5 We encourage investors and policy makers to consider other markets where audit quality is high but concentration low, such as the public sector audit market in the UK. Notably this market exhibits the following features; periodic audit tenders, independent bodies which monitor quality and determine appointments and fees, and a broader audit scope to encourage bold assurance and value for money statements.

4.6 Consultation should be sought as to whether there is support among investors for an independent body monitoring appointments and fees and/or the introduction of tapered, over a five year period say, restrictions on the market share of audit firms in order to reduce concentration in the large, public listed audit market and lessen the impact of any collapse of one of the largest audit firms. This should be supported by initiatives to encourage large, listed companies to explore the benefits of using firms other than the four largest to provide non-audit services and using multiple audit firms to carry out the audit work on groups, for example, using an alternative audit firm to audit components of the group. At the same time, intermediaries such as banks should be prohibited or discouraged from including contractual restrictions that limit audit or related appointments to the four largest firms.

Question 2: Does a lack of competition mean clients are charged excessive fees?

Question 3: Does a narrow field of competition affect audit objectivity of advice provided?

Question 4: Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?
Question 9: If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

4.7 We are not aware of any evidence that audit fees are excessive in the markets in which we operate. Audit fees are negligible in comparison with the market capital values of the audited companies. Nor do we consider that greater concentration has reduced audit objectivity or quality. All firms would recognise that reputational risk is so great that, like an airline, we simply cannot afford any crashes. For this reason, whatever the field of competition, no firm can afford to be anything less than fully robust in terms of the objectivity of the advice provided. This desire of audit firms to safeguard their own reputations is augmented by a strong, independent inspection process, the results of which are now published. We consider that these are adequate safeguards of audit quality and strong incentives to provide objective advice to clients even where it may be unwelcome. We and other firms have in place procedures to prohibit the acceptance of audits where we suspect that management are so-called “opinion shopping” or seeking to find alternative advisors who will sign up to a proposed accounting treatment that their current advisors have refused to endorse. We think that the FRC already has the tools it requires to ensure that we and the other large audit firms maintain a healthy degree of scepticism when conducting their work and that this remains the most effective regulatory approach.

Question 5: What is the role of auditors and should it be changed?

4.8 We do recognise that there is a compelling case for the role of the auditor to be enhanced for some or all listed companies as well as banks. We are actively promoting debate with investors and other stakeholders on this and other topics.

4.9 The Policy and Regulatory Group (“PRG”) which represents the six largest UK firms on public policy issues, and which we chair, has made the following recommendations to the FRC:

— a publication to be prepared by the ICAEW to raise awareness of what a modern audit entails and how auditors discharge their duties to ensure audited financial statements give a true and fair view;

— the establishment by the FRC of a working group, including preparers, investors, auditors and BIS, to develop a framework which would enable large listed companies to provide improved and more relevant disclosures in areas such as the business model, risks, and management estimates and judgments; in due course these enhanced disclosures might encompass controls reporting and sustainability;

— the establishment of a further group to develop a framework for the provision of assurance reports on these enhanced disclosures.

We have also urged the FRC and BIS to consider safe harbour provisions for preparers and auditors who publish enhanced disclosures and assurance statements diligently.

4.10 As a member of the ICAEW Financial Services Faculty, we support the Faculty’s June 2010 Report on an enhanced role for the auditors of banks. Among the key policy proposals it contains are:

— more frequent bilateral and trilateral meetings between the prudential supervisor and audit firms on both generic pressure points within the sector and bank specific matters;

— specific, targeted reports to the supervisor by bank auditors, or another audit firm, on regulatory returns, control activities and governance;

— views on how to establish a coherent framework which would enable banks to provide high quality disclosures on matters such as more detailed explanation of the business model and identification of key risks, a detailed going concern statement, a capital statement and benchmarking. These disclosures would be reported on by an auditor.

4.11 These recommendations would further enhance users’ understanding of the entity’s results and state of health.

4.12 Should, as has been proposed, a further working group be established to develop a framework for provision of assurance reports on the enhanced disclosures, then this could be designed in such a way to permit the involvement of a firm other than the auditors to opine on this report. We see no reason why the provision of this opinion need be restricted to the largest four firms and could see this as a possible method for delivering the benefits of multiple auditors to stakeholders, companies and audit firms seeking a foothold in the large listed market.
4.13 At the same time, we would caution that the existing arrangements remain appropriate for the vast majority of our smaller listed companies. Therefore any expansion of the audit scope beyond banks and the large, sophisticated listed companies may need to be weighed carefully to ensure that it is proportionate for those smaller, less complex businesses and does not unduly increase the compliance burden for them without providing any additional assurance to stakeholders.

Question 6: Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

Question 7: What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of the banks?

Question 8: How much information should bank auditors share with the supervisory authorities and vice versa?

4.14 We believe that there should be free and open, two-way communication between the prudential supervisor and bank auditors. We accept that this will require the audit firms, as well as the supervisor, to educate their people to ensure that this dialogue is both full and frank such that it is a meaningful and productive as possible and we are committed to doing this.

4.15 We are aware that the FSA and FRC have raised questions around professional scepticism by audit firms and we are participating in that debate. At present we do not believe that firm conclusions have been reached, and we would simply reiterate our belief that healthy competition is a long term driver of innovation and quality. We note that the FSA has reported that even where it disagrees with judgments made by preparers, and accepted by auditors, it has found no cases where it believes the 2007 (pre-financial crisis) financial statements prepared by banks and large financial institutions failed to give a true and fair view. In our responses to the FSA, we have made the point that the FSA should make greater use, than was the case around 2007, of skilled persons (“Section 166”) reports on selected governance and other issues at regulated financial services companies and that in many of those cases it would be more appropriate for a firm other than the auditor to carry out those reports. This is one way in which greater competition might be promoted.

4.16 Grant Thornton was the first firm to call for publication of the results of independent audit inspections. If there is evidence of examples of inadequate professional scepticism we believe the FRC should be robust in dealing with them, including reporting the firm publicly where necessary. If such a case were felt to involve a Grant Thornton audit, we commit to dealing with the matter and any training needs robustly. If there are examples at other firms we do not believe we should be tarred with a broad regulatory brush.

4.17 We have raised a concern that the FSA, the current prudential supervisor in the UK, operates within certain legal constraints that it believes limit the amount of information it may share with the auditors of a bank or other financial institution. If so, we believe it would be timely for such legal constraints to be re-examined.

Question 10: Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

4.18 Indisputably conflicts of interest can arise between audit and consultancy roles. In our experience the existing principles already result in the decline of appointments that would result in a genuine conflict of interest. Those that remain are largely a matter of perception, and this view has been echoed by a number of large UK institutional investors we have spoken with. We would not support any further prohibitions on non-audit services provided by auditors since we believe that this would likely result in additional costs to companies for little or no benefit.

4.19 We do, however, support robust mechanisms to preserve both the appearance and actuality of auditor independence and specifically the IFAC Code of Ethics which is accepted by a large number of countries around the World. In the UK, the Ethics Standards which govern the ability of audit firms to provide non-audit services to their audit clients and the Smith Guidance which governs the way audit committees of listed companies oversee provision of other services by their auditor are monitored by the AIU. We are satisfied that the current guidelines are sufficient for these purposes provided all firms honour the principles of the standards and do not seek to treat them as rules which can be bent to permit undertaking assignments that may in fact be contrary to the principles of the standards. We support the recommendations of The Institute of Chartered Accountants of Scotland that audit committees of listed companies should provide clearer information about their policies to avoid conflicts of interest arising and reasons for involvement of auditors in providing substantial non-audit services.
Question 11: Should more competition be introduced into auditing? If so, how?

4.20 We believe that it is of paramount importance that more competition and choice be introduced into the large, listed audit market in order to mitigate the catastrophic damage that could be caused by the collapse of four into three large firms. We are calling on policy makers and regulators to consider regulatory intervention. We suggest examination of other markets (such as the public sector market in the UK) where audit quality is high and concentration is low and consideration of the following:

- a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest; in the first instance this might be as auditors of subsidiaries within large, public listed groups;
- placing tapered limits on the market share of firms measured by the number of appointments held over, say, a five year period, monitored by representatives from regulators and investors;
- prohibition of contractual restrictions that prevent companies from appointing firms other than the four largest for audit and/or related services.

Question 12: Should the role of internal auditors be enhanced and how should they react with the external auditors?

Question 13: Should the role of audit committees be enhanced?

Question 14: Is the auditing profession well placed to promote improvement in corporate governance?

4.21 Internal audit is an important aspect of a company’s governance and risk management. It is the responsibility of management to put in place a system of internal control appropriate to the size and complexity of the business and internal audit plays an important role by enabling management to monitor both the design and operation of internal controls. We believe it is essential that there is no blurring of the lines between internal and external audit but instead a full and open dialogue between internal and external auditors.

4.22 We believe that audit committees have a key role in bringing about the enhanced disclosures we have suggested in our covering letter. We are proposing that listed company financial statements should include an audit committee report which provides clear disclosures on the business model, risks and critical management judgments and estimates and that the auditor or another audit firm provides a fairness opinion on that report. A framework for the provision of this additional assurance will need to be agreed so that the responsibilities of management and the auditor are clearly defined and understood by all parties.

4.23 The auditing profession is well placed to promote improvements in corporate governance. Providing assurance over governance statements and advising on this subject are at the heart of the skill set of large audit firms. It is already a part of the audit of a listed company, since the auditor is required to report on parts of the Governance Code. Many of the large audit firms have substantial specialist teams that deal with governance advice. For example, Grant Thornton has produced the FTSE 350 Corporate Governance Survey which sets out a seven year trend of compliance with the Governance Code by the UK largest listed companies and our specialists were consulted last year by Sir David Walker and the FRC in their respective reports on governance reform.

Letter from Mazars LLP (ADT 21)

Mazars, the integrated international accountancy organisation is pleased to submit its evidence to the Select Committee’s enquiry into the above issue.

The Importance of Statutory Audit

Statutory audit is a fundamental element of good governance. It provides assurance to shareholders on the stewardship of their businesses and plays an important role in ensuring confidence in the capital markets. We recognise the privilege afforded to us as a firm in being registered to undertake statutory audits and firmly believe that with this right comes the obligation to help foster an open vibrant audit market that is responsive to the needs of shareholders and the public interest more widely.

Extending the Auditor’s Role is Dependent on Confidence in the Core Audit

It would be helpful to review the scope of the audit and whether this should be extended to encompass additional assurance on areas such as risk and other aspects of narrative reporting. We recognise, however, that support for such a move will only be forthcoming if there is a strong level of support from investors, regulators and others for the way in which the core statutory audit is operating with regard, for example, to how auditors report their findings and the structure of the audit market.
A More Competitive Market Needed to Protect the Public Interest

A more open vibrant audit market, especially for large listed companies, would better serve the public interest. It would reduce the potential negative risks were one of the currently dominant four firms to leave the market unexpectedly and would also, in line with experience in other sectors, be likely to lead to audit firms as a group being more innovative and more responsive to shareholders’ needs.

A Stagnant Audit Market for Large Listed Companies, not Changed by Voluntary Initiatives.

Figures calculated from independent research by Oxera and published by the Financial Reporting Council in 2006 indicate that a FTSE100 auditor can expect to remain in place, on average, for a period of 48 years, with some having held office for over a century, and those in the FTSE250 for 36 years. Oxera also found that more than 70% of the FTSE 100 had not put their audit out to tender for at least 15 years.

As the fifth progress report from the Financial Reporting Council on the implementation of the recommendations of its Market Participants Group highlights, the change to the above state of affairs brought about by market-led initiatives has been disappointing. It is now time to move on from a purely voluntary approach.

Key Areas for Reform—Fair Tendering, More Shared Audits, No Restrictive Covenants

To address the situation outlined above, we believe reforms are needed to bring about, in particular, fair and regular tendering; greater use of shared audits and an elimination of restrictive covenants.

Fair and Regular Tendering

Large listed companies, as they constitute the part of the market with both the greatest concentration and the highest related systemic risk, should be expected to tender their audits at regular intervals. Without this change, the opportunities for a firm to increase their market share, whether one of the existing leading players other than the Big 4 or a new entrant, are extremely limited.

Consideration also needs to be given to the arrangements to be made when audits are put out to tender. For listed companies, these might involve publishing tenders to ensure firms with the necessary capabilities are able to tender and having a two-stage process providing for the submission of a short document at the first stage by a number of firms from which a shortlist would be selected for the final presentation. Arrangements for the independent oversight of tendering might also be helpful.

More radically, exploration for alternative methods of appointment of auditors by, for instance, independent shareholder panels could also be explored.

Shared Audits

We strongly support considering how to actively promote the involvement of more than one firm in the audit of large listed groups. Innovative thinking is needed and the participation of each of the shared auditors may take a number of different forms. For example, one of the shared auditors may perform the statutory audits for certain subsidiaries.

Joint audits, where two firms, take full joint responsibility for the audit opinion offered, are a particular form of shared audit. We believe there would be merit in requiring leading banks in the UK to appoint joint auditors given the systemic risk involved, the complexity of their operations and the inherent subjectivity in their financial statements.

Conclusion

Our response to the detailed questions is set out in the attached appendix.

24 September 2010

Appendix

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

There are some economies of scale in relation to the auditing of, for example, listed companies but they do not explain the current levels of concentration in the audit market for such companies especially at its upper end. Investment is clearly needed in areas such as the provision of technical expertise, training and development, the development and updating of audit methodologies and the maintenance of quality control systems and
those related to independence. Significant investment has been made by our firm and a number of other firms in this area and thus the existence of some economies of scale cannot be used to justify the dominance of the largest four firms. There may also be some diseconomies of scale with respect to the largest firms due to their significant overhead structures covering areas other than those related to ensuring the quality of work undertaken. Moreover, the geographical coverage of Mazars and the main networks outside the Big 4 is sufficient to enable us to deal with the vast majority of listed companies.

Auditing has become very concentrated amongst the Big 4’s global networks, each made up of a number of independent firms, due, for instance, to the absorption many years ago of regional firms by the leading players to create what at the time were the eight largest nationwide firms in the UK; the subsequent absorption of a number of mid-tier firms by the larger firms; the merger of some of the larger firms themselves and finally the collapse of Arthur Anderson in the wake of the failure of Enron, leading to the emergence of the Big 4. On the demand side, we understand that some investors and advisers have encouraged companies to appoint a Big 4 firm when first joining the listed market or subsequently. As large listed audits rarely come up for tender, there has been ratchet effect on concentration—it has steadily increased over time with little prospect of it reversing.

2. Does a lack of competition mean clients are charged excessive fees?

Any views on whether clients are charged higher fees than they would be in a more competitive market will tend to be inherently subjective as audit fees will always be dependent to some extent on company—specific factors in a given accounting period and over a period of years fees may vary due to both changes in the internal environment of the company and in the external marketplace, for example, as a result of the introduction of new accounting standards or changes in company law. That said, it would generally be expected that if there were more regular market testing of fees through tenders and a greater choice of firm that this would have an impact on audit fees.

3. Does a narrow field of competition affect objectivity of advice provided?

We do not believe that the lack of competition would lead any firm to offer advice that was other than professional.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

We are not persuaded by any suggestion that limited competition makes it easier for the auditor to provide unwelcome advice.

This and the previous question seek to elicit views on the relationship, if any, between the objectivity of advice and the degree of competition. We would suggest the enquiry should also have regard to related issues such as the relationship between the quality of service and the degree of innovation on the one hand and the degree of concentration amongst the dominant firms on the other.

5. What is the role of auditors and should it be changed?

The current primary role of the auditor is to express their view on whether the financial statements show a true and fair view for the period covered by the audit. There are additional responsibilities relating to checking whether the financial statements are in accordance with the underlying accounting records, to the director’s report and to separate corporate governance statements (with regards to the Transparency Directive).

There has been recent discussion on whether the role of the auditor should be widened to encompass reporting, in some form or other, on matters related to the principal risks of the company and how they are being managed and also possibly to some other aspects of narrative reporting, eg concerning discussions of business performance and future prospects. We think these issues should be fully explored, as should assurance on sustainability issues, but it is vital that this be done by reference to which reforms would best serve the public interest and, within that, those of shareholders. Matters to be considered include which areas of reporting should be covered by any additional assurance requirements; what form of assurance would shareholders find to be of real value, eg on the processes undertaken by the board in the relevant area or on the outcomes: whether any additional assurance should form part of the statutory audit or represent a separate assignment; what would be the cost of providing the additional assurance and whether the additional costs involved are outweighed by the expected benefits?

Before considering extending the scope of the audit it will also be essential to ensure that shareholders, including in particular institutional shareholders, have full confidence in the current core audit. This includes considering what is the most helpful way for auditors to report their findings or, alternatively, whether the
audit committee should report on issues it and management have discussed with the auditor who could confirm his or her agreement with the disclosures made.

There would be merit in discussing whether there is concern that the exercise of judgement in arriving at the audit opinion on truth and fairness has been reduced in recent years by greater emphasis on reporting and auditing standards.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

We are not in a position to comment on this issue as we do not have access to the necessary information. We are, of course, aware that the FSA and FRC have published a paper on this issue.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

We consider that the introduction of joint audits would provide additional audit assurance in respect of leading banks and could be justified for them on the grounds of the systemic risks involved in their operation; the complexity of their business and the inherent subjectivity of their financial statements.

With regard to whether the auditors could have helped to mitigate the banking crisis, we would observe that the peak of the banking crisis occurred some months after the auditors had reported on the last set of annual financial statements for the leading banks and that the drying up of liquidity in the financial markets had not happened for an extremely long period. Moreover, when it manifested itself during the crisis it did so with relatively little notice.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

We support effective two-way liaison between the regulators of banks and their auditors. Each has access to information not available to the other and so gaining the full picture requires consultation between them. In appropriate circumstances it may be helpful also to involve the financial institution in such dialogue although there is likely to be benefit in some discussions taking place just between the regulator and auditors. Some of these discussions would best be on a collective basis between the regulators and the auditors of all the leading banks together at which sector trends, their impact and the regulator’s general concerns could usefully be discussed. In addition, we would expect appropriate one-on-one discussions between regulators and a bank’s auditors on bank-specific matters at appropriate times in the year, eg after the conclusion of the audit though, if circumstances merit it, meetings should naturally be held whenever necessary.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

We believe that fulfilling professional obligations rather than incentives should be the primary driver for providing high quality objective advice whether welcome or not.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

Conflicts of interest can clearly arise between audit and consultancy roles. Ethical standards require that the audit partner should determine whether any proposed additional services provides a conflict of interest, including a perception of one, and that where this is the case the potential assignment causing it should not be taken on unless appropriate safeguards are first put in place. Notwithstanding the above, the provision of certain services by the audit firm is prohibited.

11. Should more competition be introduced into auditing? If so, how?

For the reasons discussed in the covering letter, we strongly believe that it is essential in the public interest for substantially greater competition to be introduced as a matter of priority.

It is now clear that voluntary initiatives in this area are not achieving the desired results but if we thought the necessary change could be achieve through, for example, a robust code, eg the UK Corporate Governance Code, which was properly monitored such an approach may have merit. The issue is a European and global one, as well as a UK one and this needs to be taken into account in determining the best way forward. We believe a package of reforms will be needed and should probably include:

- leading listed companies being expected to put their audit out to tender at regular intervals;
- fair tendering processes that have proper regard to the capabilities of all appropriate firms; and
12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

Internal audit has a vital role to play in the overall assurance framework relating to large businesses. We believe there would be merit in setting out in a little more detail in the UK Code on Corporate Governance the role of the internal audit function and appropriate reporting lines which emphasise its independence from management. The primary reporting line should be to the chair of the audit committee. We also consider the head of internal audit, assuming the function is not outsourced, should have a level of seniority equivalent to that of a member of the senior management team or an executive director on the board.

If the external auditors are satisfied as to the level and range of skills of the internal audit team; the adequacy of the resources available to them and the independence of the internal audit function they should be able to place reliance on its work and take this into account in determining the amount and nature of external audit work to be undertaken.

13. Should the role of audit committees be enhanced?

We consider the UK Code on Corporate Governance and the supplementary guidance for audit committees contains significant guidance on the role of audit committees and on key issues impacting on their effectiveness.

Whilst the guidance available is generally adequate, we would encourage audit committees to review how it is implemented in their company and to give particular attention to behavioural and cultural issues in order to ensure the committee is achieving its full potential.

14. Is the auditing profession well placed to promote improvement in corporate governance?

We believe the auditing profession is one of the players with an important role in promoting improvements in corporate governance. As a firm we seek to do this through the provision of assurance services and those on board and audit committee effectiveness, risk management and internal audit and through the development of publications and organising of events to disseminate best practice.

Examination of Witnesses

Witnesses: Mr David Herbinet, [Mazars], Mr Steve Maslin, [Grant Thornton], Mr Simon Michaels, [BDO LLP], and Mr Russell McBurnie, [RSM Tenon].

Q114 The Chairman: Good afternoon and welcome to the Economic Affairs Committee. This is the fourth hearing in our inquiry into Auditors: market concentration and their role. I have just one or two points to make before we start. Copies are available of the Members’ entries in the Register of Interests and of declarations of interest relevant to this inquiry and one or two Members may declare something again today. Two Members of the Committee, Lord Currie and Baroness Kingsmill, are not taking part because of conflicts of interest.

Can I welcome the four gentlemen from the various accountancy firms? Thank you all for coming and thank you very much for your very helpful written evidence. Before we begin with you, can I just make it clear for everyone else in the room that we are stopping at 4.45 pm for a quarter of an hour in private session, but mainly to enable us to set up the video link with Australia? Then we will be resuming at 5 pm with the Institute of Chartered Accountants in Australia, who are getting up at 4 am to attend this hearing.

I would be grateful if you would speak loud and clear for the webcast and the shorthand writer. When we do have the questions we would be very happy, in order to save time, if one of you kicks off in answer and all the others simply agree. Don’t all feel that you have to come in each time, but please do if you want to. Would anyone like to make an opening statement or shall we go straight into the questions? Good, thank you very much.

My first question is a very general one to set the tone. We have had a lot of concerns and one of the reasons for setting up the inquiry was the domination of the Big Four, in terms of auditing. I’d like to ask you what you feel are the dangers in having the Big Four in such a dominant position in relation to present lack of competition. I refer to the comparatively rare testing of auditors, which has come through in some of your evidence; to the number of tendering occasions and the number of changes that are made, which are very few; and so on. Who would like to kick off with an analysis of why you feel this is a worrying situation?
Mr Michaels: I’d be happy to kick off, if I may. The position we have at the moment is a market that is heavily dominated by four large firms. Those firms are very internationally focused and also domestically focused but they have a significantly high share of the market, particularly the top end of the market; the FTSE 350 is an example. Because the market is so concentrated I feel that, in the event that one of the Big Four were to exit the market, there is a risk of systemic failure with the profession being unable to provide the market with the services that need to be provided.

So I get to the position that something needs to change and the market has tried to come up with market-led solutions for some time as a result of significant work that has been done over the last few years—that has particularly been led by the FRC and a group they formed the Market Participants Group. But that has not led to the market driving real change and, therefore, without intervention it’s unlikely that that change is going to come about in at least the medium term and potentially the longer term as well.

Q115 The Chairman: Does anyone else want to add to that?

Mr Maslin: We share that view and would say that in order to effect change in the marketplace we do think that would take a little bit of time and, therefore, in our written submissions we’ve said we think the start place for changing the market structure would be the FTSE 250. If changes were brought about there over, let’s say, the next three years that would provide a more solid platform for more firms to be able to challenge credibly in the FTSE 100 market.

Mr McBurnie: I would agree with the comments and merely add that, in terms of the negative impact on what I would see in terms of auditor stagnation—lack of movement in that area in terms of the Big Four—is that what you get is a lack of added-value service from bodies who feel they don’t need to go the extra mile to prove that they should have the audit again. One of the dangers of stagnation is a lack of a fresh pair of eyes over a set of numbers or over a business that is always useful in driving business forward and helping with the controlled environment in general.

The Chairman: I think that is one of the reasons for our inquiry and you mentioned FRC. Clearly some of the solutions haven’t really worked. So we’ll be interested, in this session, to hear what solutions you have. Lord Tugendhat?

Q116 Lord Tugendhat: Can I ask a supplementary to that? Do you regard the audit as a transaction between the auditor and the company that is being audited much like any other service that a company receives or would you regard an audit as a public good from which all citizens gain or lose?

Mr Maslin: Shall I make a start on that? I think audit is a unique service and it’s really incumbent on auditors to remember that their primary client is the investors as a whole. Therefore, while much of the interaction is with a company’s management team and with its audit committee, the ultimate beneficiary of the assurance that derives from audit is the owners of that company—so the shareholders of that company—so we must always bear in mind that they are our primary client.

Q117 Lord Tugendhat: Could I press you a bit further? I agree that the owners obviously have an interest, but surely not only the owners. The fact that a company’s accounts are audited—obviously what I am saying applies with more force to bigger companies—is a matter of significance to the owners but it’s also a matter of significance to the investment community as a whole and to the regulators in those industries that are regulated. Indeed, could one not argue that the investment community as a whole and the regulators rely on the audit to as great an extent as the owners of the company?

Mr Maslin: I think it is a very fair comment, Lord Tugendhat, that there are other stakeholders that do place reliance on the audit and I think of particular relevance here is in the context of groups like the bank supervisor. One of the issues that our firm has spent a lot of time on since the financial crisis is working with the Bank of England to try and learn lessons from the financial crisis. Our view at the moment is that the biggest contribution the audit profession could make, coming out of the crisis, is to improve the way that we talk to the banking supervisor and that is why we have been spending time with the Bank of England.

Lord Tugendhat: Thank you.

Q118 The Chairman: This is a question we were going to ask you, so let’s deal with it now. Would you like to say a bit more about that and where you are at and what you think the bank involvement should be?

Mr Maslin: One of the things we have been trying to do with the Bank of England at the moment—I think it’s been a very constructive discussion so far—is to think about the various ways in which it would be appropriate for the bank auditors to have formal and informal communication with the banking supervisor. That could be done in a number of ways. It could be bilateral and trilateral meetings that involve the individual bank audit team and the Bank of England. It could deal with specific issues with regard to specific banks and financial services companies.
There is another tier of useful communication where perhaps the bank would talk to the senior partner of the audit firm about general issues that are coming up in the financial services sector. There is at least a third tier, which probably would be a meeting between the banking supervisor and the large audit firms generally. Where there could be some sharing of concerns and pressure points that have come up in bank audits and pressure points that the supervisor is aware of. So the audit firms can all go into the next audit cycle armed with that information, so that we’re all sharing knowledge.

What we’ve been doing with the bank is to see if we can just have a very simple dialogue framework that sets out what are the reasonable expectations of the various tiers of that discussion.

Mr McBurnie: I think we probably need to differentiate between banks and other such very complex institutions in the way they are audited because I think, in terms of the financial structures that they have in place and some of the financial instruments they use, they are incredibly complex and they have, internally, people who are paid excessive sums of money potentially, but certainly large sums of money, to come up with these ideas. Are auditors and all audit firms capable of fully understanding them? Because you can’t audit something if you don’t understand it and we probably need to look very carefully at the expertise that audit firms have in looking at bank transactions and whether there needs to be special accreditation that is regulated by the ICAEW to look at these sorts of areas. When you think about how long it is going to take the Lehman’s insolvency to be unwound, because it is such a mammoth beast, imagine having to audit that and whether people can understand that in order to give a proper opinion on those accounts.

Mr Maslin: I think that’s a fair comment. With regard to the banking financial services sector, there are very complex issues involved and it takes very specialist teams to consider those matters. Some of the specialists at the large audit firms are capable of dealing with those issues but it’s certainly something that my firm would always be very careful of before taking on any new type of audit. It would only do so if it felt it had the appropriate skills and the appropriate depth of those skills. Clearly banking and financial services companies, the largest banks, are very complex beasts.

Mr Michaels: Mr Chairman, can I come back on a broader point, and I’ll also deal first with the point you raised there. One of the things that adds to some of the difficulties in the marketplace is simply the extent to which financial reporting has become so complex, particularly in relation to those financial institutions. While there is a public interest element in terms of the audits that are undertaken, there are gaps in perceptions around what is the role of audit. Other assurance could be provided to investors and it makes sense to also review how one might establish what the purpose of an audit really is and the nature of corporate reporting to reduce complexity. I think that is something we would favour being led, primarily by the FRC but also with significant input from the investor community. Without really understanding exactly what it is that investors need and want, additional levels of complexity are not really helping them make informed decisions about the risks that are being taken.

There is also an argument, I think, for a greater level of detail disclosure in relation to some of the key areas and judgements that are being made, again to help investors understand the decisions that they are making. So I think there is a much wider piece in relation to the role of audit, and a much wider piece in relation to complexity of corporate reporting.

I want to add just one more layer, if that’s okay, which is the market is segmented in a number of ways. BDO focuses primarily on the mid-market. We have a lot of fully listed larger clients and we deal with that complexity as well. But intelligent auditing means that you have some businesses that are smaller caps or privately owned; that don’t need the level of complexity or auditing that some of those larger, more complex, businesses need. I think there is pretty strong argument to have a fundamental review of what the market needs and wants and what is being provided by the profession.

Mr Herbinet: Can I take this one? I think the answer to that question, from our point of view, is unequivocally “yes”. The reason why I am saying “yes” is because we are already doing it. But let me take a step back. We understand that the prime concern of yours is the issue of systemic risk in the markets and the risk were a Big Four firm to fail. Therefore, we’ve looked a little bit more into this
issue of systemic risk and, when you look at it in more detail, I think you come up with essentially three parts of the market where systemic risk is greatest: one is banks, two is other similar financial institutions and three is the FTSE 350 market.

There are some interesting statistics on that, in that 95% of the UK market capitalisation is with FTSE 350 companies. Within that, 80% of the market capitalisation in the UK is with FTSE 100 companies. Therefore, if you are serious about addressing the issue of systemic risk, in our view it is in that segment of the market that something needs to happen because that is where essentially the value of British PLCs is. At present, only one-tenth of 1% of audit fees in the FTSE 100 is not earned by a Big Four firm; that’s my friends from BDO. That is one-tenth of 1% of the fees in the market. Therefore, we think if a solution has to be found to reduce systemic risk it is in that market that we need to concentrate our efforts.

That leads me straight into one of the questions that you may want to raise later on, on joint audit. Mazars, my firm, are already the joint auditors of Europe’s third largest bank, which is BNP Paribas, and a number of other top European listed companies. If you look at our client base, 13 of our clients would feature in the FTSE 50 in the UK, i.e. would be among the 50 largest UK companies. This has been achieved through joint audits. So I think our view is that the FTSE 100 market is where, in our view, something needs to happen and we believe that there are ways to address this issue of systemic risk in this market.

**The Chairman:** Lord Smith?

**Q121 Lord Smith of Clifton:** We are really moving on here quite logically on what follows. We are talking about size and capacity. How much investment is needed for mid-tier firms to compete for audits of large companies and financial institutions and in what areas is investment most needed?

**Mr Maslin:** May I pick this one up? Again, the way that our firm has looked at this question, Lord Smith, is to say that our recommendation is that if changes are made in the audit market structure, it’s about building greater presence in a more vibrant audit market in the FTSE 250 and we would suggest starting there. But if you look at the average size and audit fee size in the FTSE 250—if you elect to move 20% of the audits away from the four largest firms to one or a collection of other firms—we estimate that that size of market would be about £25 million to £30 million. Certainly our firm and some others believe we have the cash reserves that we would be able to make the investment to serve the entirety of that market straightaway.

So if we’re talking about making a significant change in the FTSE 250 and then building a more stable platform to look at changing the structure in the FTSE 100, we don’t think it’s a question of lack of investment capacity. Our firm has signalled the fact that if there were a change in buying patterns in the FTSE 250 we would be prepared to invest more in that market.

The reality is—and it’s shown by, I think, the lack of success of the FRC in recent years—that typically buying patterns are such that it tends to be just four firms that are successful in that FTSE 250. So we really don’t think it would require our firm to raise additional capital, even probably to get additional bank lending, to make a significant change in the FTSE 250. We would start there as a firm because we would be nervous about starting at the very largest companies in the FTSE 100 because we think that would give us a danger of an unstable business model where, too quickly, we could become dependent on one or two companies and we would not feel comfortable with doing that.

**Q122 Mr Michaels:** If I could add, from BDO’s point of view investment is not holding us back. We are a substantial international network. We audit one of the FTSE 100. We audit six of the FTSE 250. It is about us building our reputation, gaining the experience and getting the scale to be able to take on more of those opportunities which, as Steve Maslin has said, don’t come around that often. So we don’t see investment is the issue. The issues are much more, we think, around some of the institutional prejudice that exists there; that size and revenue in terms of size is seen as a proxy for quality and maybe that it’s a safer bet to buy the Big Four rather than buying one of the mid-tier firms.

**Mr McBurnie:** Can I just pick up on scale and expertise? From RSM Tenon’s point of view we couldn’t do a bank audit. We freely admit that; we do not have the expertise. I think it’s very important that whatever comes out of discussions today and in the future ensures that what we don’t do is force companies to have audits from people who aren’t capable of doing the job properly, because that is the other end of the scale and a clear risk here. From our point of view, top 100 companies would probably be out of reach in terms of scale. While we would have the expertise to do ones that weren’t bank-led or bank-related, I think—very much like my colleagues here—we would have issues in terms of the sheer scale and volume that a single job required. Investing in that and then potentially losing that audit and then having a surplus of staff would cause us issues.

While we don’t see our main competitors as the Big Four and our target market is not the top 100 or indeed the top 250, we see that mid-tier firms would...
relish, in certain cases, the opportunity to compete. But that has to be very real competition. There is no point in investing to be an also-ran; there is no point in investing just to knock the price down or cause price pressure on the Big Four. It has to be about real competition and if that is not going to be the case then I don’t think firms would choose to invest.

Q123 Lord Smith of Clifton: Do you think there is any likelihood of further mergers among mid-tier companies in order to up the threshold and the capacity or is that a leading question?
Mr McBurnie: It would certainly be a potential shortcut for dealing with the perception issues in terms of scale. The biggest thing that the mid-tier firms have to get over is the perception issue; that is, the perception of the banks and the perception potentially of investors, of brokers, of audit committees and of finance directors.
Mr Michaels: I don’t think that a shortcut of merging mid-tier firms is an appropriate solution. If you combined the revenue value of firms 5 to 10, you don’t reach the size of the smallest of the Big Four. It doesn’t deal with your reputation as well. You get a collection of mid-tier firms. In fact the investment has to be more sustained, it has to be co-ordinated on an international basis and it really has to be about gaining the experience and the scale in a very measured way and building your reputation such that people feel comfortable making different buying decisions. I should say we also act in an advisory capacity, so a non-audit capacity, for about 30% of the FTSE 350. So the buying decisions are slowly starting to come through but we’re taking a medium to long-term view because nothing is going to happen in that audit market for some time unless there is intervention.
The Chairman: Lord Forsyth and then Lord Maclennan. Lord Forsyth?

Q124 Lord Forsyth of Drumlean: I wanted to pick up on Mr McBurnie’s point where you said you wouldn’t be able to audit a bank and you wouldn’t take on a bank audit. Is that because you wouldn’t invest in the people and the expertise because you would have no chance of getting a bank audit? Isn’t it a bit chicken and egg?
Mr McBurnie: I wouldn’t disagree; there is a chicken and egg situation there. I think what I’m talking about is our current capacity and where we are now, we couldn’t do it.

Q125 Lord Forsyth of Drumlean: That is not going to change, is it? If you think you have no prospect of getting into the banking market you’re not going to recruit the people.

Mr McBurnie: Absolutely. My next point really was that firms will invest if they see that there is potential for real competition and not being on a tender list for an audit to drive the price down, but if they have a real chance. You do have this “chicken and egg” thing. For example, we are trying to break into the market on large university audits and you will get audit committees coming back to you and saying, “Yes, we really liked your tender; yes, we thought you could do the job. But you do not have any experience of that area, so we’re going to go with someone who has experience”. Well, how do you get experience of that area unless you change the market?

Q126 Lord Forsyth of Drumlean: Yes. Jut to follow up: the word “prejudice” was used; the prejudice in the market. Is it prejudice or is it just the old adage: no one was fired for buying Goldman Sachs?
Mr Michaels: I used the word and I think there is an element of that, no one was fired for buying IBM. But also the NED community that services the FTSE 350 is very well networked with the Big Four. The FDs of those FTSE 350, inevitably would have been trained at the Big Four. So it is quite deeply ingrained and, therefore, to break through—which you can do—it just takes an awful lot of time to give people that confidence.

Q127 Lord Forsyth of Drumlean: Sorry, you said most of them would have been trained. Are you suggesting it’s patronage rather than prejudice; the old school tie?
Mr Michaels: No, I’m not saying it’s that explicit. I’m saying I think it’s more subtle. I just think there is an understanding of how those businesses work, such that the comfort is there to buy those big brands from people they know and trust and that making the buying decisions outside of the Big Four—unnecessarily in my view and, I think, our view—is seen as a risky bet.
Mr McBurnie: It’s a whole raft of factors that add up to quite a barrier. So, is there a covenant in a banking agreement that says you have to go with a Big Four firm? Does the banking agreement say that they can say who your auditor should be and what is a bank likely to do? Well, they might say they want the safety of a Big Four audit. It’s the attitude of investors or the perceived attitude of investors—“If I change from a Big Four audit and go to a mid-tier audit what will that say to the City?” It might say nothing, because everyone sitting in this row here believes that mid-tier firms are perfectly capable of doing audit there. But there will be audit committees and finance directors who sit back and have that conversation and it’s breaking those barriers down.
The Chairman: Lord Maclennan?
Q128 Lord Macclennan of Rogart: Mr Michaels, in your initial answer to the Chairman’s question, which was the broad question, you referred to the systemic risk or a risk of systemic failure. But it does seem to me that in your subsequent answers to the more particular questions you have been suggesting that there is really no short term way in which that systemic risk could be tackled because you—and, similarly, others—have said that companies such as yourselves don’t want to scale up to the level at which you could spread the risk. I don’t quite see what your—

Mr Michaels: Let me clarify, if I may. The systemic risk point, in my mind, still stands. The other observations I’ve been making are that in my view things are unlikely to change and that systemic risk will not go away but it will be brought to the fore if one of the Big Four, for whatever reason, exited the market. I do think there are ways to accelerate progress and de-risk the market with intervention. I’ve mentioned the possibility of intervention.

Q129 Lord Macclennan of Rogart: Are you speaking about regulation?

Mr Michaels: I think the intervention could come in a number of ways. You have the regulators, you have investors and you have government as well. If I take the regulators to start with, you could get a situation where the regulators had more input into audit appointments within the FTSE 350. That would certainly help over a period of time to de-risk it if there was a wider choice in that marketplace. I think that is where the greatest concentration lies. If that was tied together with much tighter liaison with the audit committee chairs that ultimately have the responsibility for making those decisions, I do think you could start to de-risk the market more significantly and more quickly.

The second point I would make in relation to regulatory intervention—as the point has already been made—is that there are restrictive covenants that exist in certain parts of the market in terms of undertaking some of the banking work. If those could be outlawed in some way, which would need regulatory intervention, that would open up buying ability. The third area—and, again, it has been mentioned already—is potentially approving networks or firms to undertake certain types of work so the market has confidence that the regulator believes those firms are capable of delivering. So in terms of the regulator, without burdening and bureaucracy, I think there are simple things that could be done. In terms of investors, the more investors are prepared to engage on auditor appointments and use their influence, accepting they’re not a homogenous group—linking with audit committee chairs, again—I think there is more of a chance to de-risk the market. On government spending, again, a lot of government spending goes to the Big Four and widening that market out creates more opportunities. So I do think there are things that can be done to speed up change but if there isn’t any intervention the market won’t change in a hurry.

The Chairman: We are going to have a round-up question towards the end, I think, about solutions and what recommendations you would make in that respect and we will come back to that later. Lord Hollick, did you want to come in at this point?

Q130 Lord Hollick: Yes. I wanted to pick up on Mr Herbinet’s comment that in Europe, and I think it was in France, you jointly audit companies that, if they were listed in the UK, would be part of the FTSE top 30. So you have the skills, the reputation, the heft if you like, and the experience that could be transferred to audit those companies in the UK or companies of similar size in the UK. As a result of that expertise, have you been invited to tender for the audit process in the UK for companies of that size?

Mr Herbinet: I think one of the critical issues is that it is currently a very stagnant market. There has been some independent research carried out that shows that, on average, a FTSE 100 auditor can remain in place for 48 years—which means that they were appointed in 1960—and, on average, I think 70% of FTSE 100 companies have not had an audit tender for 15 years. So in that market, no matter which capability you have, you just don’t have the opportunity of showcasing it.

Q131 Lord Hollick: Do you think the practice of a joint audit is something that could be usefully introduced into the UK?

Mr Herbinet: That’s definitely our position, yes, and that’s the position we’ve been putting forward for the last 10 years. We think that would bring significant benefits to addressing this issue of systemic risk. Very simply, in our view, this is the only proven mechanism that has reduced concentration in a major economy and in the segment of the market where systemic risk exists. We’ve put together a short paper on joint audits, which I would be happy to leave with you at the end, but if I may I will highlight a few of the key points that I believe would be worth further consideration.

There are a number of misconceptions around joint audits. A joint audit is essentially two or more firms that express an opinion together on the financial statements of a group. The first misconception is that it is the audit being done twice by two firms; it is two firms working together to jointly form an opinion on the statements of the group. What they do is they
look at the most complex and challenging audit issues together and, therefore, you have more input into the challenge and the scepticism the need for which has been highlighted by you. There are benefits and potential inconveniences of joint audits. In terms of benefits, I think I would just flag three points. One would be that you have the “four eyes” principle that is quite key to regulation, whereby you have more people looking at the complex issues. What that creates is a permanent and inbuilt quality control during the audit on a real-time basis and focusing on judgement more than on compliance. Point two, and it’s a critical one for addressing systemic risk, is that it encourages new players to come into the market, because what you do is you offer visibility—the point that Russell was making earlier—offering the opportunity for a return on the investment that you make over the longer term.

The third point is that it facilitates rotation of work and of firms over time. One of the issues that most large FTSE companies raise is that it’s a major inconvenience to change auditors because they have to learn everything from scratch and some argue that when you change auditors you create an additional audit risk because a new auditor doesn’t really know the business. 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. So there are some clear benefits.

A number of criticisms have been made. The first one is that it’s French and I hope that we can rise above this at a time when we are combining our efforts in the Armed Forces. Factually this is wrong. It’s like rugby; joint audit was not invented in France but it has found the soil to grow and develop in France. The second criticism is that it’s very expensive. There is simply no evidence to support that criticism. The third criticism that we hear most often is that it’s a race to the bottom in terms of audit quality. Again, it’s anything but that because you have more people looking at the complex issues. Probably the best answer to that challenge is that most Big Four, all Big Four, are very happy to put their name on the same audit report as Mazars, on the companies that we audit with them. So they clearly have no issue there in terms of quality.

There is an interesting recent report that was produced by the French equivalent of the CBI—and that report was produced with the audit firms, including the Big Four—that concluded that the practice of joint audit brings more benefits than inconveniences. That included business, Big Four and key stakeholders in the market.

Q132 The Chairman: Is it mandatory anywhere else other than in France?

Mr Herbinet: It is mandatory in South Africa where they put this in place after the last major banking crisis in the mid-1980s.

The Chairman: Lord Best?

Q133 Lord Best: Am I right in thinking that Mazars do more than half of all of the joint audits in France? More than half; is it getting on for 60% of all of the joint audits are done by your firm in France?

Mr Herbinet: In France my firm audits 30% of the CAC 40 in a joint audit capacity and, within these joint audits, I think you will have a balance of work allocated to one or the other firm. On balance, my firm would probably do between 30% and 50% of the overall work on that audit.

Q134 The Chairman: We were going to ask you about joint audits in particular. I think we’ve probably covered that now but if there’s anything else you would like to add to it please do submit another paper to us.

Mr Michaels: Could I just add one thing, which is a slightly alternate view? We’re not equally sold on joint audits. This isn’t clearly a homogenous group that has a consistent view. I haven’t done the analysis on the cost piece nor the efficiency piece, but I wouldn’t want to be in a market where we’re seen as being appointed as the poor relation of the Big Four to make up the numbers, frankly. I think what I’d rather do is try and find a more permanent solution. So, although I can see how that work could be helpful in some regards and might be able to reduce the risk—I do accept that point—I don’t see that it necessarily is as permanent a solution as we might need.

The Chairman: Quite quickly, because we must move on.

Q135 Lord Forsyth of Drumlean: Before we leave that, just following up on that point and perhaps I am being stupid, but I thought the whole argument for joint audit was that it would create more diversity in the marketplace. If you are doing such a big proportion of the CAC business, why is that not working? The argument for joint audit is that it will give more firms, as I understood it, an opportunity to come into the market so there is less domination. But you’ve just described the French market where you are very big and where there doesn’t seem to be that diversity. So why is that not working?

Mr Herbinet: I would look at the market in a slightly different way. In that market you have the Big Four, you have my firm, but you have, through joint audit, the opportunity for other firms to come and establish themselves. Practically, at this point in time, Steve’s firm, Grant Thornton, is making very significant progress in the French market through joint audit.
Simon’s firm, BDO, before their previous firm was acquired by Deloitte, had a significant presence in the French market in key joint audits. So what this brings in a market is the opportunity for a firm to really go for it and make the investment and establish themselves in the market as a key player. You have many firms constantly coming into this market.

Q136 Lord Forsyth of Drumlean: So you wouldn’t say the difference is you have a Big Five instead of a Big Four?
Mr Herbinet: No, I don’t think so. I think it creates a much more open market.
Mr McBurnie: Can I just say, as a representative of mid-tier and also a finance director of a main listed company, I tend towards Simon’s view that we would not be in favour of joint audits. I cannot see how they cannot be more costly and inefficient, because it just seems the logic must be that. I also worry about responsibility falling between cracks and between firms in terms of the way the work is divided up.

The Chairman: There are a lot of other questions we want to ask you, so I think we must move on. Lord Maclennan, the fourth one, on the capital point.

Q137 Lord Maclennan of Rogart: One of you said £25 million might be enough to enable the firms to compete with the Big Four. Is that a considered view?
Mr Maslin: Yes. What I said is if one looks at the average—the average audit fee in the FTSE 250 is around about £600,000. To get down from a concentration, at present, of about 96% to 80% would involve a shift of only about 40 audits but that would be quite a significant change in the audit market. That suggests that the total amount of fee shift would be about £25 million to £30 million and, as Mr Michaels has said, our two firms would have the cash resources to be able to invest in the entirety of that market shift. But we would only make that investment if there was a change in buying patterns and we felt there was a realistic opportunity of being successful in winning those appointments.

Q138 Lord Maclennan of Rogart: What would stimulate the change in buying patterns, as you put it?
Mr Maslin: If I were to leap ahead to possibly the last question, we think there would be a lot of merit in the FRC convening a group of the largest UK institutional investors to take more of a top-down look at the audit market rather than what happens at the moment, which is that audit procurement decisions are a whole bunch of bottom-up decisions. We think that situation works relatively well in the UK public sector market where you have much lower levels of concentration and demonstrably high levels of audit quality.

I was interested in the comment of a very well respected fund manager from Schroders, albeit in a slightly different context, who made the point that if the largest UK institutional investors act together in the companies in which they invest, they tend to get the change that they’re looking for. We think it would be a very interesting model to look at; for the FRC 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. Virtually all of the FTSE 250, firms like ours have the international reach, the investment capacity and the audit quality as measured by the public reports of the inspection units, to do high quality audits in those areas. We think that is a model that would be worthwhile examining.

Q139 Lord Maclennan of Rogart: The existing investors or partners would not be concerned about the dilution of their stake if that external investment took place?
Mr Maslin: In terms of our firm?
Lord Maclennan of Rogart: Yes.
Mr Maslin: That’s what I’m saying. We wouldn’t need to dilute the ownership stake of the partner. We have the cash reserves to make that level of investment and we’ve demonstrated that we’ve been prepared to make investments of that size. Three years ago we invested about £40 million acquiring Robson Rhodes to increase our size and we’re on public record as saying that we would be very enthusiastic under the right conditions to invest in taking a substantial part of the Audit Commission work, which currently runs to several hundred million pounds. We’re very happy to make those levels of investment but we will only do so if we think there are realistic opportunities of that getting a payback in terms of winning a reasonable number of appointments, but we are able to do it without diluting a partner.

The Chairman: Mr Michaels?
Mr Michaels: If I could just build on that point, if I may. Equally, lack of investment isn’t an issue; lack of capital is not an issue. But we’ve had support from investors, very visible support, previously. When we roll the clock back to when the Oxera report was done for the FRC and the DTI on competition and choice in the audit marketplace a number of investors—and I have the letter here—sent a note to a particular business that they don’t believe there is an issue with appointing a non-Big Four firm. So I think in that sense the investor community are generally supportive and I think more engagement and more...
intervention on their part, with some encouragement, might bring about some reasonable change as well as in the other areas.

The Chairman: Lord Lipsey?

Q140 Lord Lipsey: I can see all the advantages to your firms of broadening out this market but I would like to try and get a finger on the advantages to the people who I suppose this Committee, in a sense, represent who are investors, the firms themselves, and the wider public interest. Is this really about price—you have a conflict in your evidence because BDO says the Big Four monopoly does push up prices, Grant Thornton in their evidence say there isn’t any evidence that it does—or is it about quality? Is it about radical new approaches to audit? What are the advantages for Joe Public in widening this market out so you can get more business?

Mr Maslin: Shall I lead on that? The start point I think of all of these discussions is that audit quality must be maintained and Mr Michaels’ firm and my own have consistently over a long period called for publication of the results of the independent audit inspection into the large audit firms because we would only wish to compete in any market on the basis of quality. I think the FRC missed an opportunity in December 2009 in not doing a better job of publicising the results of the respective levels of quality of firms such as ours in comparison with the largest four. So the start point must be that quality is at least maintained and we believe in the longer term you need a vibrant audit market to drive quality innovations.

I think, in terms of the public interest benefit elsewhere, we’ve never particularly seen concentration as our issue. Our firm will grow very significantly and if there are not opportunities to grow in the FTSE market we will find other areas of the market and other businesses to grow. Over a long-term period it’s investors in this country and regulators around the world that have recognised the risk of forced exit of one of the largest firms. The policy proposals we’ve put forward might bring about some reasonable change as well as without some sort of intervention the market is not going to find that solution in a hurry itself.

The Chairman: Lord Hollick?

Q141 Lord Lipsey: Yes. I think your answer is, “We will produce very good quality”. I suppose the difficulty with the quality argument always is assessing it; whether a company can assess it, an investor can assess it. It’s very hard for a layman to know what is a good audit and what is not a good audit, isn’t it?

Mr Maslin: Again, that is why—I’m sure Mr Michaels has the same view—we were very frustrated in terms of the way the AIU findings on the firms in 2009 were presented. One of the things that the AIU does is to publish a table grading the individual quality of the files that it has inspected and over the last two years it has inspected, I think, something like 183 large audits of what it calls the major firms. Within that table, Mr Michaels’ firm and mine, in December 2009, were the two firms that didn’t have any audits criticised as requiring significant improvement. I’m not complacent and I’m sure Mr Michaels isn’t complacent about that and we will have files criticised in future. But we thought there was a real opportunity there for the FRC to demonstrate that audit quality isn’t confined to four firms. What it actually did was present those findings in a way that has enabled many commentators to think that any firm outside of the Big Four doesn’t have the capability of producing quality. It was very frustrating to us.

Mr Michaels: The other aspect to build on, taking on some earlier points, is in a way it’s a shame but there’s not a lot of evidence to say that investors assess audit quality in whichever form. I think maybe it’s time that they did because if they took more interest in that again it would help.

The other point that I made earlier, about revenue or size being seen as a proxy for quality, is a consistent frustration because there’s a feeling that is where you get your reputation from. Our global network has revenues of $5 billion, yet we’re not seen as big enough to service some of those largest companies. It seems ridiculous. So it’s going to take some time and I think the more effort that can be put into articulating what quality really is and how that is recognised in the market such that it starts to influence buying decisions, the better. But I think we both go back to the point, and others as well, where we’ve said that without some sort of intervention the market is not going to find that solution in a hurry itself.

The Chairman: Lord Hollick?

Q142 Lord Hollick: Staying with the question of quality for a moment, one of the things that the Institute of Chartered Accountants said to us was that the audit has become largely an audit of compliance. It has ceased to have, or it has much less than it used to, the question of judgement around the quality of the accounting, the quality of the business model, and obviously this goes to the problems of some of our financial institutions. In a world where the audit process itself has become compliance, how do you differentiate yourself? How do you win business when it would appear that it is being robbed, denuded if you like, of its original purpose of giving a true and fair and prudent view?
Mr Maslin: I think different firms would clearly respond to that in different ways. In our firm one of the things we try to do to differentiate ourselves is to think about the way we’re delivering services, which is very much to try and focus specifically on what are the needs of an individual audited entity rather than saying, “There is a generic Grant Thornton way of delivering an audit and that is what you get”. Certainly we’ve had some very favourable feedback in terms of audits that we have won from some very large companies. I think it goes too far to say that there are no judgements in the modern audit and certainly when I ran our audit practice for seven years there were at least four occasions when, as a result of judgement disagreements with some of Grant Thornton’s largest firms, we decided that we would resign, and sometimes in very public situations, from those situations. So I think it goes too far to say that there are no judgements exercised.

I mentioned the work stream we had with the Bank of England earlier on but a second work stream with the bank and with the FRC goes to this issue as to whether more colour around judgements and the quality of judgements that are made by auditors and the volatility of valuations that are inherent in values in the balance sheets could be provided in the financial statements and the auditors could be responsible for giving some sort of statement on the fairness and reasonableness of those disclosures around judgements. I think there is a pressing need coming from investors for that type of disclosure. Interestingly, I think that that would help audit firms to compete on the basis of quality because the quality and robustness of our challenge to management and audit committees would become a matter of public record.

Mr Michaels: You talk about differentiation. One of the areas that we focus on very heavily is the service quality plus technical quality as well. So, while we put an awful lot of investment into the methodology on an international basis, into the IT, into the training, we also put a huge amount of investment and time into the service experience that our clients get because we think that is a way of differentiating and building an overall impression of quality that goes beyond the pure function of an audit.

There is another piece as well that I alluded to earlier, which is that I think again there is a wider debate to be had about the purpose of audit and the complexity of that corporate reporting and really asking investors what it is they need and want from the market, not assuming it means extending audit services. It is about looking at the wider level of assurance that can be provided to the market and what is appropriate for the relevant companies that are either investing or providing services to those businesses, where they seek to place a reliance on what is being produced by the profession.

The Chairman: We are covering a lot of ground but we have only another just under quarter of an hour and there are some other questions we want to move on to, but you’re being very helpful. Lord Moonie?

Q143 Lord Moonie: Thanks, Chairman. I should declare an interest at this point that I’m the chair of an audit committee of a company whose audit is carried out by BDO. Just in passing, I assume that you don’t think that the size affects the quality of the audit, the size of the company doing it.

Mr Michaels: The size of the company doing the audit work?

Lord Moonie: Yes. It is not aligned with quality?

Mr Michaels: No. As I said before, I think it’s a red herring but the perception is that it is an issue.

Q144 Lord Moonie: What effect does lack of choice in the market for large firm audit have on audit price and quality? Are there any other effects?

Mr Michaels: Yes. In our submission, the Oxera study that was done for the DTI and the FRC in 2006 did suggest that, following the PricewaterhouseCoopers merger in the late 1990s and following Andersen’s exit from the market in the early 2000s, price did increase. BDO also funded an independent study by the LSE a few years ago that said that a 10% reduction in concentration in the market would lead to a 7% reduction in price. It’s very difficult to say that is the case until you’re there doing it but certainly there is a suggestion that price, in our minds, would be impacted. There is no suggestion, however, that the concentration in the market leads to a lack of quality.

Mr McBurnie: I’ve benchmarked prices because I’ve had to make decisions about who does our audit and the Big Four are quite simply more expensive, pound for pound, in terms of doing the job than other mid-tier firms. We do need to be careful about balancing price with quality. Audit cannot become a commoditised service. If it is too cheap there is the risk that it is not done properly and one of the jobs of the audit committee is to make sure that a proper price is being charged for an audit. So, for example, I see my job as a finance director potentially to beat up my auditors on price but the audit committee has an overview on that price and signs off on it and it says, “Is that job being done at a reasonable price to ensure that they can do the job that they need to do properly in terms of coming to their audit opinion?”

In terms of choice, the other impacts—not just on price and on quality but more on the service side, which we’ve already sort of discussed—is the fact that if you have stagnation, if you have lack of movement, if you have a firm doing the same audit for 48 years,
what sort of onus is there on that firm to provide the value-added services; to look at the financial accounting controls and report on them, which they should be doing as part of their job, if they don’t need to in order to maintain that audit? It’s those sorts of areas. It’s the value-added; it’s the fresh pair of eyes; it’s that sort of thing that you don’t get if you have the same audit firms doing the same audits over and over again.

Q145 Lord Best: Isn’t it true that you have chosen one of the Big Four to be your auditor?
Mr McBurnie: That is correct. However, let’s be clear who I think our main competitors are. They are the mid-tier firms. Therefore, I use a Big Four firm because we don’t compete with the Big Four. I know people can talk about independence but I put it to you that if Tesco sold audits, Sainsbury’s wouldn’t buy one from them.
The Chairman: Lord Forsyth?

Q146 Lord Forsyth of Drumlean: I’ll resist the temptation for once. I think I know what the answer to this question is going to be. Some people have suggested that internal audit should be mandatory for UK-listed companies rather than explain why you don’t have internal audit procedures, if that is the case. What do you think about that?
Mr McBurnie: I think for the right size of firm internal audit should be mandatory. I wouldn’t put it for all companies. You might say it’s the top 100, it’s the top 250, but it has to be internal audit that is written very clearly with clear guidelines: what are they going to report on, what are they going to do and a framework within which they work very closely with the external auditor as well in order to get the best value from it?
Mr Maslin: Could I offer a variation on that view? It comes back to the concept of the FRC perhaps convening a group of leading institutional investors to look at audit appointment issues but audit issues more generally. I note earlier this week there was a study released by Deloitte in which a number of internal auditors of large companies expressed some concern that their internal audit functions weren’t as well resourced as they would like.
I think it’s easy to have a regulatory intervention that says, “Do something, have an approach” and someone can tick off a box and say, “Okay, we never used to have an internal audit function. We now have a part-time person doing internal audit”. I think a more effective way of looking at concerns around internal audit and all sorts of other governance issues would be to get a dialogue going so that if there were a concern like that it could be assessed and evaluated by institutional investors together and if they felt there was a weakness in the market they could bring pressure to bear on the companies in which they invest to bring about improvements.

Mr Michaels: I agree. I wouldn’t make it mandatory. I think the FRC guidance is adequate and I think it depends on the complexity of the business and the need for the appropriate checks and balances to be provided rather than should be driven by the regulator.

Lord Forsyth of Drumlean: That wasn’t the answer I was expecting.
The Chairman: We’re coming to the big mop-up question, I think. Lord Best?

Q147 Lord Best: I chair an audit committee that uses BDO and I chair another organisation that uses BDO for its internal audit. So I declare that interest.
The big question is what is the one single measure that each of you would suggest in order to widen choice in the audit market? Perhaps you could set that in the context of the fact that the consultation that goes on with the profession through the Financial Reporting Council, the FRC, is almost entirely with people who have a self-interest, a vested interest, in the outcome of that consultation. I think about 85% of those consulted are in the profession themselves. But, even with that backdrop, what would be your suggestions for change to give us more choice in the audit market?
Mr McBurnie: I don’t think there is a silver bullet that solves this in one go but I do think this is a once-in-a-generation opportunity, if you like, to grasp the nettle and do something about it. For me that single issue is around intervention, around the regulators, around investors and around government as well in terms of spending. Building on that point of intervention, I think, without it becoming bureaucratic, there is an awful lot you can do to speed up the de-risking of the market and creating more choice for investors and making sure absolutely that the market is providing them with what they need and want as opposed to a solution that isn’t necessarily appropriate for their means.

Mr Maslin: I would go back to something I’ve said a number of times, which is that the ultimate user of audit services is the investor community and that’s why I quite agree, Lord Best, that the valid views here are from the investor community, not from Grant Thornton and other audit firms. But I do think there is a role for a strong steer to be given to the FRC to convene a grouping of large institutional investors to take on some of these issues and I think that would be the most effective way of getting the market and the investor community to bring about change in the audit market structure for the companies in which they invest.
The Chairman: Mr Herbinet.
Mr Herbinet: I was a member of the market participant group that the FRC put together to try and come up with market-led solutions and we are where we are today with very little impact from the recommendations made. So I would totally agree that regulatory intervention, in my view, is needed as part of a programme of reforms. If you ask me to select one measure I don’t think anyone here would be surprised that I would recommend joint audit; in particular for banks and other listed companies posing a systemic risk to the market, the economy and society at large. All firms will be looking at it and all stakeholders will be coming at it with an element of self-interest. I think it’s down to people like you to assess whether the recommendations would have an impact on this issue of systemic risk.

Mr McBurnie: I would tackle the audit committees, because that’s where the decision-making in terms of audit choice lies. I would strengthen the role of the audit committee. I would ensure that members of the audit committee had proper and clear qualifications in order to be able to do their job properly and I would insist that there was greater transparency. So there should be some words in the audit report that forced the audit committee to report on performance review of the auditors, retendering timetable, pricing, reasons for their choice of auditors, what work they undertook with audit planning, the work undertaken to review what the auditors did as part of the audit committee, review of key judgemental areas affecting the figures, why they’ve chosen not to retender the audit. That has proven to work in the public sector because by having a very open tendering process you can have audits based on quality assurance rather than just price and perception.

Mr Michaels: May I make one more observation, a very short one, which is that there is an EU Green Paper out at the moment on audit policy, which I’m sure you’re aware of? I think the solutions that one might seek to impose in the UK, given the international nature of business and given the international nature of the investor committee as well, it’s going to be very important that they are, where possible, done on a much more co-ordinated basis; much as certainly we would like to see the UK taking the lead in that.

Q148 The Chairman: Can I just come back to the tendering point? There has been increasing pressure in the last 10 to 15 years, in corporate governance to retender in all sorts of areas—financial advisers, in the pension world, actuaries and so on and so forth—and there is a fairly standard process for a lot of us now in doing that every five years. You’ve mentioned that a lot of firms haven’t changed their auditor in over 48 years. Do you think that retendering should be made compulsory?

Mr Michaels: No.

Mr McBurnie: No, but I think—

Q149 The Chairman: Would you like to get it more consistent?

Mr McBurnie: What I would like to see is a very open decision-making process on why they decided not to retender. I don’t think you should force a company to retender and go through a process if they have the right set of people doing the right job. That seems to me to be creating bureaucracy for bureaucracy’s sake.

Q150 The Chairman: You’re putting a heavy weight on the chairman of the audit committee then to take the view instead.

Mr Michaels: Yes. I think the linkages with the investor community are absolutely vital to make those decisions but the point I would just add to it is there is a study, which we would be more than happy to share with the Committee, that says that mandatory rotation compounds the concentration issue. This is because, while audits are put out to tender, those that are done so by the non-Big Four firms are generally sucked up by the Big Four and it’s very difficult for the non-Big Four to win them back. So I wouldn’t favour mandatory rotation in that sense and I will share the research so you have that as a reference point.

The Chairman: I would be grateful if you would let us have a note on that. That would be very helpful.

Mr Maslin: If I could say very quickly that more regular tendering is necessary clearly to effect change in the audit market but, of itself, if there is no change in the buying behaviours as a result of that, then I don’t think it gets us anywhere. So I agree with Mr Michaels.

The Chairman: Lord Forsyth?

Q151 Lord Forsyth of Drumlean: It is a slightly rude question but is it the fear that you would lose business to the Big Four if there was such a process? Is that part of the thinking behind it?

Mr Michaels: I would build on the point Steve Maslin made, which is unless the buying patterns are going to change on a permanent basis mandatory rotation could be a one-way ticket. So I think there’s a combination of factors in it.

Mr McBurnie: My view is based on what the company is doing, what is best for them, because it makes no difference to our firm at all whether there is mandatory rotation in the top 100 and 250 because it’s simply not a market we’re competing in against...
the Big Four. So we have nothing to gain or lose, as it were.

The Chairman: Gentlemen, you have given us a fascinating afternoon with a different perspective, which is exactly what we expected and you’ve certainly fulfilled our expectations. So thank you very much indeed for coming. We will now adjourn for 15 minutes and then be on the line to Australia, and it will be an open session at 5 pm. Thank you.

Supplementary memorandum by Mr Steve Maslin, Grant Thornton (ADT 22)

Having viewed a number of the oral sessions and read some of the written submissions to the Committee, I am moved to write to you to reinforce two points I made at the oral session, as I am very concerned that the Committee could be misled by aspects of the evidence supplied by some other parties. If protocols permit, I should be grateful if you would bring this note to the attention of the Committee and I would be happy for its contents to be put on the public record. As ever, I would happily take your advice on how best to deal with this matter.

The first point concerns audit quality, a matter my firm views as a priority. I expressed the view at the hearing that the FRC had missed an opportunity in publishing the results of the 2009 findings of the AIU on the large audit firms to make a positive comment on the audit quality of some firms outside the four largest. While I am not complacent about Grant Thornton’s ability to deliver high quality audits on a consistent basis, and acknowledged that the firm would be likely at some future point to have audits that the AIU believe were less than satisfactory, those 2009 AIU findings highlighted that while each of the four largest firms had audits graded “requires significant improvement” neither Grant Thornton nor BDO had any such negative findings in the audits examined by the AIU. (I have provided a summary of the 2009 AIU findings in the attached memorandum.) Not only did the FRC miss this opportunity to correct some false perceptions about relative audit quality at firms such as Grant Thornton and BDO, in publishing the 2010 AIU audit findings it allowed some commentators to perpetuate further the myth that the four largest firms have a monopoly on audit quality (for example in response to the 2010 report of AIU findings the Times ran a piece on 21 July which stated:)

“Regulators have been concerned for years that the audits of big companies are concentrated among a handful of top accountants—but if the smaller firms are not up to the job, what choice do those companies have?”

despite the fact that the AIU report did not contain criticisms of Grant Thornton or BDO). While in its own written submission to the Committee the FRC does seek to redress this balance, I continue to believe it could do much more when publicising the AIU findings to make a positive comment (where merited) about respective levels of audit quality.

I am keen to reinforce this point now, ie that the evidence of the AIU findings is that firms such as Grant Thornton and BDO are capable of providing high quality audits to large corporates—which is a priority, and arguably on a more consistent basis, as I see that one of the largest audit firms in its written evidence has sought to make a link between size of audit firm and levels of audit quality. I believe that it would easily be possible for a reader of that submission to draw the false conclusion that the AIU’s findings support the audit quality of the four largest firms over firms such as Grant Thornton and BDO. While in its 2010 report the FRC did criticise the audit work of some small firms, this criticism was clearly directed at certain firms very much smaller than the four largest and indeed much smaller than Grant Thornton or BDO.

The second point concerns the levels of investment required, inter alia in global “audit approaches”, for firms such as Grant Thornton to provide high quality audits to large corporates which operate on a global scale. I expressed the view at the hearing that Grant Thornton already has the capability to deliver high quality audits to possibly all of the FTSE 250 and indeed much of the FTSE 100 and that we have the cash resources already in place to acquire the people necessary to audit at least 20% of the FTSE 250 without diluting partner capital.

I am keen to reinforce this point now, as I see that one of the CEOs of the four largest firms is reported to have told the Committee that his UK firm had spent approximately £40 million to roll out the firm’s revised audit approach project in response to the changing needs of its clients and that the “overhaul” cost the network globally around $400 million. However, Grant Thornton (both in the UK and throughout all of the Grant Thornton International member firms which operate in approximately 100 countries) has already invested in and successfully rolled out its own modern audit approach which is enables us to meet the industry international quality kite mark (ISQC 1) and all modern audit standards and regulations. Moreover, the
results of the AIU inspections, coupled with the various audit awards Grant Thornton received in 2009 (which include:

— the CBI/Real Director Auditor of the Year (Large 6) Award (voted by the FDs if 1,000 of the UK’s largest entities);
— the AIM Auditor of the Year Award; and
— the Accountancy Age Global Audit Firm of the Year Award

suggest to me that we have successfully implemented this modern audit approach in a way which enables Grant Thornton to continue to provide high quality audits in a way which meets the needs of its large corporate audit clients.

I am sorry to introduce a further piece of written evidence, as I am sure that the Committee is already faced with a large amount of material. However, Simon Michaels of BDO and I have both referred to the danger in the audit competition and choice debate of false perceptions being allowed to circulate and I am very keen to reinforce Grant Thornton’s record of and commitment to delivering high quality audits to large corporates on a consistent basis (without in any way being complacent about that record) and its commitment and capability to invest in securing a significantly higher proportion of FTSE 250 audits (and over time FTSE 100 audits) and indeed similar investments on an international basis.

That increase in market penetration can only come about with a change in the buying patterns of these companies. We believe that regulatory action is necessary to provide a stimulus to change those buying patterns and we believe that the package of proposals we submitted to the Committee are a practical start point.

*December 2010*

**Summary of AIU findings published in 2009**

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**Supplementary memorandum by Mr David Herbinet, Mazars (ADT 48)**

I thought it may be helpful if I followed up on Questions 135 and 136 from Lord Forsyth of Drumlean concerning the audit market in France.

An independent review carried out in the UK on the audit market indicated that more than 70% of FTSE 100 companies had not held a competitive tender for at least 15 years (in some cases it may, of course, be for a considerably longer period). By contrast over 50% of CAC 40 participants in France have put their audit out to tender in the last five years.

In the FTSE 250 in the UK just 4.4% are audited by a non-Big Four firm. This compares with France where in the case of the largest 2010 listed companies outside the CAC 40 80% are audited, in a joint audit capacity, by a non-Big Four firm. Moreover, 101 audit firms are involved in these audits in France which enables them to gain exposure to the listed company audit market and, if they choose to invest, they can do so in order to build a bigger market share.

The key lessons we would draw from the above analysis are that joint audit has enabled firms to compete and establish themselves in the audit market for large listed companies and that fair and regular tendering is essential if non-Big 4 firms are to build their market share. Joint audit facilitates regular tendering since if the
The scale of international financial market activities has grown substantially over the last 10 to 15 years. In particular the growth of cross-border financial activity is even more rapid—international capital flows have been increasing at over 10 per cent a year over the last 15 years. As business and the financial markets have grown and become more international there has been a strong desire from parts of the business community to have one audit firm—across many jurisdictions—meet their needs. This desire has been a strong incentive to some firms to continually build their global size.

In setting a context for our response, we wish to outline three particular themes which we believe are important to consider:

— Future of Audit—the global events of recent years have shown that there is more work to be done by all stakeholders to contribute to identifying, analysing and responding to “systemic risk”. Systemic risks stem from the size and complexity of institutions and their relationships with other parts of the financial systems. Many and varied proposals about systemic risk have been brought forward. An auditor’s current practice with its clients is to identify risk within the company. However it can be seen looking forward that there will be much greater emphasis at country level as well as industry and company level on business risks. Auditors are well placed to be involved with the reporting on risks to the business model and the potential for that model to fracture.

— Continuous Assurance—enabling technology now permits business to be conducted 24 hours a day, every day of the year. While this dramatic change has occurred in the business environment, the financial reporting and assurance model continues to focus on the past, reporting in accordance with a historical financial reporting framework. In our view there is merit in exploring changes to this model to permit “closer to the event” assurance in order to align the assurance model more closely to the business model. The term “continuous assurance” is used to describe such a model. It may well be that this type of assurance is complementary to, but does not replace the current historical financial reporting framework. We attach a copy of our recent thought leadership paper on continuous assurance.

— Audit Quality—Shareholders, company directors, audit committee members, auditors and regulators all agree that quality external auditing is fundamental to capital market confidence. In just a few years the concept of audit quality has evolved from being a relatively static concept, loosely discussed and poorly acknowledged to having “real” substance and understanding. The pace of evolution of Audit Quality is accelerating and there are great opportunities for the audit firms and professional bodies to influence the ongoing enhancement for the benefit of all. For example in recent years there has been significant work in clearly understanding the drivers of audit quality. That work is then used by participants and stakeholders with the common goal of continuing to improve audit quality. We produced *The Benefit of Audit—A Guide to Audit Quality* based upon the drivers to enhance communication (in plain English) between the audit committee and the external auditor—it has been well received. We attach a copy of our Guide.
Australian Treasury noted earlier this year that our audit regime compares well with international best practice and that the audit regulatory framework appeared to be functioning effectively during the current uncertain economic conditions. We believe that the above three themes are of sufficient importance that we will be investing substantial resources in their further development.

Finally, in presenting an Australian perspective, it is important to recognise the presence of Professional Standards Legislation in our regulatory framework that places limits on the liability of auditors. This is important in keeping audit attractive to providers, because of its impact on reducing the incentive or the need for auditors to exit public practice, as well as reducing the barriers to entry. It is also an essential driver of overall audit quality and in ensuring that the market continues to receive quality audit services.

September 2010

RESPONSES TO SPECIFIC QUESTIONS

1. **Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?**

   The emergence of four major audit firms over the last 10 years is due to a number of factors. Firstly the increasing globalisation of business and clients' preference for engaging one firm of auditors in all the jurisdictions in which they operate. Clients do value all of their operations being subjected to independent external audit using the same approach and methodology. The globalisation of business has also led to dominance of certain providers of other types of commercial activities—outside of auditing—such as investment banks.

   Secondly the rapid demise of Arthur Andersen in 2002 left a considerable limit on audit firm options.

   Thirdly the rapid ascent of significant engagement and public commentary by audit regulators has led to some rationalisation of audit providers. Some practitioners in Australia have considered it more beneficial to change their business models to move away from auditing services to the delivery of other types of accounting services. We have seen a contraction in the Australian market of audit firms and registered company auditors. However, the first question being asked could infer that only the four major audit firms are capable of servicing multinational clients. The Institute's experience is that this is not the case, and many firms other than the four majors can, and do, provide quality auditing services to multinational clients.

2. **Does a lack of competition mean clients are charged excessive fees?**

   Whilst the Australian listed market's audits are dominated (by market capitalisation) by the four major firms there are approximately 100 different audit firms currently engaged with a listed client. There is not a lack of competition amongst audit firms in Australia. There is strong contest around audit and current evidence showing aggressive fee reductions to encourage clients to change auditors or incumbent auditors to retain clients.

   This strength of fee competition has recently led our audit regulator to take certain actions to preserve the delivery of quality auditing. The Institute has warned our members that audit files of entities which have changed auditors and where a substantial fee reduction is evident, will attract closer scrutiny under our quality review program to ensure fee reductions do not lead to a reduction in audit quality.

5. **What is the role of auditors and should it be changed?**

   Notwithstanding many years of work on the clarity of communication, the role of external auditors in general is not well understood by many stakeholders—even by groups who have regular on-going contact with their auditors. The “expectation gap” is the differences between what auditors do and what stakeholders perceive they do is very much alive—and potentially growing wider. The statutory audit report—a primary output of an audit—is important to stakeholders in terms of the fundamental assurance it provides, enhancing the credibility of information reported on. However the current model of audit needs to change and expand. Part of this change lies in the general annoyance that audit is seen to be only focused on the past and “why didn’t the auditor see this beforehand?”

   The role of the auditor has been, and continues to be, to provide an independent professional opinion on whether the financial statements of the entity present fairly the entity's state of affairs and financial results for the period. The financial position and operating results directly reflect the results of the decision of management and the Board of Directors of the entity.
We believe that the role of the auditor should be expanded to focus on:

(i) the reporting of risks to the business model and
(ii) “closer to the event” assurance.

We have outlined these themes in more detail in our opening comments to this response.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

As mentioned above, it is not currently the responsibility of auditors to assess and report on risks to the business model. That area has clearly been the responsibility of the entity’s Board of Directors and management. However if that role of the auditor could be expanded we believe that it would assist with the identification of systemic risk and the supervision of the banking sector.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

Conflicts of interest can arise between audit and consultancy roles being performed by the same audit firm. The conflicts could be real or perceived. However the main issue here is how the firm and individual practitioner identify and responds to those conflicts.

Our members of the Institute are obliged to comply with the IFAC Code of Ethics for Professional Accountants. The Code is principles based and adopts a “threats and safeguards” approach to potential conflicts of interest. There are a range of responses that a firm may use with different circumstances including not accepting work or terminating an engagement if a conflict arises. Furthermore, some jurisdictions have prohibited specific activities or relationships which are considered to impair auditor independence.

In Australia the Corporations Act 2001 prohibits audits being undertaken where certain conditions are present.

With the increasing focus on conflicts of interest, audit firms have invested heavily in developing systems, policies and processes to record and identify any potential conflicts of interest. They also have well developed approaches to responding once a conflict is identified. Also with the ascent of audit regulators in recent years, a considerable amount of their work has been focused on understanding how the independence of audit services is delivered and the focus on conflicts of interest. All of these initiatives have added greatly to managing conflicts of interest.

Also we would bring focus onto the important role that the Audit Committee has to play in monitoring any non audit services that may be provided by the auditor’s firm and determining whether there any threats to the independence of the auditor. The Audit Committee must work with their external auditor to ensure that conflicts of interest—real or perceived—are managed appropriately.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

The role of internal audit is an essential contribution to the accountability and governance arrangements of a company. It plays an essential function of being “the eyes and ears” for the audit committee. Our analysis shows that there are a number of areas of better practice in the way internal audit operate and those should be further developed and adopted. For example the reporting lines for internal audit should be appropriate and there should be clear alignment and integration with risk management practices.

Also the role of the internal auditor could become even more effective if the current reporting and assurance model is supplemented by closer to the event assurance. Our thought leadership paper Continuous Assurance for the Now Economy, suggests that:

“... the emerging field of Continuous Assurance attempts to better match internal and external auditing practices to the reality of the IT-enabled entity in order to provide stakeholders with more timely assurance.”

The paper further suggests that most large organisations have several audits (internal, fraud, compliance, quality assurance, Basel II) which often have different structures and platforms and do not share findings. "Rationalisation of these audit-like functions, closer coordination and technology integration with external audit, and common platforms for audit/compliance, etc would create efficiencies and substantial improvement in the handling of risk."

As more experience is gained in closer co-operation it is likely that the audit model will evolve to extend reliance on the work of internal auditors in certain circumstances.

We believe there is great benefit in exploring this thinking for the role of internal audit further.
13. Should the role of audit committees be enhanced?

An independent audit committee is a fundamental component of a sound corporate governance structure. Importantly it brings together in one place non-executive directors, management, external audit, internal audit and advisors. The role of the audit committee has evolved significantly in the last 10 years and will continue to evolve. It has moved from being a fairly limited function primarily focused on the completion of the audited financial statements to a much broader and integrated focus of responsibilities. Drivers of this evolution include regulatory expectations, market expectations and better practice initiatives.

We believe that further enhancements can and should be made to the role of the audit committee. An essential element of the audit committee’s role is to interact effectively with the external auditor towards obtaining a quality audit. In order for this to happen the audit committee needs to be equipped to understand what a quality audit entails and to engage with their auditor meaningfully. We are assisting with this goal and have a range of initiatives underway to assist the director and audit committee community. To support these initiatives we have used *The Benefit of Audit: A Guide to Audit Quality*.

We also believe some further analysis needs to be undertaken about potential “barriers” to effective audit committees and how those barriers may be overcome. This could include what potential changes could be made to the law (if any) to allow auditors to provide more meaningful reports for the better performance of the audit committee.

Communication between auditors and the audit committee is important, as is communication between the audit committee and the company’s stakeholders. In our view there is merit in exploring an enhanced role for the audit committee in external communication and contributing to an improved understanding of what auditors do.

14. Is the auditing profession well placed to promote improvement in corporate governance?

Yes. In short, the training and experience auditors receive make them invaluable in promoting improvements in corporate governance. In addition it is the auditor who is able to engage with a client in a close and meaningful way but still retain that view of independence—that is a rich and unique perspective.

The IFAC *Code of Ethics for Professional Accountants* is the foundation on which the work of professional accountants and auditors is constructed. More particularly, the Code embodies the fundamental principles of integrity, objectivity, professional competence and due care, confidentiality and professional behaviour, which are integral in all the professional work undertaken by auditors.

The auditing profession in Australia already makes a substantial and broad contribution to improving corporate governance practice and that contribution should be developed further for the benefit of all.

*September 2010*

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**Examination of Witnesses**

Witnesses: Mr Lee White, [Institute of Chartered Accountants in Australia], and Mr Andrew Stringer, [Institute of Chartered Accountants in Australia] gave evidence.

Q152 The Chairman: Good morning. Can you hear me all right? Mr White: I can, thank you. Good morning, or should I say good afternoon? The Chairman: I think there is a two second gap between us speaking and you hearing. Mr White and Mr Stringer, thank you very much indeed for appearing in front of us, and welcome to our Economic Affairs Committee. We think this is probably the first time we’ve done a video link with Australia, so we hope that it works successfully. I’m not even looking at the camera, which I should be doing. So thank you very much indeed for that. The form is that we’ve a number of questions we want to ask you and I think you know the flavour of them. We will be taking it in turn to ask the question and the camera will pan to each Member who is doing it, but we do tend also to come in with impromptu questions. So I will try and control that at this end. Thank you very much also for your written evidence to us and we are very grateful for that. I would like to ask you whether you want to make any opening statement or go straight on to the questions. Mr White: I might just make a very brief opening statement and not really to re-emphasise what was already included in the written submission, my Lord, but really just to set a little bit of context from the Australian perspective.

Very briefly, if we look across the Australian experience in the last five or six years, there have been about four significant changes to the public policy framework around auditing in Australia that I think we should just reflect on for one moment. Those four components are, firstly, the creation of government
audit oversight, which is similar to what your UK FRC has been doing. Secondly, auditing standards became legally enforceable in Australia from 2006. Thirdly, there were a number of independence rules written into our laws for auditors, and fourthly was the creation and development of professional standards legislation and proportionate liability, which really is around the capping of liability for auditors. So in a very brief period of time we have seen—excuse me for a minute, I think our lights have just gone; my apologies. You have to keep moving occasionally here to keep the lights going. But those four changes have been very important in the auditing framework in Australia.

Q153 The Chairman: Thank you very much for that. Your written evidence suggests that the Australian market for large firm audit is less dominated by the Big Four than elsewhere and certainly than here in the United Kingdom. Why do you think this is and is the Big Four market share in large firm audit a concern in Australia? We have just heard evidence before you from some of the second-tier firms and one of our starting points is that there is clear concern that if one more major audit firm disappears we really are in a risk situation. That is the concern here. Is that sort of concern shared in Australia or is your position different?

Mr White: That last concern is certainly one that we do share, but let me set a little bit of context again from an Australian perspective. If we look at the listed market community in Australia, there are approximately 1,800 entities currently on the market. If we drew the ASX 200, the top 200 entities, that would account for in excess of 80% of the market capitalisation. So you can see in the spread of our listed markets we have 1,800 by number but most of the market capitalisation concentrated in the top 200. So that leads us to seeing that we have a lot of entities on the market that need auditing that are spread around Australia and, in some senses, the geographical spread of Australia has been one of our strengths to encourage audit firms to remain competitive within the market.

One further element of that, my Lord, is certainly around Western Australia. So that is where we have a lot of the mining community and a lot of the junior miners that are listed on the market to try and raise monies, which may or may not be successful. So partly it is the geographical spread that has allowed our markets to have a little bit more healthiness than perhaps what you have in the UK. But the other element I would like to point out, which is something building from my opening remarks, is that the presence of the professional standards legislation and the proportionate liability arrangements in Australia have certainly been an element that our membership has said has allowed them to remain within the audit community and practising as auditors and if that strength wasn’t in existence then perhaps they would have left the Australian market as well.

Q154 Lord Best: Could I preface my question by asking to what extent the Institute of Chartered Accountants in Australia is dominated by the Big Four in terms of your income as an Institute and in terms of the influence that the Big Four exert on your affairs?

Mr White: It is a bit mixed. Certainly they are members; so individual partners and staff are members of the Institute. We have about 55,000 members all up. I couldn’t tell you the proportion exactly but it wouldn’t be a large element individually of that membership. They do contribute strongly in terms of assistance with some of the work that we’re doing with the rest of our membership. So we will find leaders within the major firms who are giving time to share experiences with other colleagues within the profession and to assist in some education and training as well. So that would be their primary contribution. They do have representatives that come and exist on our governance boards at times as well.

Q155 Lord Best: Okay. Your evidence notes that there has been a reduction in the number of audit firms, and indeed the number of registered auditors, and you imply that this is because of the more onerous regulations. Has that, in itself, led to an increase in the market share from the big firms because they can cope with all the heavy regulation? So on balance do you think these auditing rules have gone too far, become rules focused neglecting underlying principles, and have themselves led to a greater concentration in the hands of the Big Four firms?

Mr White: Okay. There are a few elements to that question. The implication that you’ve raised is one that we would certainly say that’s what we were implying. So those changes that I made reference to in my opening remarks about the introduction of government oversight and inspection and also that the auditing standards in Australia having the force of law, did lead to certain auditors in Australia saying in our markets, “This is too hard now to participate in this market. We will withdraw and do other things as accountants, other than auditing”. So, in some senses, that was a concern for us but we also saw that it was a natural evolution; that as thresholds continue to increase and expectations of auditors increase, then perhaps some who no longer wish to do this in a part-time capacity would leave. So that’s what we’ve seen in recent times in the Australian market.
But where we saw people leave was perhaps at quite the small end of the registered company auditor community and we didn’t really see that work flowing up or concentrating into the major firms. In some senses that work flowed up into the next layer above those firms and perhaps then also assisted some of what we might call the mid-tier firms; but in Australian terms that would be the next 20 firms underneath the Big Four. We did also see, my Lord, in that grouping of the 20 firms underneath the Big Four, some consolidation or aggregation of those firms. So we started to see some greater concentration in mid-tier firms arising from this need of trying to keep up with regulations and focus as well.

The final part of your question was about whether auditing rules have gone too far—and I will use that phrase of auditing rules as not being just about auditing standards. We think in Australia at the moment there is probably a fairly good balance. We would reach out and say we in the community all have one goal and that goal is the delivery of high quality auditing for the consumers of those services. So we think the combination of the government oversight, the legal enforceability of the auditing standards, together with the presence of professional standards legislation and the capping of liability, have all brought about the right components for a rigorous framework.

Mr Stringer: If I could add something to that. The question about the auditing standards being heavily rules-based and neglecting the underlying principles is misplaced, but the standards that we have are very much principle-based and scalable to all sizes of entities and, from the Institute’s perspective, one of the core objectives is to make sure we make available tools to enable smaller practitioners, in particular, to remain on top of the standards.

The Chairman: Thank you. Lord Forsyth?

Q156 Lord Forsyth of Drumlean: You referred in your written evidence to the regulator’s focus on audit quality. Has that come about because there have been cases of inadequate audit quality?

Mr White: The regulator’s focus on the audit quality has been in existence pretty well since the creation of their oversight function in 2005. The regulator puts out onto the public record, fairly regularly, an aggregated report of their findings. Through that work they have not really identified any systemic issues that are threatening audit quality in Australia, but they have identified areas of focus for practitioners to continue to develop and improve on in the work that they’re doing.

In recent times the regulator has spoken quite publicly—and we have supported the regulator on this—about the current level of discounting, for want of a better word, of audit fees in the Australian community. That is coming not from the regulator having seen evidence of deficiencies in audit quality at this point; rather, it is coming, and rightly so, from the regulator looking forward and saying, “I am concerned that significant discounting of audit fees could potentially lead to a compromise in audit quality in future years”. So the regulator is really on the front foot in saying, “You, the audit community, need to be very careful here that, in striving to win or retain work by heavily discounting fees, that is a business decision you can take but you need to be careful you do not end up compromising audit quality”.

The Chairman: Thank you. Lord Tugendhat, do you want to come in on the same point?

Q157 Lord Tugendhat: This is a supplementary to that point. In this country it has been increasingly the case that the relationship between the board and the auditors is conducted by the audit committee and that the main relationship is that way. First of all, is that equally the case, do you think, in Australia? Secondly, do you feel, in terms of audit quality, that the concentration on the audit committee has created problems and that if the board as a whole had more access to the auditor that would lead to a wider coverage of issues and questions?

Mr White: The first question is that the audit committee presence in Australia has been an evolving practice. Currently in Australia we have some requirements for the top 300 listed entities to have an audit committee. Now, that audit committee can be just simply the full board or it can be a sub-committee of the board. But, my Lords, you can see, again, over a fairly short period of time that the importance of the audit committee in the governance structures of companies in Australia has grown in importance quite substantially and will continue to do so. Why are we seeing that? Because you’re seeing a mechanism which brings together independent directors, management, external auditors, internal auditors, and I think we’re certainly trying to encourage the practice and the thinking of the audit committee to be much broader than perhaps it previously was. In Australia, perhaps only a few short years ago, the audit committee was only focused just on the financial statements and its breadth now is expanding quite substantially.

The second component to your question was about the dynamics between the board and the audit committee and how easily that works in the Australian environment. I’d have to say to you it is a little bit mixed. We would certainly see some experiences where the audit committee engagement with the auditor is, in our opinion, first rate but that audit committee then also assists the board quite substantially in its deliberations as well. But in other
senses we are perhaps not seeing that performance as strongly as we would like.
But we certainly would come and reach out and say that we think there is a future for the audit committee to continue to build on what we have as a very good foundation. But the risk in Australia at the moment is whether the liability for an individual existing on the audit committee is potentially much stronger than if that individual just remained on the board, if that makes sense. There is a sense that being on an audit committee, particularly if you are an individual with a level of financial acumen, trained financial acumen, you might start to be carrying more personal liability than if you remained on the board and that potentially can lead to the right sorts of people not being on the audit committee.
The Chairman: Lord Hollick?

Q158 Lord Hollick: How might auditors expand their role into reporting on risk to a client’s business model and its scope to fail? For instance, might auditors start to provide assurance on narrative content within annual reports including the director’s corporate governance assertions, risk management assertions and other narrative assertions?
Mr White: Thank you. We are very confident and optimistic that the role of the auditors does need to expand. We believe that the relevance of audit in remaining simply a retrospective examination primarily of financial statements is important, but still seems to be losing its relevance with a lot of the business community and analysts and so on. We feel that auditors being involved in some prospective work—looking at perhaps prospective figures or risk-to-business models—is the right way for the audit function to move. To answer the first part of your question, we feel it would come from perhaps the audit committee or the full board making disclosures in the annual report outside of the financial statements about these risks to the business model and then for the auditors to provide a level of assurance but not necessarily the type of assurance they would in a normal statutory audit report. So the disclosure would first come from the organisation. Then the onus would be on the auditors to look at that type of disclosure on the key business risks and then to offer their opinion on that.

Q159 The Chairman: I think this is a very interesting point and I notice that in your written evidence to us you had three themes and the first one was future of audit and you did stress this point when you said that auditors are well placed to be involved with the reporting on risks to the business model and the potential for that model to fracture. That’s getting away from the traditional role and skills of the auditors in many ways and I wondered whether you think that this presents a new challenge to auditors—the need for new skills and wider skills—and also whether clients would be prepared to pay for that extra service?
Mr White: We’re quite passionate around this and the reason we’re passionate is that we feel, at least in the Australian environment, that this relevance of audit is starting to wane and we need to really think about how it can substantially contribute back into the capital markets. The implications, some of which you’ve captured there in your questions, are where we’re thinking as well, my Lord. Certainly the first one around the skill sets and the experience of auditors will need to change. The mind-sets of approaching and thinking about risks to a business model auditors do to some degree now, as part of their work, but I think that we’re taking this to a very different level. So we, as a professional body, will need to demonstrate our leadership in building it into our core education programmes and training. So I think there’s a large piece of work there that if you’re going to change the model you need to make sure your profession has the right skills and experience. I think we’re coming from a good foundation there but I think there’s much more to be done around how that could be improved.
The pricing element is really a very interesting question and the pricing element comes back to this core function around the relevance matter. At the moment in Australia, as I indicated, there is a degree of quite substantial discounting of audit fees going on. To some purchasers of the audit that means or it feels like audit is just a commodity that you can take off the shelf and anyone can buy. What we’re trying to think about is making sure that the relevance and the value proposition is clearly understood. In doing that, if we can get the value recognition of audit to be improved, then I believe you will get the pricing to flow through as well.
The Chairman: Thank you. Lord Smith wants to come in on this one and then Lord Tugendhat.

Q160 Lord Smith of Clifton: Yes please. With regard to your second point, you were talking about mission creep on the part of the profession—the analysing business models and so on and just move away from just retrospective analysis of past finance—surely this needs to be delineated very carefully, because you are almost getting a sort of professional imperialism there. What is left to the board? If you have your auditors doing the business model and doing the retrospective analysis who, apart from the salesmen in the company, are doing anything?
Mr White: Understood. I would fully agree and support your phrase that we need to very careful in the delineation. We believe that clearly the responsibility for the organisation rests with the management and obviously the board of directors.
So, in the earlier comment that I made, the disclosure around the business model and the risk to those business models needs to, first and foremost, come from the organisation. So that information would then be what the auditor would need to reflect on. Now, that is where you’re going to have to be very careful about whether there is new information that the auditor wishes to then introduce and how would that occur. But I haven’t taken that as far in my thinking as perhaps where you’re asking me to, but I certainly do support the issue around the delineation.

**The Chairman: Lord Tugendhat?**

Q161 **Lord Tugendhat:** Some of your most important companies in Australia are in the mining business and the most important market for the mining business is increasingly China. Doing business in China and being dependent on China gives rise to risks and hazards and unexpected eventualities that don’t necessarily apply in other markets. Now, in the light of what you were saying and what Lord Smith said about mission creep, do you think that there are aspects of the business of companies in China that, in practice, are very difficult indeed for auditors to assess?

**Mr White:** I might need a little bit more information there to understand the question. If I could perhaps at least offer up a first comment and then perhaps pass back to you, my Lord. Certainly the Australian economy at the moment is very reliant on our exports and what Lord Smith said about mission creep, do you think that there are aspects of the business of companies in China that, in practice, are very difficult indeed for auditors to assess?

**Mr White:** I agree wholeheartedly. I suppose we could at least offer up a first comment and then perhaps pass back to you, my Lord. Certainly the Australian economy at the moment is very reliant on our exports and what Lord Smith said about mission creep, do you think that there are aspects of the business of companies in China that, in practice, are very difficult indeed for auditors to assess?

Q162 **Lord Tugendhat:** Yes. I mean China is a very different place from OECD countries and Japan, of course, is an OECD country. So the more involved in China your biggest companies become the more there is an element of the unknown and uncertainty in the business environment, which both the management and the auditors have to consider.

**Mr White:** I agree wholeheartedly. I suppose we could think of some other jurisdictions outside of China as well. That comes back to then the auditors discharging their responsibilities in a robust way and they have rules and points of focus that they need to deal with in what we would call group audit situations. In dealing with countries where potentially there is some level of greater risk, then the onus is really on the auditor to do what is required above and beyond perhaps the norm between an Australian and an English environment to making sure that they’re getting the right level of audit evidence to support their opinions around that Chinese subsidiary, or any other country for that matter.

I think an important element in this as well is how the regulatory frameworks are building up in each country and, again, how government regulators are starting to exchange information as well. Now, again, China is perhaps a little bit further away than some of the more western countries in these discussions but you can see this as being an important element to assist audit quality as things develop over time, too.

**The Chairman: Lord Lipsey?**

Q163 **Lord Lipsey:** Can I ask about limited liability? It is allowed in the United Kingdom but, on the whole, it’s not been taken up; perhaps because there is a suspicion in many minds that it is auditors trying to get out of paying up when they mess up. But you appear to have felt that it has brought benefits in the Australian system. I wonder if you could expand on them and, in particular, might I ask does it apply across the board in Australia or only where it is agreed between the company and the auditors?

**Mr White:** Let me just give a little bit of the Australian dynamics because I think the Australian model is quite different to what may have been introduced into the UK. As I understand it, in the UK your laws were modified to allow two parties basically to contract together about limiting liability and, therefore, you have this discretionary element to the arrangements. That is quite different to what we do have in Australia and I would have thought, without being derogatory in any way, the English model may be working against certainly some smaller audit firms or even mid-tier who might be wishing to engage with some significantly larger clients who then might be putting pressure on them to not go down the route of contracting out around liability.

The Australian example or the Australian context is that it’s mandatory. So anyone who is holding an Auditing Practising Certificate is required, under legislation, to hold minimum levels of professional standards capping. Therefore, while I think I heard some reference to saying, “Well, this is just the auditors getting out of situations”, the drivers of this in Australia were quite different. The drivers in Australia were that the insurance markets for professional services pretty well dried up in the earlier part of this decade and, therefore, it was seen that legislation was required to bring the insurance back into a level of supply.

Now, why was that incredibly important? Partly for the auditors but partly for the consumers of the audit services. You needed consumers to have confidence that the people they were dealing with had appropriate insurance sitting behind them. So it’s an important component of consumer protection. The other part of the Australian scheme that works is that by being given the limited liability the auditor...
profession and practitioners have to demonstrate how they are improving their risk management and how they are improving the delivery of audit quality in order to see that level of giving, in order to bring the insurance components in.

My Lord, I give just a little bit of further context here and I apologise—and it is starting to sound like I am more like a lawyer than an accountant, which is my training. The other element important to this in the Australian environment has been around proportionate liability. So, again, in earlier years we didn’t have clarity in our laws around proportionate liability and that was more under the joint and several implications, which again meant that auditors, at times being the last man standing, were seen to carry too much of a burden in proportion to perhaps the directors or others involved in whatever financial difficulties there were.

So the introduction of proportionate liability was a very important element to strengthening our audit profession and community. It meant basically auditors bore a proportionate amount of responsibility to what the courts felt they were responsible for. So the two elements that have contributed a lot to strengthening the Australian framework were the introduction of compulsory professional standards legislation, the capping of liability, together with the proportionate liability as well.

The Chairman: Thank you. Lord Maclennan?

Q165 Lord Smith of Clifton: Yes. Gentlemen, we see from your evidence, when we’re looking at this issue of conflict of interest between auditing and consultancy and providing other services, that the ICCA members follow a “threats and safeguards” approach to manage this potential conflict of interest. While it is broadly similar to the UK approach, while both may deal with what you call the real conflict of interest, how can we deal with the perceived conflict of interest that forms at least part of the expectations gap? And, on this, we have heard from other witnesses that they maintain Chinese walls and things like that. Well, I don’t know about the Antipodes but in this part of the world Chinese walls are very permeable.

Mr White: And, with no disrespect to our major trading partner now, yes, they’re probably a bit vulnerable down here too, my Lord. It’s really tough with the perception. It is really tough. It’s like you and I both could be looking at a similar set of circumstances and I might be okay with that and you might just have a very different view. So it is a little bit that each individual will have a slightly different view in their own perception. But where I would reach out and say, “How do we tackle the perception issue”—because it’s as strong as the real, no doubt about that—perhaps comes back to the conversation we’ve already had with some of the other Lords here today, which is around the future positioning of the audit committee.

So in Australia if we can see the evolution of the audit committee developing, then the engagement of the external auditor in other activities outside of just the statutory audit really needs to be tested by an independent third party. To me, the right independent third party falls back to being the audit committee.
So if the audit committee can clearly communicate to its stakeholders and shareholders that they have continually considered the relationship between the external auditor and any other services that auditor might be providing, notwithstanding they might be legally allowed within the frameworks within Australia, I think that goes a long way to helping deal with and tackle some of these perceptions.

My advice to our membership is always very much focused, first and foremost, on perception rather than reality. While I may have some members at times who come to me and say, “But, Lee, we can deal with this, it’s appropriate”, I always say, “But how would you feel if this was on the front page of the Financial Review?”, which is like your Financial Times. “If it was on the front page of the Financial Review, would you feel comfortable with being able to explain that perception?” I think that’s always a really simple way to keep them focused on making sure that’s first and foremost in their thinking.

The Chairman: Thank you, Lord Tugendhat?

Q166 Lord Tugendhat: Well, we’ve come quite a long way down the question list. If I could ask you this question. If you could introduce one measure to improve competition and choice in the Australian or the global audit market, what do you reckon it would be?

Mr White: I have been thinking about this question, because it’s quite a good one. I will probably, if I’m allowed, talk about two measures. First, I probably have already made enough representation around this, but it wouldn’t be from an Australian perspective, it would be from a global one. It would involve saying if we could try to have alignment of the legal structures around the capping of legal liability and proportionate liability, I think that alignment would go a long way to assisting audit quality; because that’s the goal that we are striving for.

I think the second element would be that we need to be very careful that the growth of regulation cross-border activities does not become a barrier to auditors wishing to remain or at least join the audit profession. By that I mean that in Australia we have made mention that we have government oversight; the UK has the government oversight through the FRC; America has the PCAOB and so forth. What we are experiencing in Australia now is the visit from different audit regulators other than the home regulator.

So, for example, the United States has been an audit regulator that comes to the Australian community and conducts oversight of Australian firms. So, if it is not managed carefully, as more countries develop audit oversight, you’re going to have layer upon layer upon layer of regulators from different countries all visiting audit firms and firms will just say, “This is too hard”, and will lead to a greater concentration of audit firms. So I reach out to regulators to make sure that they can try and align their work as sharply as they can.

Q167 The Chairman: I was interested that you put the capping of liability first. I was going to ask you, if you hadn’t mentioned it, where you would rate it but you have already dealt with that. Can I just ask you one question about it, though? I think I heard you say that this would, in particular, help to deal with quality and I just wondered to what extent you would also say that it would help very considerably to introduce more competition and make it easier for the non-Big Four to break into the big market?

Mr White: Let me clarify my reflections there, my Lord. Certainly the first is around the quality and we agree with that. The second is we have certainly had direct feedback from our membership to say that they would not have remained in audit practice in Australia unless professional standards legislation and proportionate liability had been introduced. So it was very clear to us, particularly as you started to go down in size of firms, that this was a really important piece for them to remain competitive. Has it assisted firms come in? Very unclear for me to say that but I certainly can say it has been a very important component to preventing greater concentration in the Australian market.

Q168 The Chairman: Well, I think it is a very interesting note for us to end on; unless there is anything else you would like to say?

Mr White: I’ll ask Mr Stringer as well whether he did. Mine would be to say thank you very much for the opportunity. We share the passion and the focus of our British friends around audit quality and so thank you for the opportunity to present our views. And we look forward to the tour around the Ashes and we look confident that we will remain successful in that sphere, my Lord.

The Chairman: Are you going to say anything, Mr Stringer?

Mr Stringer: I would just like to echo Mr White’s comments and thank you again.

The Chairman: I won’t comment on the controversial last point.

Lord Tugendhat: I was in Melbourne, down in Australia, when you won 5–0 last time. I think hope springs eternal, but we have a better team this time.

The Chairman: Can I also thank you very much, not only for the interest you have taken in our inquiry and for the evidence you’ve given us, but for the very helpful dialogue we’ve had today. We’re particularly grateful to you for doing this at such an ungodly hour, from your point of view. So thank you very much indeed for your help.
Memorandum by the Financial Reporting Council (ADT 24)

1. INTRODUCTION AND MAIN POINTS

1.1 The Financial Reporting Council (FRC) welcomes the opportunity to give evidence to the Economic Affairs Committee’s inquiry into Auditors: Market concentration and their role.

1.2 The FRC is the United Kingdom’s independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. The FRC and its operating bodies have a number of responsibilities in relation to audit, including policy, standards, monitoring and investigations. These functions are carried out with the primary goal of improving audit quality.

1.3 The FRC is concerned about the current concentration in the audit market and we have expressed these concerns for some time. Currently, the audit market is not delivering a fully competitive environment, particularly for FTSE 100 and FTSE 250 companies and in sectors such as banking and insurance. Choice and innovation in the market are therefore less extensive than we would wish. We are also concerned about the disruption and cost that would arise in the event of a large firm leaving the market and a subsequent reduction to three or fewer major players.

1.4 We have attempted to address these concerns over the last five years but with no real change in the level of concentration. A new analysis of the impact of the current market structure is now warranted. It needs to take into account the global nature of the audit market and seek the advice of competition authorities here and overseas.

1.5 The FRC works unequivocally to enhance audit quality, which enables investors to make sound judgments, and thereby supports efficient capital markets. We believe that further safeguards should be put in place to enhance audit quality. Specifically, the regulatory framework which determines the relationship between the FRC, audit firms and professional accounting bodies should be strengthened to provide greater transparency, accountability and independence in the public interest.

1.6 We particularly recommend that the FRC should take on certain functions of the professional bodies and should have a wider range of sanctions to address shortcomings in audit quality and for use in disciplinary situations. For example, we believe the FRC should have responsibility for the licensing of auditors of public interest entities—a task that should be undertaken in addition to the general licensing of auditors within the profession itself.

An unambiguously robust and independent regulatory oversight of the audit profession would ensure a speedier response to risks, an increased focus on audit quality and, ultimately, enhanced market confidence in the role and value of audit.

1.7 The Government’s decision to abolish the Audit Commission should be used as a catalyst for greater competition in the audit market. The Commission’s in-house audit practice is the fifth largest in the UK. Although this work is not in the corporate sector and does not address the international coverage issues, if secured by a non Big Four firm it would enhance their scale and strength and so reinforce their ability to compete. Conversely, if the work goes to the Big Four, the reverse will be true.

2. CURRENT SCOPE OF AUDIT AND ROLE OF AUDITORS

2.1 Audit gives confidence to investors and supports effective capital markets. It provides independent assurance to shareholders that the directors have prepared the financial statements properly and that those statements provide a true and fair view. Additionally, although not its primary purpose, the existence of an audit acts as a deterrent to fraud.
2.2 Given its importance, audit must be done well and investors must have justifiable confidence in its quality. Audit quality is difficult to define and there is no agreed definition of audit quality that can be used as a standard against which actual performance can be assessed. The FRC has sought to address this and to improve understanding of audit quality via its Audit Quality Framework (AQF). The AQF identifies key characteristics and drivers of audit quality to assist companies, audit committees and other stakeholders to assess the effectiveness of audit and auditors.

2.3 Changes that affect the UK audit market should not be made without consideration to the profession’s competitive strength and its strategic importance (as part of a successful professional services sector) to the UK economy. Accounting standards are based on international requirements and the largest audit firms are members of international networks and serve many clients with global operations. Any significant regulatory change that would affect the structure of the auditing profession or the role of audit needs to be considered on an international basis.

2.4 The Enron scandal and the subsequent collapse of its auditor, Arthur Andersen, in 2001 led to worldwide concerns about the quality and reliability of audit. In the UK, those concerns were addressed by the introduction of independent monitoring of public interest auditors, oversight and standards-setting to the auditing profession, which had previously been self-regulating. The FRC and its operating bodies were given responsibility for this independent regulation in 2005.

2.5 The auditing profession in the UK has a long history. Most of today’s global firms have their origins in UK-based practices. Today, the FRC and the UK profession provide worldwide thought leadership on matters such as auditing standards, ethics and governance. Individuals from the UK are prominent on international regulatory bodies and in the global governance of the largest firms. The UK’s thought leadership provides a catalyst for international developments and debate.

2.6 The audit profession’s history and importance to capital markets provide evidence of its strengths. The monitoring work of the FRC’s Audit Inspection Unit (AIU) also indicates that the audits of most listed companies are performed to an adequate standard. That assessment does not mean, however, that there is no room for improvement. The number of audits requiring significant improvement is too high at around 13% of those inspected. The AIU’s report on the 2009–10 round of inspections also noted that four FTSE 350 audits, including two in the FTSE 100, required significant improvement. Appendix B gives a detailed breakdown of AIU inspection findings over the past two years. Whilst the achievement of the highest AIU quality ranking for all audits is probably unachievable at a proportionate cost, we believe that a FTSE 100 audit requiring significant improvement should be a rare and exceptional event. As noted above, we believe that strengthening the FRC’s powers to include a broader range of sanctions would both incentivise audit firms to improve the quality of their work and ensure there were more effective tools available to hold the firms to account.

2.7 The AIU’s inspections in 2009–10 confirm that major firms have policies and procedures in place to support audit quality. However, the number of audits requiring significant improvement indicates that firms are not always consistently applying their policies and procedures on all aspects of individual audits. In addition, policies and procedures can only go so far in supporting and encouraging desirable behaviours to deliver audit quality. These must be underpinned by other incentives and support for auditors to exhibit the right behaviours and appropriate sanctions when they do not.

2.8 In considering behaviour and culture within the firms, the AIU has identified a number of instances of firms failing to apply sufficient professional scepticism in relation to key audit judgements. This lack of scepticism may manifest itself in a number of ways: over-reliance on management representations; failure to investigate conflicting explanations; failure to obtain appropriate third party confirmations; or seeking to obtain evidence that corroborates, rather than challenges, judgements made by client management.

2.9 Application of appropriate professional scepticism is vital as, unless auditors are prepared to challenge management’s assertions, they will not be able to confirm, with confidence, that a company’s financial statements give a true and fair view. The AIU therefore looks closely at the evidence of scepticism during its inspections and, if concerned, will seek an improved approach by the firm. The AIU also pays attention to whether recruitment, appraisal and promotion policies reward personnel for delivering high quality audits including displaying appropriate scepticism in their audit work.

2.10 We believe that audit firms and the profession should do more to promote auditor scepticism, for example during recruitment, training and continuing professional development. We have recently published a discussion paper to promote debate on these issues within the profession.

1 The UK is the first major jurisdiction to introduce a governance code for large audit firms, including the appointment of independent non-executives.
2.11 In addition to our focus on scepticism we also believe it necessary to remain vigilant about the potential for conflicts of interest to arise when an auditor provides non-audit services to their audit clients and for these to undermine audit quality. The primary purpose of audit is to provide assurance to shareholders. However, auditors are in practice selected by a company’s management and the appointment only ratified by shareholders, who rarely show interest in the choice. Auditor independence rules exist in part to minimise the risk that auditors become overly influenced by client management, for example in the hope of winning contracts for non-audit work.

2.12 The rules on auditor independence are set through the Auditing Practices Board’s (APB) Ethical Standards. The APB has recently consulted on whether auditors should be subject to further restrictions. It has concluded that there is not sufficient evidence to warrant an outright ban on the provision of all non-audit services to audit clients. Indeed all stakeholders, including investors, generally opposed the suggestion. However, the APB has concluded that some tightening of the standards is justified and has recently published revised provisions for comment.

2.13 Audit quality is not driven by auditors alone. Auditors report on the financial statements which have been prepared under particular accounting standards. Those accounting standards should facilitate the production of an accurate picture of the company’s financial health. If they do not, auditors cannot be expected to rectify such deficiencies.

2.14 Corporate behaviour also plays a significant role. Boards are stewards of investors’ money and have a responsibility for ensuring that the corporate culture and environment is one which encourages open dialogue with their auditors at all levels. Auditors and individual partners should not fear removal if they challenge management assumptions.

2.15 Audit committees have primary responsibility for the appointment, reappointment and removal of external auditors, and should also review annually the effectiveness of their audit arrangements including the experience, expertise, resources and independence of the audit firm. Audit firms report to us that strong and effective audit committees are a powerful driver of audit quality and that there has been an improvement in the overall effectiveness of audit committees in recent years.

3. WIDENING THE SCOPE OF AUDIT

3.1 Despite enhancements in the regulatory environment and in overall audit quality there remains evidence of an expectation gap between the actual scope of an audit and public perception of the information an audit should reveal. This gap was particularly evident in much of the commentary following the financial crisis, with many people querying how a bank could have received an unqualified audit report, only to collapse a few months later.

3.2 In recent months there have been suggestions from various market participants, including some audit firms, that there would be value in widening the scope of audit and in extending reporting requirements beyond shareholders to include bodies such as regulators.

3.3 In June 2010 the FRC and FSA published jointly a discussion paper on the contribution the auditor could make to prudential regulation. The paper suggests a number of recommendations, which are intended to contribute to better supervision of banks and financial institutions.

3.4 The European Commission plans to publish a Green Paper on audit in the autumn and is currently consulting on the role of audit as part of its recent Green Paper on corporate governance. Early feedback suggests that auditors could validate a wider range of risk-related information on financial institutions and engage more closely with supervisory authorities. Although focused on financial services, there is no reason why such an extended audit approach could not be applied across other sectors.

3.5 For its part the FRC has recently launched a project to examine the lessons from the financial crisis and other market developments as they impact on corporate reporting, accounting and auditing of non-financial services companies. To assist with this, the FRC has appointed an advisory group consisting of senior figures from business and the accountancy profession. A discussion document will be published later this year, covering various matters including whether the role of audit should be extended. Our consultation is likely to cover the following topics:

- Greater transparency on the level of assurance provided by the audit;
- Enhanced reporting of the auditor’s views on matters arising from the audit, such as values involving significant judgements;
- Assurance on the directors’ narrative reports;

3 “Enhancing the auditor’s contribution to prudential regulation”, FRC/FSA, 2010.
— Reporting on risk/company’s business model;
— Cost-effectiveness of any changes;
— Safe harbour against liabilities arising from any extra work.

3.6 We will be able to provide further information about this work, including an indication of our early conclusions, in oral evidence to the Committee. We believe it is particularly important to ensure that responsibility and accountability rest in the right place between management, the Board and its audit committee, and the auditor. We would be happy to provide a written update later in the autumn if that would be helpful to the Committee.

4. Market Concentration

4.1 The market for the audits of the UK’s largest companies is highly concentrated. The “Big Four” audit 99% of the FTSE 100 and 95% of the FTSE 250. Similar levels of concentration are seen in most other developed countries.

4.2 There are a number of reasons for this concentration, which are explored in more detail in Appendix A. However, we believe that market perception is the main barrier to the expansion of non-Big Four firms into the audit market for large public interest entities. Appendix C shows current levels of concentration in the London main market and in AIM. It is notable how few of the smaller fully listed companies use a non-Big Four auditor in comparison to AIM companies. There appears no other obvious explanation for the difference in concentration between these markets. Mid-tier firms may not have the resources to audit the very largest companies, but they are quite capable of auditing a far broader range of companies than is currently the case.

4.3 We believe the economic impact of such a concentrated audit market should be investigated. The investigation should be charged with identifying the causes and effects of market concentration, for example on audit fee levels, as well as identifying catalysts for greater competition.

4.4 Negative features of the current market include:

— The potential for moral hazard as the largest firms consider they are “too big to fail” and judge that governments and regulators will be reluctant to take enforcement action against them if that action had the potential to result in the firm leaving the market. At the FRC we would not moderate our actions to protect a firm from failure but it is of concern that some believe such a risk exists.

— Lack of choice for large companies, particularly those in certain industries (such as banking and insurance) where only two or three firms are judged to have the appropriate expertise to act as auditor. If the company uses another large firm for other services, such as corporate finance, it may find itself without an effective choice of auditor in the short term due to independence restrictions.

— Lack of innovation in audit, with all large firms offering a virtually identical product. Regulatory restrictions on the scope of audit, independence rules and the format of the audit report offer only a partial explanation for this lack of innovation.

— Little indication that the large firms attempt to distinguish between themselves, or to compete, on quality.

4.6 Our most immediate concern is that the highly concentrated market for audit services, and a litigious market (especially in the US), poses a risk that one of the Big Four could fail. Such a failure may be unrelated to audit; all of the large firms operate other lines of business, some of which, such as corporate finance, are inherently risky and could have significant adverse impact on their reputation with clients and prospective clients. In addition, as the large firms are all members of international networks, the event would not necessarily have to take place in the UK. Whatever the nature and cause of the event, the subsequent collapse of public confidence in the stricken firm could quickly result in an exodus of clients and senior personnel, effectively destroying the business.

4.7 A large firm leaving the market would result in severe disruption to capital markets in the UK and globally, as investors lose confidence in the financial statements of the firm’s audit clients. In the longer term, the difficulties around lack of choice and independence conflicts identified above would be exacerbated. Additionally, if the event were audit-related, the remaining firms may become reluctant to audit companies in high risk industries and may even begin to withdraw from certain sectors of the market. At a minimum, a market with three or fewer large firms is likely to require a significantly more intrusive regulatory environment and therefore cost.

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4 The “Big Four” audit firms are Deloitte, Ernst & Young, KPMG, and PricewaterhouseCoopers.

5 The only recent example we have seen of innovation in the audit product is the “extended audit” service offered to some large companies such as Rentokil plc.
4.8 However, we do not believe that the Big Four should be preserved at all costs, and regulators and legislators should not be afraid to take action against a Big Four firm if it is warranted. We would certainly not wish to preserve a firm from commercial failures. We would prefer to see action after failure to prevent the market becoming dominated by just three firms.

4.9 In 2006 the FRC and the then DTI commissioned Oxera to produce a study on the UK audit market. Following the publication of the Oxera study, the FRC consulted on a discussion paper seeking stakeholder views on mitigating risks arising from market concentration. Respondents to the discussion paper had a clear preference for market-based solutions to these risks and to assist in the identification of such solutions the FRC created the Market Participants' Group (MPG) which issued 15 recommendations aimed at reducing risk and increasing choice in the audit market.

4.10 The FRC has been monitoring the implementation of these recommendations and published the most recent Progress Report in June 2010. The majority of the recommendations have been implemented but to date this market-based approach has had minimal impact on market concentration.

4.11 Taking into account the evidence the FRC has received to date, we do not believe that purely market-based solutions have had, or will have, a significant impact on concentration and choice, and that there is a need for regulatory solutions. In June we committed to publishing by the end of 2010 an analysis of the work done so far on the Audit Choice project, together with suggestions for further action. However, given the initiative planned by the Committee we will defer this until we have seen its conclusions.

4.12 Furthermore, in light of the decision to abolish the Audit Commission, the Government should use the opportunity afforded by this change to open up competition to non-Big Four accountancy firms to take on work currently conducted by the Audit Commission.

5. CONCLUSION

5.1 The FRC welcomes this inquiry and looks forward to playing a part in the solution to the current problems caused by a highly concentrated audit market.

5.2 The FRC believes it has a significant role to play in driving up audit quality and encouraging a more competitive audit market. Currently, the FRC’s work shows that audit quality is of an acceptable standard, although a significant minority of audits remains unsatisfactory. With increased powers and a tiered sanctions regime, the FRC could be more effective at holding the profession to account and improving standards.

5.3 Consideration should be given to extending the current scope of audit. However, any changes must be examined carefully to assess their cost-effectiveness and impact on the UK’s competitiveness.

5.4 Concentration in the audit market limits choice and poses a substantial risk to capital markets. Market-led solutions have not proved effective and therefore regulatory solutions should now be considered.

5.5 Given the AIU’s inspection findings, the FRC is mindful that any efforts to improve choice must not be at the expense of quality.

5.6 The FRC stands ready to work with the Committee to identify and implement practical and workable policies that will improve audit choice and quality for the good of the capital market.

September 2010

APPENDIX A:

CALL FOR EVIDENCE—QUESTIONS

Q1 Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

A1 There are many reasons for the dominance of the UK audit market by the Big Four and these are explored at length in the Oxera study referenced in the main body of our submission. However, some of the most important include:

— The desire for the largest and most complex global companies to use an audit firm with a strong international network.
— Difficulty for new or growing audit firms to raise sufficient capital to expand into the market for the largest companies.

8 “Competition and Choice in the UK audit market, Oxera, 2006.”
— The ability for audit firms to achieve sufficient scale to absorb the cost of investment in new or emerging markets.

— The increased size and complexity of companies being audited.

— Regulatory decisions permitting the Coopers & Lybrand/Price Waterhouse merger.

— The collapse of Arthur Andersen.

— Market perception or the “IBM factor”\textsuperscript{9}; there is evidence that listed companies are often reluctant to choose a non-Big Four auditor for real or perceived reputational reasons. On occasion this perception we are told is backed up by contractual obligations, for example clauses in loan covenants which specify that the company may only engage certain auditors.

Q2 Does a lack of competition mean clients are charged excessive fees?

A2 Competition theory would suggest that high market concentration and limited tendering—both of which are features of the audit market for listed companies—lead to higher fees.

When audit tenders do take place there is usually strong price competition and in many cases the new audit fee is substantially lower than the previous fee. However, relatively few tenders take place.

Analysis by Oxera suggested that the Coopers & Lybrand/Price Waterhouse merger had led to a 12% overall increase in audit fees. A number of other academic studies\textsuperscript{10} support the view that consolidation in the audit market has increased the level of audit fees. Oxera’s conclusions were however disputed by some of the large firms and, given the FRC’s focus on quality, this issue was not pursued further.

Q3 Does a narrow field of competition affect objectivity of advice provided?

A3 We do not believe that concentration in the market has affected audit firms’ objectivity directly. However, audit firms also provide a number of other services, eg tax and consulting, and the reputation firms have earned through their audit work has led to concentration in these other markets as well. It is therefore the degree of concentration and market dynamics for non-audit services that creates the actual and perceived risks to auditor objectivity which the Ethical Standards are designed to address.

Q4 Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

A4 Strong audit firms contribute to audit quality. Strong audit firms provide a safeguard against the risks associated with providing unwanted advice. No one audit client is so significant to the overall long term success of a major firm that it is worth risking its reputation for. The challenge for major firms is in balancing the risks of the short term impact of the loss of a major client with the longer term reputational impact of not providing unwelcome advice when necessary. This is risk is greater in relation to the significance of individual clients to the reputation and profile of individual partners within major firms and various safeguards have been established to mitigate against this.

Strong firms\textsuperscript{11} contribute also to quality because they have the capital to invest in the training, systems and expertise necessary to deliver high quality and effective audits.

Q5 What is the role of auditors and should it be changed?

A5 As noted in paragraph 2.1 of our main submission, the purpose of audit is to provide independent assurance to shareholders that the company’s directors have prepared the financial statements properly, and that those statements provide a true and fair view. In paragraphs 3.1—3.6 we set out the arguments for enhancing the scope of audit and the role of auditors. There is much to recommend such an enhancement, but any changes must be cost-effective and must not put the UK at a disadvantage when compared to other major capital markets.

Q6 Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

A6 See paragraphs 2.9—2.11 of our submission for our comments on scepticism. The FRC has not seen any evidence that concentration in the audit market contributed directly to the financial crisis.

\textsuperscript{9} “No one gets fired for buying IBM”

\textsuperscript{10} For example Basioudis & Ellwood (2005); Beattie, Goodacre, Pratt & Stevenson (2000).

\textsuperscript{11} Not just the Big Four, but a number of other large firms.
Q7 What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

A7 As noted in paragraph 3.3 of our main submission, in June 2010 the FRC and FSA published jointly a discussion paper on the contribution the auditor could make to prudential regulation. The paper suggests a number of recommendations, which are intended to contribute to better supervision of banks and financial institutions:

— Meetings between the FSA and the auditors of high impact financial institutions should occur more frequently and at an earlier point in the audit process.

— Enhanced engagement between auditors and the FSA should result in an increase in statutory and voluntary reports by audit firms to the FSA.

— Further information-sharing between the FSA and parts of the FRC—including the Audit Inspection Unit, Financial Reporting Review Panel and Accountancy & Actuarial Discipline Board.

Q8 How much information should bank auditors share with the supervisory authorities and vice versa?

A8 The FRC/FSA paper mentioned above discusses this point in some detail. Currently, supervisors meet with the auditors of “high impact” financial services firms (such as banks) at least annually. There is evidence that auditors have not always shared all relevant information with supervisors and there have been occasions where, for example, both the FSA and the audit firm have been pressing management on a particular judgement, but neither was aware of the other’s concern. Where there is a concern, the default for both the auditors and the supervisors should be to share information unless there are legal or regulatory impediments to them so doing.

Going forward, the FSA proposes more frequent meetings between auditors and supervisors and also that they be held earlier in the audit process. Trilateral meetings between auditors, supervisors and the bank’s audit committee have also been proposed.

Q9 If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

A9 Several incentive factors may encourage auditors to display scepticism and to deliver unwelcome advice when necessary. At firm and at office/business unit level, no single client should represent a disproportionate amount of revenue. In addition, the firm’s management should show a proper concern for reputation and exposure to litigation and should set an appropriate “tone from the top”.

On an individual level, firms should ensure that their recruitment, appraisal and promotion policies reflect and reward personnel who display appropriate scepticism in their audit work. Firms should be aware of the risks arising from individuals’ long association with a particular client.

Regulators such as the FRC provide an incentive to firms to provide such advice due to the reputational risks associated with the transparency of the FRC’s findings from audit monitoring and inspection. This incentive could be enhanced by a wider range of sanctions for use where examples of poor quality are identified and in disciplinary situations, allowing proportionate action to be taken whilst retaining the nuclear option of withdrawal of a firm’s audit licence.

Q10 Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

A10 As noted in paragraph 2.12 of our submission, there is the potential for conflicts of interest where auditors provide consultancy or other non-audit services to their audit clients. UK Ethical Standards, along with similar rules elsewhere in the world,12 contain prohibitions on certain activities, such as auditing ones own work, acting in a management capacity or acting as advocate for an audit client. Other services may not be prohibited, but are recognised as a threat to independence which can be mitigated by the application of appropriate safeguards, such as restrictions on who may undertake particular work or review by partners or firms independent of the audit.

Increased transparency also mitigates this risk, for example through disclosure in the audit client’s accounts of the type of non-audit services provided by and fees paid to the auditor.

12 For example: the IFAC Code of Ethics; SEC independence rules.
In its most recent Annual Report\textsuperscript{13} the AIU highlighted its concerns over whether firms too readily identify safeguards to mitigate threats to their objectivity and the effectiveness of those safeguards. In particular the AIU recommended that firms must embrace the principles underlying ethical standards and accept they should not provide non-audit services to audit clients when appropriate safeguards do not exist.

Q11 \textit{Should more competition be introduced into auditing? If so, how?}

For the reasons set out in the main body of our submission, the FRC believes that the audit market would benefit from greater competition. This is not a simple thing to achieve in the short to medium term. Market-led solutions have not been effective to date and there may be a need to consider regulatory alternatives.

However, we would stress that any effort to reduce the degree of concentration in the market must not be at the expense of audit quality.

Q12 \textit{Should the role of internal auditors be enhanced and how should they interact with external auditors?}

The internal audit function is intended to provide management with a degree of assurance on internal controls. There is, therefore, some overlap between internal and external audit.

Analysis of the credit crisis has identified concerns about the quality of information about risk and internal control on which boards base their decisions, and raised the question of how boards can get assurance that they are receiving the information they need at the appropriate time. One way in which this might be done would be through an enhanced role for internal auditors. This is an issue on which the FRC will be consulting as part of its review of its existing guidance on risk management and internal control, which is due to begin later in 2010.

In recent months some audit firms have offered clients a new service, which includes as part of the external audit service certain functions traditionally associated with internal audit. We understand that combining certain internal and external audit functions can be attractive financially to the client. However, there is a risk that auditors offering both services can find themselves in breach of independence requirements by auditing their own work and/or acting in a management capacity. The AIU and APB have looked into one high-profile example of this (Rentokil plc) and believe that the service as described is compatible with existing independence rules. We will keep developments in this area under review.

Q13 \textit{Should the role of audit committees be enhanced?}

The main role and responsibilities of audit committees are set out in some detail in the UK Corporate Governance Code and accompanying FRC guidance. The issue is less whether the role should be enhanced but whether it can be carried out more effectively. As noted the overall effectiveness of audit committees is considered to have improved in recent years, and the FRC is hopeful that the recent changes to the UK Corporate Governance Code will lead to further improvements.

The FRC is currently consulting on guidance to audit committees that is intended to improve transparency of a company’s policies in relation to the provision of non-audit services, in parallel with the consultation on the Ethical Standards referred to in the main submission.

Audit committees also have a responsibility for assessing the effectiveness of their audit arrangements and the FRC provides information to assist in this process. However, from an initial review of 57 sets of accounts for the financial year ended 31 December 2008 (including 23 FTSE 100 companies) it was not evident that audit committees had either complied with FRC guidance or made use of the Audit Quality Framework or of the additional information on audit quality which we have made available. It is unclear to us whether audit committees require further guidance and information to discharge this responsibility effectively.

Q14 \textit{Is the auditing profession well placed to promote improvement in corporate governance?}

External auditors have a role to play in those aspects of corporate governance relating to financial reporting, in particular risk management and internal control. Listed companies in the UK are required under the UK Corporate Governance Code to issue an annual internal control statement. Under the UKLA’s Listing Rules auditors are required to review this statement, and the FRC’s Auditing Practices Board issues guidance on how this should be carried out. It is for consideration whether this role should be enhanced.

The case for auditor involvement in other aspects of corporate governance is less compelling. It would not be appropriate to ask the auditor to opine on issues such as the composition of the board, for example, which are rightly a matter for the board and shareholders and on which the auditor has no particular competence. As noted in paragraph 3.5 of our submission, there may, however, be an argument for auditors to verify the accuracy of some disclosures.

APPENDIX B

<table>
<thead>
<tr>
<th>Firm type</th>
<th>Good with minor improvements required</th>
<th>Acceptable but with improvements required</th>
<th>Significant improvements required</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>No.</td>
<td>%</td>
<td>No.</td>
<td>%</td>
</tr>
<tr>
<td>Big 4</td>
<td>60</td>
<td>55.5</td>
<td>38</td>
<td>35.2</td>
</tr>
<tr>
<td>Other major firms</td>
<td>8</td>
<td>25.0</td>
<td>18</td>
<td>56.2</td>
</tr>
<tr>
<td>Smaller firms</td>
<td>4</td>
<td>18.2</td>
<td>7</td>
<td>31.8</td>
</tr>
<tr>
<td>Overall total</td>
<td>72</td>
<td>63</td>
<td>63</td>
<td>27</td>
</tr>
</tbody>
</table>

The table above shows the results of AIU inspections over the last two years, broken down by the size of firm and the AIU’s grading of the audit.

— The “Big Four” are Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers
— “Other major firms” are those firms outside the Big Four which are subject to a full scope AIU inspection. There are five such firms: Baker Tilly, BDO, Grant Thornton, Horwath Clark Whitehill and PKF
— “Smaller firms” include all other firms which audit between one and ten public interest entities. Individual audits conducted by these firms are subject to AIU review but monitoring of firm-wide procedures is delegated to the monitoring units of the recognised supervisory bodies.
— There is a fourth category of firm which makes up the bulk of the 8,000 firms registered for audit in the UK. These firms do not audit any public interest entities and are reviewed solely by the monitoring units of the recognised supervisory bodies.

APPENDIX C

APPENDIX C—MARKET CONCENTRATION BY INDEX MAY 2010

<table>
<thead>
<tr>
<th>Auditor</th>
<th>FTSE 100</th>
<th>FTSE 250</th>
<th>Fledgling/ Small Cap</th>
<th>AIM</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Companies</td>
<td>100</td>
<td>250</td>
<td>413</td>
<td>1012</td>
</tr>
<tr>
<td>PricewaterhouseCoopers</td>
<td>40</td>
<td>27.3</td>
<td>22</td>
<td>11.6</td>
</tr>
<tr>
<td>KPMG</td>
<td>23</td>
<td>22.2</td>
<td>22</td>
<td>15</td>
</tr>
<tr>
<td>Deloitte</td>
<td>20</td>
<td>26.6</td>
<td>19.1</td>
<td>10.8</td>
</tr>
<tr>
<td>Ernst &amp; Young</td>
<td>16</td>
<td>18.7</td>
<td>17.9</td>
<td>7.8</td>
</tr>
<tr>
<td>BDO</td>
<td>1</td>
<td>2.4</td>
<td>3.9</td>
<td>13.7</td>
</tr>
<tr>
<td>Grant Thornton</td>
<td>0</td>
<td>1.6</td>
<td>9.2</td>
<td>18.4</td>
</tr>
<tr>
<td>PKF</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>4</td>
</tr>
<tr>
<td>Baker Tilly</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>7.3</td>
</tr>
<tr>
<td>Horwath Clark Whitehill</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
<td>0.2</td>
<td>4.1</td>
<td>10.4</td>
</tr>
<tr>
<td>Non Big Four Share</td>
<td>1%</td>
<td>4.4%</td>
<td>19.2%</td>
<td>54.7%</td>
</tr>
</tbody>
</table>

Based on Hemscott Corporate Advisers Rankings Guide with the agreement of Hemscott, a Morningstar company. Figures include companies treated as FTSE constituents by the London Stock Exchange. Table shows percentages except where otherwise stated.
Memorandum by the Financial Services Authority (FSA) (ADT 25)

1. We are submitting this memorandum as part of the Committee's inquiry into Auditors: Market concentration and their role. It covers:
   - our overall role and views in relation to competition in auditing;
   - the role of auditors;
   - auditing and client asset protection; and
   - internal audit and corporate governance.

2. The submission draws heavily on the recent joint FSA and Financial Reporting Council (FRC) Discussion Paper, DP10/3, Enhancing the auditor's contribution to prudential regulation published in June 2010 (copy attached).\(^1\)

**Competition in Auditing**

3. The FSA is not a competition authority and therefore does not offer views on the questions posed on competition issues in the audit market. While we believe that there is an important debate to be had on audit market concentration there are also important matters to address on the quality of auditing. We believe that these issues can and should be dealt with separately.

**Role of Auditors**

4. In addition to their role under the Companies Act 2006, auditors have a duty to report to the FSA under the Financial Services and Markets Act (FSMA) on matters that may be of material significance to the FSA in carrying out our functions in relation to the entity being audited.

5. High quality audit and assurance support effective governance of firms, which is critical to achieving our objectives relating to market confidence, financial stability and consumer protection. Audited financial information is also an important part of the information that we rely on in supervising firms.\(^1\)

6. As outlined in the joint FSA/FRC Discussion Paper, although we have seen examples of good audit and assurance practice, there have been other cases that indicate clear room for improvement. In particular, there have been cases involving valuation, provisioning and disclosures where the auditor’s approach has appeared to focus on gathering information to support management’s assertions, and whether management’s valuations and disclosures comply with the letter of the accounting standard (rather than whether the standard has been applied in a thoughtful way that would better meet its objectives). Given that the application of accounting standards require management judgement in many key areas and a range of different approaches may be possible, auditors may also be faced with different firms making different judgements on the valuation of similar instruments. In our Discussion Paper and in our regular meetings with auditors, we have highlighted our concerns in this area, challenged where appropriate and emphasised the need for adequate disclosure in financial statements in this area. The work of our Accounting Review Team is key in this regard.

7. We have also questioned whether auditors always exhibit sufficient professional scepticism. For example, we believe that they need to challenge management more on the quality of their disclosures. On fair value estimates, our work on valuation methodologies has led us to question whether auditors are sufficiently sceptical when challenging management’s basis for determining the models and assumptions used to derive ranges of estimates, and the selection of particular estimates from within such ranges, where key inputs may be unobservable. The FRC has also raised its concerns over insufficient auditor scepticism with the major global audit firms, and the APB has issued a discussion paper highlighting the importance of scepticism.\(^2\)

8. In the earlier stages of the crisis, there was a significant loss of confidence in banks' financial reporting, as investors and other stakeholders were concerned that published accounting figures did not capture the reality of emerging problems. Given that accounting standards are framed to be used by entities of a wide range of sizes and complexity, it should be no surprise that disclosures that go beyond the specific detailed requirements will usually be necessary for larger and more complex financial institutions.

9. As a result of lessons learned from the crisis, we have adopted a more intensive supervisory approach. We now have a far more intense relationship with auditors than in the past. We have increased our engagement with auditors to emphasise their role in the oversight of firms. We recognise that, in the past, bilateral meetings between the FSA and the auditor of a supervised firm took place on an ad hoc basis. However, following the implementation of our Supervisory Enhancement Programme, our supervisors of high-impact firms now meet

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\(^1\) Not published here.

\(^2\) In this response, the term “firms” means FSA regulated firms.

\(^2\) Auditor scepticism: Raising the bar, Auditing Practices Board, August 2010.
the auditors of high-impact firms at least annually. Matters discussed are specific to the firm but include, for example, financial results, systems and controls and the auditor’s view of senior management. This has required us to become more involved in the scrutiny of specific accounting practices and judgements in order to consider more fully their implications from a prudential perspective.

10. We have also established the Accounting Review Team, a team of experienced qualified accountants whose primary role is to support supervisors on accounting and audit-related matters. The Accounting Review Team does this by reviewing financial information and providing supervisors with advice and analysis on the firms they supervise, as well as supporting supervisors in their communications with auditors. This proactive approach is designed to ensure that we make full use of information in firms’ financial statements and auditors’ knowledge of firms to inform our supervisory judgements.

11. To help us focus on potential risks in individual industry sectors, we also meet audit firms in a number of fora. These include high-level bilateral meetings with audit firm partners, technical bilateral meetings with audit firm directors and roundtable meetings with the largest firms to discuss key financial reporting and audit issues in particular sectors. We also still hold high-level meetings with audit firms where, among other things, we discuss key risks that we have identified in particular sectors.

12. We have also published a Discussion Paper and Feedback Statement on enhancing credit institutions’ financial reporting disclosures. We believe that there remains room for improvement in this area, both by firms and in auditors’ approach to auditing disclosures. However, there have been some improvements in firms’ disclosures on credit exposures, risks and uncertainties since the crisis, including:

- more granularity in disclosures on financial instruments (for example, information on the “fair value hierarchy”, which shows the extent to which unobservable inputs are used in the valuation methodology);
- improved disclosures on instruments most affected by the financial turmoil in 2008 and 2009 (such as residential mortgage-backed securities and collateralised debt obligations); and
- the inclusion of glossaries providing a definition of key financial terms that are not explicitly defined in accounting standards.

**Client Assets**

13. Client asset protection is another key aspect of maintaining market confidence, financial stability and consumer protection. Our existing client assets regime aims to address those objectives by, among other things, ensuring client assets are kept separate from those of the firm and establishing where client assets stand in the hierarchy of creditors in the event of a firm’s default.

14. In this context we have historically given auditors a role in providing external independent assurance that regulated firms have adequate systems to enable them to comply with the client assets regime. This is achieved by periodic reporting by firms’ external auditors on the adequacy of their client assets systems.

15. However, through supervisory work we have established evidence of material failings in some of the auditor’s reports on client assets, including indications that some auditors lacked understanding of the relevant FSA requirements. In our review of the auditor’s reports, we uncovered further material weaknesses in a number of reports received. The specific failings we have seen include:

- auditors providing unqualified (ie “clean”) reports, despite the regulated firm having committed significant breaches of our client assets rules;
- auditors’ reports covering the wrong chapters of client assets rules;
- failure to undertake to provide the report on client assets because the auditor was not aware of, or did not understand, the reporting requirement on client assets; and
- auditors submitting their reports several months late (in some instances, they were submitted years after the period to which they relate).

16. Because of the nature and number of issues identified, we concluded that these failings are not localised to one or a limited number of auditors, but rather indicate a general deficiency by auditors in understanding and applying our requirements relating to client assets, and a need to take steps to improve the quality of the auditor’s reports on client assets.

17. We have recently launched a specialist unit—the Client Assets Sector team—to increase focus on the regulation of client assets. The sector has brought together staff responsible for policy, data collecting and monitoring and analysis. As well as continuing to use auditors’ reports on client assets to monitor firms’ compliance, the team monitors the quality of the auditors’ reports on client assets to ensure that the steps we are taking (as summarised below) lead to improvements in the standards.
18. We have taken notified firms and their auditors of the material failings and weaknesses we have identified in firms’ systems relating to compliance with the client assets regime. We have also established referral arrangements with the auditors’ supervisory bodies, and have referred a number of individual auditors to the Institute for Chartered Accountants for England and Wales (ICAEW) and the Accountancy and Actuarial Discipline Board (AADB) in relation to auditors’ reports on client assets that we consider failed to meet our requirements.

19. On 27 September we published a Consultation Paper proposing amendments to our Handbook. The Consultation Paper proposals, together with the other actions we are taking, aim to drive improvements in the quality and consistency of the auditor’s reports on client assets by:

- confirming and clarifying the standards required for the auditor’s report on client assets;
- increasing and making consistent the information provided within the auditor’s reports to enhance its supervisory value; and
- improving firms’ governance oversight of both their auditors and their compliance with the client assets rules.

**Other Issues**

20. In addition to this, we have set out several areas where we believe audit could be made more effective for our supervisory work. Enhancing information sharing between the FSA and auditors should be possible under existing legislation and could improve both auditors’ contribution to prudential regulation and audit quality. Although there are restrictions on what information we can share with auditors and the circumstances in which it can be shared, the “default mode” should be that we share with them key information that would support better quality audit. Although, under FSMA, auditors have both a duty and a right to report information to us that is relevant to our functions, there is currently a low level of reporting, despite recently having experienced the most severe financial crisis in recent years. We believe that further improvements are needed in the way in which auditors fulfil this duty (although enhanced engagement between us and auditors, both now, and as this develops further in the future, should also increase the incentives for auditors to improve on the current low level of reporting).

21. Changes in legislation to create additional regulatory powers may also be needed. Currently, we can refer an auditor to the FRC and the auditor’s professional body if we have specific concerns. We can also disqualify an auditor from acting as the auditor of an authorised person if it appears that the auditor has failed to comply with a duty imposed on them under FSMA. In practice, a failure to discharge duties under FSMA could vary in seriousness or significance. An appropriate package of enforcement powers could provide us with the same tools to take action against audit firms (or individual auditors) that are currently available when taking action against a regulated firm or approved person (including public censures or imposing financial penalties).

22. We have sought feedback about whether we should have an enhanced range of enforcement tools in relation to audit firms (including the power to publically censure, impose financial penalties on or disqualify the audit firm or relevant individuals within the audit firm). We intend to continue to use the platform of the Discussion Paper (and subsequent responses) to evaluate how best to enhance auditors’ reporting on client assets and whether we should seek an enhanced range of enforcement tools.

23. There could also be merit in extending the FRC’s enforcement powers so it can monitor work by auditors that does not form part of the annual statutory audit (such as the audit of interim financial information) and is better able to investigate specific issues at short notice outside the annual inspection cycle.

24. We are also considering whether enhanced assurance on regulatory returns would be appropriate. While imposing an external audit requirement for all returns may be disproportionate, we have some concerns over the quality of regulatory reporting and we are therefore considering whether data quality would improve if returns were to be subject of some form of external review. Greater use of s.166 Return Assurance Reports could be one alternative.

25. We are also exploring whether auditors should be required to report on additional specified areas for the firms they audit. This could give us more insight into significant accounting judgements that materially affect the firm’s statement of financial position, identify weaknesses in the control environment or identify the main dependencies and vulnerabilities of the firm’s business model. Such additional information would provide us with more complete information to help us judge the adequacy of relevant amounts in the annual accounts and could be presented in a consistent format which would aid comparison across firms.

17 S.166 Return Assurance Reports involve the FSA using powers under section 166 of FSMA to review a specific firm’s regulatory return where there is a perceived risk. These reviews can therefore be used to gain assurance that the regulatory return has been properly prepared in accordance with the relevant FSA rules.
26. Banks, building societies and investment firms disclose information on capital and risk management under “Pillar 3” of the Basel II capital framework. Pillar 3 disclosures are subject only to internal verification. We remain unconvinced that there is significant demand for external assurance of Pillar 3 disclosures and that an audit of all such disclosures would significantly increase their usefulness to us in making decisions. However, there may be specific measures on capital adequacy where the inherent uncertainty or relevance of these measures to decision-making means that greater assurance could enhance market confidence and add value for the users of other prudential information.

AUDITORS AND CORPORATE GOVERNANCE (AUDIT COMMITTEES)

27. Internal audit plays a crucial role in ensuring the effective governance of organisations, and represents a key defensive mechanism against the risks that they are exposed to, by providing the organisation with independent and objective assurance that line management is managing risks actively and effectively and that governance is effective.

28. Our Consultation Paper, Effective corporate governance (Significant influence controlled functions and the Walker review) published in January 2010, advanced a range of proposals designed both to improve the quality of governance and risk management in firms and to further intensify our supervisory regime, following the introduction in 2009 of our Supervisory Enhancement Programme. It also contained proposals to give effect to the FSA-specific recommendations in Sir David Walker’s review of corporate governance published in November 2009. The Handbook changes (published on 24 September), along with our Policy Statement (PS10/15), implemented these proposals, including in respect of the Internal Audit function within firms.

29. As part of our Intensive Supervision Model, we are increasingly seeking to engage with auditors to establish whether or not there is evidence within a firm to support this. It is for this reason we have now amended our approved person, Significant Influence Functions (SIF) regime, to create a separate internal audit function (CF15), as well as other SIF controlled functions for non-executive directors and Systems & Control functions. These amendments will make us better able to assess—including through interview where appropriate—the competencies and capabilities of individuals filling these roles and ensure that they possess the correct skills and experience with which to carry out their duties effectively.

30. The success of the internal audit function depends crucially on its independence from all other functions and systems within the organisation on which it gives assurance. Our new guidance sets out our intention therefore to provide guidance advising firms to restrict the holder(s) of the internal audit (CF15) controlled function from holding, at the same time, any other significant influence function. This, we believe, will protect and entrench its independence.

31. Many firms already have in place a wholly independent internal audit structure that allows for the individual(s) holding the internal audit role not to be responsible for other functions. We do, though, regulate some 14,500 small firms, many of which may have no alternative, due to their scale, but to have individuals responsible for both the internal audit and other roles and our guidance allows for this.

32. We have also amended our Handbook to emphasise and include in our rules the key role of the modern, internal audit function: that of reporting on the effectiveness of the systems of internal control.

33. In all these areas progress has been and continues to be made. While many concerns have been raised over the work of auditors before and during the financial crisis, we have worked closely with auditors, the FRC and other relevant bodies to address these. We will continue to work with relevant organisations to seek further improvements.

October 2010

Memorandum by the Office of Fair Trading (ADT 26)

SUMMARY

1. This submission is made by the Office of Fair Trading (OFT), the UK’s consumer and competition authority, whose mission is to make markets work well for consumers.

2. The OFT has been keeping the market for external audit services in the UK under review since November 2002.19

3. The OFT considers that competition in the market for audit services in the UK may be limited. Some aspects of the audit market giving rise to this concern include companies’ lack of clear incentive to switch auditors; the focus on established reputation in companies’ choice of auditor; high switching costs; the established

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18 Please note that throughout this document “audit” refers to external audit only.
competitive advantage of the “Big Four”\textsuperscript{20} over mid-tier auditors;\textsuperscript{21} the limited choice of auditors to appoint; and the difficulties mid-tier firms face in raising funds to finance expansion.

4. The OFT considers that these aspects of the audit market may explain low levels of switching of audit contracts; very high market concentration, with high and stable market shares for the Big Four being maintained at least as far back as 2002; and potentially high fees. The OFT also notes that there are significant concerns about the systemic risk arising from the potential impact of an audit firm failing.

5. Audits enable stakeholders such as investors, lenders and trading partners to assess the reliability of a company’s financial statements. If this is not done effectively, they may be deterred from doing business with that company, in which case companies would be likely to face less favourable terms of trade, including higher costs of obtaining finance.

6. Higher audit fees or higher financing costs are likely to feed through to higher prices for consumers. Weak competition may also contribute to a risk of wider, systemic failure in the audit market. Moreover, barriers to expansion 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 unexpectedly.

7. Given that competition may be limited, there are a number of changes that may have the potential to increase competition in the market. OFT’s preference would be for changes to be delivered through the market. Market-led solutions ultimately result in the right incentives being harnessed so as to deliver the best outcomes for consumers. However, certain improvements may also be sought through regulatory or legislative change, at least in the short term. The nature of the audit market is such that changes may have to be international to be successful.

INTRODUCTION

The Office of Fair Trading

8. The OFT is the UK’s consumer and competition authority. The OFT’s aim is to make markets work well for consumers. It performs this role by deploying a variety of tools at its disposal including the enforcement of consumer and competition laws and advice to policy makers where wider government policies affect competition and markets.

OFT’s Previous and Current Work on the Audit Market

9. In 2002, the OFT considered whether a market investigation or Competition Commission referral would be appropriate for addressing competition concerns following the Enron affair and subsequent collapse of the audit firm Arthur Andersen. In November 2002, the OFT stated:

“There is public concern about the increased concentration in the supply of audit and accountancy services, and its implications for competition and choice. The OFT recognises that concern. But [. . . ] we do not, at this stage, propose to launch a full-scale investigation into the sector, or to refer it for investigation by the Competition Commission [. . . ] Rather, 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.”\textsuperscript{22}

10. Since then, the OFT has provided advice to Government on the implications for competition in the audit market of proposals to permit auditors to limit their liability by way of negotiated caps\textsuperscript{23} and contributed to the UK’s submission to the OECD roundtable on competition and regulation in auditing and related professions in June 2009.\textsuperscript{24} In addition, the OFT has, since 2002, liaised, and will continue to liaise, with the Department for Business, Innovation and Skills (BIS) and the Financial Reporting Council (FRC) in relation to concerns regarding this market.

11. A recent report by the FRC indicated that a number of recommendations intended to result in the audit market working more efficiently and to increase audit choice in the UK had been implemented but had been largely unsuccessful. The FRC found that “there is limited evidence that the recommendations have had a significant impact on market concentration and the risks arising from that concentration”.\textsuperscript{25}

\textsuperscript{20} The “Big Four” auditors are PricewaterhouseCoopers, KPMG, Deloitte and Ernst & Young.
\textsuperscript{21} Mid-tier auditors include companies such as BDO and Grant Thornton.
\textsuperscript{22} See http://www.oft.gov.uk/shared_of1/press_release_attachments/accountancy.pdf
\textsuperscript{24} See http://www.ftc.gov/bc/international/docs/competitionaccount.pdf
12. In addition, in preparing this submission, we have met with four of the largest providers of audit services (BDO, PwC, Deloitte, and Grant Thornton), providing them with an opportunity to tell us their views and experiences of the market for auditors.26 However we have not shared this document with them.

13. Further details of the OFT’s ongoing work can be found on our website.27

THE MARKET

14. This submission addresses the concern that competition in the audit market may be limited and may deteriorate in the future. Therefore, it relates primarily to three questions posed in the call for evidence from the Select Committee on Economic Affairs:

Q1: Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?
Q2: Does a lack of competition mean clients are charged excessive fees?
Q11: Should more competition be introduced into auditing? If so, how?

15. In addressing these questions in particular, the remainder of this submission is presented in the following three sections:

— aspects of the audit market that may adversely affect competition;
— effects observable in the market; and
— key questions about possible changes to the market.

Relevant market

16. For the purpose of this submission, the relevant market is the provision of external audit services to large companies. This may be taken to mean FTSE350 companies. However, there may be separate markets defined more narrowly than this, for example by reference to FTSE100 companies and/or according to particular sectors that have more complex audit requirements, such as banking and insurance.

ASPECTS OF THE AUDIT MARKET THAT MAY ADVERSELY AFFECT COMPETITION

17. The OFT considers that competition may be limited as a result of the following six aspects of the audit market:

— There is little incentive for companies to switch auditor. Audit fees may not drive auditor selection and switching because they are small in comparison with the level of companies’ finances. In addition, the difficulty of discerning audit quality and the tight regulation of how audits are conducted may mean that little difference between the audits of different suppliers is apparent, so that it is difficult for Finance Directors and audit committees to distinguish between the audit offerings of different suppliers.28 Where the scope for differentiation in service quality is perceived to be limited, companies may view audit simply as a regulatory hurdle, rather than as a service that is capable of adding value.

— In choosing an auditor, companies focus on established reputation, which imposes a barrier to entry to non-Big Four auditors. Given the difficulty of differentiating quality, companies may select auditors on the basis of existing reputation, calculating that this will avoid risk and the need to consult investors, rather than on the basis of maximising the value added by the audit. There seems to be little difference in reputation between the Big Four, but a larger difference between the Big Four and mid-tier firms. As a result, mid-tier auditors may struggle to compete even on the basis of a better value or quality proposition.29

— It is very costly for companies to switch auditor. Substantial management and audit committee time is required to put an audit out to tender and select a new auditor; it takes time for a new auditor to gain an understanding of the business in order to audit it, during which time the company management

26 The invitation to meet was extended also to KPMG and Ernst and Young.
27 See: http://www.oft.gov.uk/OFTwork/markets-work
28 Source: survey of audit committee chairmen in Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also stakeholder comments and FRC (Market Participants Group) and academic papers.
29 Source: comments of institutional investors and survey of audit committee chairmen in Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) and academic papers.
will have to invest time in bringing the auditor up to speed; and there is a higher risk of a new auditor making mistakes initially.30

— **Larger auditors possess certain attributes necessary for auditing large companies.** These attributes are difficult to acquire so may constitute a barrier to entry. These include an extensive, integrated international network; relevant industry specialisation; greater experience in auditing complex businesses; a greater ability to offer additional services (audit may be used as a gateway to providing these services and larger audit firms may have an ability to provide a more attractive and complete range of services than smaller audit firms); existing links with Finance Directors and audit committee chairmen; and possibly an ability to recruit higher calibre staff attracted by the audit firm’s reputation. It seems that it is difficult for smaller auditors to develop the necessary attributes, such as reputation, expertise and resources, to undertake large audits because of the difficulty of securing large audit contracts in the first place—potentially a vicious circle.31

— **Companies may have a limited choice of auditors that they can appoint.** Companies may require an auditor with a particular technical capacity, such as a particularly large international network or a specific industry specialism, which may favour the Big Four. Choice may also be restricted by regulation, such as the USA’s Sarbanes-Oxley Act of 2002, which limits the ability of public reporting companies to appoint as their auditors firms who supply them with certain types of non-audit services. Further, choice may be limited by commercial considerations, for example companies not wanting to employ auditors that work closely with competitors. This leaves some companies with a very limited choice of their current auditor and only one or two others.32

— **There are barriers to smaller auditors raising sufficient capital to grow.** The OFT understands that substantial investment would be required for mid-tier auditors to gain a significant foothold in the market for audit services provided to FTSE250 companies and that this may very well exceed the potential returns, with significant risks and a long payback period. Further, avenues for raising capital are limited by the requirement for a firm to be majority-controlled33 by qualified auditors34 and by their partnership structure, as investment may not be attractive to older partners due to the limit that retirement imposes on the period in which they can receive a return on investment.35

**Effects Observable in the Market**

18. The OFT considers that the aspects described above could result in the following three potential market effects:

— Low levels of tendering and switching: Tendering does not appear to occur very often. One of the Big Four cited in Oxera’s 2006 report was aware of only 28 FTSE100 companies that had held competitive tenders in the previous 15 years.36 Other evidence demonstrates that between 2001 and 2009 average switching rates were less than four per cent annually.37

— High concentration: In 2009 the Big Four earned all audit fees (that is 100 per cent) levied for FTSE100 companies and 98 per cent for FTSE250 companies, with PwC alone earning 47 per cent of FTSE100 companies’ audit fees.38 Concentration is higher in some specific industry sectors including mining and quarrying; hotels and restaurants; and electricity, gas and water supply.39 The combination of high market concentration and low rates of tendering and switching gives rise to a

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30 Source: Interviews and survey of audit committee chairmen in Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, stakeholder comments and FRC (Market Participants Group) consultation responses.

31 Source: Interviews with large-scale companies and survey of audit committee chairmen in Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also stakeholder comments and FRC (Market Participants Group) consultation responses.

32 Source: Survey of audit committee chairmen in Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, stakeholder comments and FRC (Market Participants Group) consultation responses.

33 Source: modelling of prospects for entry by mid-tier firms and observations in Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) consultation responses.

34 Source: Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC. Also, FRC (Market Participants Group) consultation responses.

35 Source: Schedule 10 of the Companies Act 2006. These requirements flow from Article 3 of Directive 2006/43/EC on statutory audits.

36 Source: OFT analysis shows that rates were 1.7 per cent annually for FTSE100 firms and 3.3 per cent annually for FTSE250 firms (this analysis covers firms that are still in the FTSE250 currently).

37 These figures are calculated according to audit fees levied for current FTSE100 / FTSE250 companies only. When concentration is measured using the Herfindahl-Hirschman Index (HHI), the figure for the FTSE 100 is 3,173, while the figure for the FTSE 250 is 2,772. A HHI figure in excess of 1800 for a market is typically considered to represent a highly concentrated market.

38 Two of the Big Four supplied more than 80 per cent of audit services in wholesale and retail trade, mining and quarrying; hotels and restaurants; and electricity, gas and water supply.
stable market with limited opportunities for rivalry and few changes in market shares over time. This can be seen in the following graph of shares of supply of audits for FTSE 350 companies between 2002 and 2009.

Table 1

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— High fees: Some evidence has been found of a link between concentration and fees and also that audit fees for clients of the Big Four appear higher than for companies using mid-tier auditors, all other things being equal.40

19. The OFT considers, therefore, that weak competition in this market may mean that audits cost companies more than is necessary, with the possibility that the market does not operate as efficiently as possible and that the value added by audits is not maximised.

20. Audits enable stakeholders such as investors, lenders and trading partners to assess the reliability of a company’s financial statements. If this is not done effectively, they may be deterred from doing business with that company, in which case companies would be likely to face less favourable terms of trade, including higher costs of obtaining finance. Higher audit fees and higher financing costs are likely to feed through to higher prices for consumers.

Systemic Effects

21. The limited choice of auditors and high barriers to expansion for mid-tier audit firms mean that if one of the Big Four were to exit the market, existing competition problems in the market could be exacerbated. There might also be a short-term risk of some companies being unable to purchase audit services, leading to a loss of confidence in the financial status of high-risk companies and possibly among investors more generally. Thus the existing high barriers to entry, leading to high market concentration, can be seen as contributing to the identified risk of wider, systemic failure in this market. Moreover, barriers to expansion 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 unexpectedly.

40 Oxera’s report Competition and choice in the UK audit market (April 2006), commissioned by the Department of Trade and Industry and the FRC.
KEY QUESTIONS ABOUT POSSIBLE CHANGES TO THE MARKET

22. If indeed competition in the audit market is limited, there are a number of issues to consider before determining what changes to the market could lead to the most effective outcome. These considerations cover regulatory change, changes in ownership arrangements and planning for the possible failure of one of the Big Four.

23. We make two key observations in relation to these issues. Firstly, the OFT’s preference would be for changes to be delivered through the market. The OFT considers that market\(^{41}\) solutions ultimately result in the right incentives being harnessed so as to deliver the best outcomes for consumers. However, the OFT recognises that certain improvements may also be sought through regulatory or legislative change, at least in the short term. Secondly, we recognise that many of the potential solutions will require action on an international level if they are to be wholly effective.

24. The issues to consider in relation to different types of possible changes to the market are discussed below.

25. Under the broad heading of regulation of the audit market, the OFT has considered a number of specific changes that could be contemplated, such as:

— **Changes to the minimum requirements of the statutory audit.**\(^{42}\) We consider that it is worth exploring whether the level of detail, scope\(^{43}\) or materiality\(^{44}\) required of statutory audits should be reduced. Companies could then choose whatever methods (in addition to the statutory audit) were necessary to enable them, investors and any other bodies using the accounts (for example companies wishing to trade with them) to assess the company’s financial position with the level of confidence that is appropriate for their particular purposes. Thus they might, for example, commission audit firms or consultancies to provide a more thorough audit or whatever assessments of particular aspects of their operations, for example the performance of particular assets, divisions or products were thought necessary.

As well as potentially reducing the burden on companies, 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. Despite evident risks around such a change, the OFT considers that these must be balanced against the compelling possible gains that would result from shifting the requirements and incentives of companies when selecting auditors. Such a regulatory change could result in companies being more motivated to ensure that the potential value added by audits is maximised.

— **Reducing differences in the approach and standard of audits in different countries.** Ensuring that auditors who approve accounts in one country are able to do so in other countries could increase the ability of mid-tier firms to win contracts to audit international companies (if not on their own then possibly in combination with other firms). This might also facilitate companies employing different auditors in different countries since the likelihood of time-consuming disagreements on how to consolidate accounting results might be reduced. Increasing standardisation and harmonisation might assist in reducing concerns, whether based on fact or simply perception, regarding the ability of mid-tier firms to handle audits of international companies.

— **Changes to the rules covering the use of audit firms.** There are a number of possibilities for changes in this area, including a requirement for a company to have two auditors (either through a split or joint audit process) and the mandatory regular tendering of audit contracts. In addition, a requirement for outgoing auditors to provide information to incoming auditors in a standard format would address concerns around the time and investment by company management that is required for a new auditor to understand the business and the greater risk of mistakes being made in this initial period. The aim of such measures would be to strengthen rivalry in the market by increasing the incentives and ability of companies to switch between auditors and reducing the costs of doing so.

26. Another issue to consider is whether some form of change in the rules governing the ownership arrangements of audit firms might be beneficial. Audit firms currently have to be majority controlled by auditors which limits the scope for new investment and hence expansion of mid-tier firms.

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\(^{41}\) Market solutions are those which can be delivered by the firms within or the customers of a market, perhaps through voluntary initiatives to increase transparency. market-based solutions are solutions which are based on making the market itself function more effectively, as opposed to regulatory solutions.

\(^{42}\) “Statutory audit” refers to the functions and duties of a company’s auditor in reviewing and reporting on a company’s annual accounts, directors’ report and directors’ remuneration report as required by UK company law. See Part 16 of the Companies Act 2006.

\(^{43}\) ie coverage.

\(^{44}\) This relates to the size of error that would be required to change the view of someone reading the accounts as to whether they are “true and fair”.

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27. In the event that less interventionist changes are not successful in bringing about an increase in competition and a reduction in systemic risk in the market, attention might turn to whether direct intervention is called for in order to shift the market to a new equilibrium. However, it is necessary in all such cases to ensure that any such response is at most targeted “micro-surgery” rather than potentially more drastic intervention in order to avoid the risk of undermining competition in the long run.

28. In addition to the issues to address before determining what interventions should be used to achieve the most effective market outcome, it may also be appropriate to focus attention on what could be done to mitigate harm if any of the Big Four firms were to leave the market. In this regard, the OFT is considering undertaking further research and analysis vis-à-vis potential competition issues in concentrated markets where there may be a risk of systemic failure, where any such failure could cause significant harm to the UK economy. Our interest in such markets is distinct from other regulators who do not have a competition focus. Our interest is not on assessing the level of systemic risk as such but in assessing whether such markets currently deliver what consumers want on competitive terms that present good value to consumers and, more broadly, to the wider economy. Any such work, if undertaken, would likely consider what, if any, appropriate solutions may be available.

CONCLUSION

29. This submission has explained that the OFT considers that competition in the market for audit services in the UK may be limited. It has presented a number of issues to be considered in determining appropriate changes to the market that could increase competition in the market and thereby possibly reduce the systemic risk of failure of one of any of the Big Four, with the resulting significant impact of this on companies and consumers.

24 September 2010

Examination of Witnesses

Witnesses: MR PHILIP COLLINS, [Chairman, Office of Fair Trading], MR DAVID STAILBRASS, [Office of Fair Trading], BARONESS HOGG, [Chairman, Financial Reporting Council], MR STEPHEN HADD RILL, [Chief Executive Officer, Financial Reporting Council], MS SALLY DEWAR, [Managing Director, Risk, Financial Services Authority] and MR RICHARD THORPE, [Head of Accounting and Audit, Financial Services Authority].

Q169 The Chairman: We are here for the inquiry into Auditors: Market Concentration and Their Role. Copies are available of Members’ entries in the Register of Interests and of the declarations of interest relevant to this inquiry. I thank all six of you for coming, and thank you very much for your extremely helpful written evidence. I make the usual request, for the benefit of the webcast and the shorthand writers: please speak loud and clear. When we reach the questions, because we have a lot to get through this afternoon, if you agree with whoever is answering first, please simply nod or just say nothing. But I rather suspect that, given the range of witnesses we have this afternoon, that will not happen very often. But if it is possible please do, so that we can get through as much as we possibly can.

Would any of you like to make an opening statement or shall we go straight on to questions?

Baroness Hogg: Whichever you would like, my Lord Chairman. We have a very short one, if you would like, but if you want to go straight to questions, we’re very happy as far as we are concerned.

Q170 The Chairman: If it is very short, please do.

Baroness Hogg: We would just like to say we think this is particularly timely. The FRC has been voicing its concerns about the actual and potential threat toward equality from market concentration for several years. As you know, in 2006, we set up the Market Participants’ Group of investors, companies and audit firms, to explore ways of getting the market to work better. But in our latest report we made it clear that, whatever benefits there may have been from this work, concentration is as great as ever. So we do believe the time has come to consider more radical measures than we can pursue on our own and we hope that the combination of your Lordships’ inquiry here, and a European Commission Green Paper from Brussels, which has some potentially disturbing elements, will act as catalysts to action at both national and international level.

Of course, we are not a competition authority and you will get a much better view from our neighbours down the line on the proper limits of competition policy here. Our focus is on the quality of audit and the contribution it should make to our objective, which is promoting good corporate governance and corporate reporting in order to foster investment. So it is from that perspective we would now urge consideration of further actions at national and G20 level. That does not of course mean we support all the solutions being canvassed.

Meanwhile, there are a number of lessons we have learnt at the FRC, over the past few years, about what is needed for us to pursue our objectives fully. A
number of these relate to our roles with respect to audit regulation. As you know, my Lord Chairman, the FRC was created out of a range of regulatory and self-regulatory bodies for standard setting, guidance giving and disciplinary actions in the fields of audit accounting, reporting and governance, to which have more recently been added the actuarial profession and investor stewardship. This has been a journey along which great progress was made by Stephen and my predecessors, but we believe more needs to be done to make the whole greater than the sum of the parts; for example, by transferring licensing authority for listed company auditors from the institutes to the FRC and giving us greater investigatory and information sharing powers. But since some of this would require legislation—both primary and secondary—we are very grateful for any opportunity we may have this afternoon to explain our thinking to the committee. Thank you.

Mr Collins: Thank you very much, my Lords, for inviting us here today. We are a competition authority and the mission we have is to make markets work well for consumers and, in this case, for the users of audit services. In the context of audit services, our concern is whether competition is working in the market in a way that means that those who use the services, who are a diverse range of interested parties, investors, financiers and regulators, among others, and not just the companies who commission audits, get the information that they require.

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, which are perhaps best judged by others, including the FRC.

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, particularly by delivering optimal efficient outcomes for those users. So one question is: what to do about it? The key issue here appears to us to be whether regulation should seek to set only the outcome of the audit process; that is, stipulate the content and quality of an audit, or whether in addition it should seek to better harness market forces, in a way that focuses not just on the audit process itself but on stimulating both companies and firms supplying audit services to focus on what users of those services need and require.

Regulating quality is important, but a danger with regulating only the content and quality of audit is that efforts of market players can become focused mainly on satisfying the regulator, in all likelihood at or just above the acceptable level. Regulating outcomes is particularly difficult where the product is as complex and the quality is as hard to discern as with audit.

We therefore think it is important that regulation harnesses market forces, so that firms offering services to companies are incentivised to satisfy the needs and requirements of users. To this end we think that consideration could be given to a reduced form of statutory audit combined with such other measures, including a clear statement about the level of assurance provided by an audit. This would then leave open for companies to supply further assurance about various aspects of their activities, which are important to their investors and to other interested parties, in addition to the statutory audit, but on a voluntary basis. In this situation one could envisage a prohibition on auditors supplying non-audit or non-assurance services.

Another key question is: can we in the UK do something on our own? The answer to this is unclear, given the extent of international regulation of auditing. But we can lead by promoting both international debate and potential international action. That is why, for instance, we have sought to raise the issue for discussion among other competition agencies, including the European Commission, and international bodies such as the OECD. In particular, we are seeking to raise the issue of how merger regimes in different countries might react to a failure of a large audit firm and subsequent disposal of its assets. We also plan to make a submission in response to the European Commission’s public consultation on audit policy, and we will continue to liaise with the FRC, which over the past few years has been taking the lead in seeking to address market issues through the Market Participants’ Group, as you have heard. Thank you very much.

Q171 The Chairman: Thank you very much. I think we have already established that there is a great deal of concern about the dominance of the Big Four, the impact on competition and choice, and the risk of a failure of one of the Big Four. What is much less clear to us at this stage is what the answers are, and I notice that there is already some difference in the opening statements we have had, and in the evidence. For example, one of the FRC’s comments in its paper is, [odq]Market-led solutions have not proved effective and therefore a regulatory solution should now be considered,[cdq] whereas the OFT’s preference is for changes to be delivered through the market. So these are all issues I think we will be exploring this afternoon.
Could I begin by asking you the question: do you think there has been regulatory capture by auditors and auditor firms themselves? Then perhaps to the FRC: is the danger greater in the FRC where auditors play a very active part and, in particular, where the Big Four play an active part in seeking solutions? Baroness Hogg: Before answering that question, may I just go back to this point about market solutions, because it is possible that we’re using the language in different ways and, therefore, you might be led to consider that the difference is greater than it really is. The market solutions referred to in our paper were those that came through the Market Participants’ Group; that is, those that came out of an engagement of discussion with investors, audit firms and ourselves. I think we want to go with the grain of the market in the economic sense quite as much as the OFT does, because that is the powerful way to do it. We have a number of specific suggestions that, in that sense, are very much market-based, which I would love if I may to come back to. Might I do that now or would you like me to answer the question?

Q172 The Chairman: I think answer the question because we will come back to that again later. Baroness Hogg: Okay. On the issue of regulatory capture, I think the journey of travel at the FRC has been exactly in the opposite direction. That is to say, it was born out of a quasi self-regulatory system and over time, under Stephen and my predecessors, a greater degree of independence has been created in the structure. For example, the AIU has become more transparent and more public, where it sees issues to criticise in the audit of listed companies. But we feel that there is further to go on this journey. I touched on some of the issues in my opening statement but if I may I will ask Stephen to pick up on that.

Mr Haddrill: First of all, at the moment we are not the body that registers an audit firm to be a public interest auditor, an auditor of listed companies. That is done by the relevant institute, generally by the Institute of Chartered Accountants in England and Wales. We think that there should be an additional registration of such auditors by the FRC in future. On the basis of that, that would enable us to exercise a wider range of sanctions, should we find something wrong in the way that the auditor is conducting its affairs. At the moment the only sanction we have is to recommend to the institute that it removes the registration from the audit firm. That is obviously a nuclear option. It is not an option in our control. It is an option for us to recommend it to the institute. We would expect them to enforce it but we don’t have that power.

If we had registration in our own hands we would wish to seek a wider range of sanctions, including being able to set conditions on how the audit firm does business in future, if there is evidence that it is doing it wrongly; to set fines; maybe to ask a particular partner to be removed from the list of people who do public interest audit work. At the moment we do have a responsibility to register these bodies that set qualifications, the institutes themselves. But our only sanction if they don’t do their job properly is effectively to wind them up and to remove that qualification, that registration. So again, in relation to the institutes, we would also want a wider range of sanctions to exercise.

Next, we wish to be able to conduct—much more easily than we can at the moment—preliminary investigations when something has gone wrong. This may be something that we come back to when we talk about the financial crisis and what’s happened since then. But 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 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.

Finally, we still have problems, because of the way that we have been set up and the way the legislation works, in passing information from one part of the FRC to another. That is something that we think should be dealt with as part of any set of changes.

Q173 The Chairman: We may come on to that later. But pursuing the question of regulatory capture for a moment and how far you have got—given, of course, that I think a lot of the evidence we are getting, and no doubt from some of you, goes way beyond pure accountancy and wants to look at systemic risk and all those sorts of issues in companies—can you tell us what proportion of the FRC’s board and committees are members of the accountancy profession? Of these, how many work for the Big Four and would any of the chairs of FRC committees fail the criteria for independence in the FRC’s corporate governance code? You may not be able to answer the statistical questions at the moment but perhaps you could let us have a note.

Baroness Hogg: The key first point I would like to make is that we do not have practising practitioners on the two disciplinary bodies. That is to say, we don’t have them on the POB and we don’t have them on the AADB.
You have described them as [odq]subsidiaries[cdq] but they are in fact operating bodies, and one of the issues that Stephen has been alluding to is that a lot of the powers are vested in the operating bodies rather than the FRC itself, which is an umbrella. So each of these is drawn broadly from the communities of investors, auditors, actuaries, accountants, people with experience on company boards, and the FRC board itself is a mix of these qualities.

But we have quite a complicated board because the board is made up at the moment of the chairmen of all the operating bodies and it is a very debateable point whether those are non-executive, because they are non-executive with respect to their membership of the FRC board, or executive, because they are chairmen—some of them executive, some of them non-executive—of the distinct operating bodies. Then we have other members of the board who have no other position within the FRC framework. I'm sure I have made that even more confusing than it was to begin with, but we asked exactly the question you asked, my Lord Chairman, and it is very difficult to answer in terms of the structure of the FRC.

Q174 Lord Tugendhat: I listened with great care to Mr Collins and I thought perhaps I wasn't going to need to ask this question—which is the first of two—about why it is that the OFT has never done an inquiry into the audit profession? I heard exactly what you said, I think, but it is such an extraordinary situation, with four firms dominating to the degree that they do, that I would have thought that a report setting out the considerations, the dangers, the reasons why you are not recommending further action, or why you might have recommended further action, it does surprise me that you have never done it.

Mr Collins: Perhaps I could reply looking at history, and I think you have already heard evidence about the way in which the 16 firms have reduced to four over the last 30 years. I think that is roughly the way it has gone. Of course, there was a significant change in the latter part of the last decade, with the merger between Price Waterhouse and Coopers and Lybrand. Then, of course, there was the unexpected collapse of Arthur Andersen. When Arthur Andersen collapsed we did have a look at the market and we said we felt at that time, given the fact that the market was in transition as a result of bits of Arthur Andersen going in different directions, that, while we would keep the market under review, we didn’t think at that stage a detailed investigation was appropriate. You will recall in fact that the Price Waterhouse, Coopers and Lybrand merger had in fact been cleared by the European Commission, I think, in 1998.

If we move forward, the action then moved to the FRC, because, from 2006 onwards, it constructed the Market Participants’ Group, which was working with the industry. We didn’t feel it was appropriate at that stage, given that work going on, to carry out a review. Now we see the outcome of that review, and I think it is public that the FRC will not produce a final report until after this committee has reported. We will have to consider the position then. But the thing I would emphasise is that, because of the nature of this market—we can see it purely from a UK perspective—it is a very international market. We have to look in terms of what the solutions might be and what is practical in an international setting. So 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.

Q175 Lord Tugendhat: The other question I wanted to ask arises almost from something you said when you talked about consumers of audit services. Could I ask you whether you feel that one ought to look at this market as being one in which you have suppliers and consumers, like many other markets, or is the nature of audit such that one ought to regard audit as a public good from which benefits flow for all citizens, or if not all citizens at any rate all investors, benefits and disbenefits, because it is not just the owners of the company, it is the whole investing community? So it is a public good, isn’t it? Or would you say not?

Mr Collins: It’s a public good, in the sense that it’s a statutory monopoly regulated by statute and it’s put there for a good purpose, which is to protect the public in the broadest sense. In that sense, one might regard it as being in the public interest or a public good. But I was very clear in my opening remarks to say that, so far as consumers are concerned, we recognise that it was a very broad category of interested parties who are concerned to see high quality and reliable audit services being provided. So I don’t think it’s necessarily a question of supply or demand or public good or not. Clearly, the audit requirement is there for a purpose and the question is: are the different users—and there are a diverse range of users—getting the benefit of the services that are being provided?

Q176 Lord Levene of Portsoken: We have seen in the last couple of years some pretty spectacular disasters hit the banks, and yet they were all audited. Why have there been no regulatory sanctions against the auditors who gave unqualified opinions on those banks just a few months before the real facts came out?
Baroness Hogg: There are two big questions here and it’s an extremely important challenge. Question one I think is: did auditors fail in the sense that there was professional misconduct? The second question is: did audit fail, in that it did not perform the function that one could reasonably have expected it to do?

With respect to auditors’ responsibility in this area, or the power to act, is with ourselves and the FSA. The FSA—I know Sally will want to say more about this; I shouldn’t talk about the FSA—in carrying out its investigations while it has the power to disqualify auditors, probably most relevant to this immediate point of misconduct, has the responsibility to refer to the AADB—one of our operating bodies—any evidence it may come across that might lead to a finding of professional misconduct. So I can mention them, because they are in the public domain: the AADB is considering investigating the auditors of Lehman’s and, in a specific area of its activity, JP Morgan.

The story is not over yet, but I shall park that for a moment and talk about the role of audit and did audit fail. That is a challenge that again we have tried to tackle jointly, in terms of a consultation document on the role of audit and auditors in general in macro-prudential regulation, and the extent to which the audit process and the regulation of audit was doing its job. You will have received a copy of the joint consultation paper we put out on this issue, which raised a number of questions about this. The FRC has also put out a paper on the subject of the degree to which auditors exercise professional scepticism. I would like if I may to ask Stephen to pick up on that and our other specific actions in the [odq]audit fail[cdq] area, which is going to be a debate for some time.

We have to steer a course between asking too much of audit and assuming in some way that it can perform the function of management, which it can’t and mustn’t, or expecting too little, which is our challenge at the moment—was too little expected?

Mr Haddrill: I think firstly there is a combination of the role of audit and the role of the accounting standards themselves. The accounting standards set what the management prepare and then the auditors audit that. So first of all, I think it’s important to look at the two together. Secondly, we feel that there is quite an obvious danger in the auditors having to sound the alarm just as a crisis is happening. What we need to make sure of is that the auditors are in a position to send an early warning signal; perhaps it was a matter for 2006/2007 rather than 2008/2009.

I think the nature of that early warning signal is around the quality of the management’s reporting on risk, as it sees it facing the business, and the assurance the auditors can give that the business has gone through a good quality process in assessing risk and then reporting on it. Also, the auditor explains to the investor clearly what assurance they can give and what the audit isn’t covering, because I think sometimes there is a misconception that the audit is providing more assurance than perhaps people should rest on. So there are areas where we are exploring whether the auditor can do more, but I think it’s a question of doing it at an earlier date.

On the question of scepticism, essentially what the auditor is doing is looking at the judgments of management. They must be challenging those judgments and that requires them to be sceptical. They need to challenge them when the sky is still fairly blue and the cloud is quite a long way out on the horizon, not just when it has actually started raining. That scepticism is something we want to see built more into the training and qualification process, particularly of the audit partners. There is very little formal qualification required after an auditor has been qualified as a partner to do public interest audits, but in the 25-year period after that has happened the world moves on. I’m not saying that they clearly don’t try and keep up, but there isn’t a formal process. Clearly the financial services regulation requirements have moved a lot in that period as well and need to be fully understood.

Thirdly, there is this question about the scepticism being enhanced by dialogue with the regulators who see the macro picture, not just the micro picture, in the individual business that’s being audited. I know that’s something that the FSA is seeking to address. Baroness Hogg: Before we pass over, there is just one final piece of the jigsaw, which is in our camp, where Stephen rightly emphasised the role of the company in reporting appropriately on the business model and the risks. In the new version of the corporate governance code there is much greater emphasis on these reporting responsibilities. So it doesn’t all fall to the auditor, it does fall to the boards of companies as well, and one of the most important early reviews that we carried out was of the Corporate Governance Code, in parallel with the Walker report on governance in financial institutions.

Q177 The Chairman: Does the FSA want to comment?

Ms Dewar: Yes, thank you. There are a couple of things I would say, and I absolutely support what has been said already: the focus we would have at the FSA is on the firms we regulate and the approved persons. So in that context we have brought a number of disciplinary actions against the accountants who were approved persons, so it was in their capacity as approved persons. That was for failed firms during the crisis.
But we don’t take it as the FSA’s role to take the lead in bringing the disciplinary action against accountants and auditors for professional failings. As Baroness Hogg has said, we would work with the FRC to let them know of failings that we think we have found, or issues that we have come across, as part of our normal “business as usual” work. We will discuss that with the FRC and will pass that information on, and then they would take it forward through their disciplinary board.

In respect of client assets where the assurance of the audit is to the FSA specifically, then we have taken action ourselves and we have made referrals to the institute, which is taking those cases forward, so there are several cases going through that process.

The Chairman: I know there are a number of Members of the committee who want to follow this particular issue up before we return to others.

Q178 Lord Lawson of Blaby: Thank you. If I may summarise the answers we have heard to Lord Levene’s question, it is that you were asleep on the job and, to the extent that you were half awake, your eye was not on the ball. I think it might be helpful to go over the background to this because it is a rather important issue. As Baroness Hogg will be aware, when I was Chancellor in 1984 I set up a committee to look into the question of banking supervision in this country and to make recommendations, and I appointed the then Governor—Robin Leigh-Pemberton, now Lord Kingsdown—as chairman of the committee. Among its important conclusions were that the iron curtain of confidentiality that separated bank supervisors from bank auditors should be replaced by a regular dialogue. This was incorporated into the 1987 Banking Act as a further safeguard, as one of the provisions of the Act—and this has not been repealed so far as I am aware—that bank auditors could disclose information to bank supervisors if they felt it right to do so, with protection from any action for damages that might be laid. What has happened to this regular dialogue? Of course, the institution is mainly culpable. Obviously it is the FSA who had the main responsibility—and I will come on to them in a moment—and they are the principal culprit in this area. But presumably, the FRC was monitoring what was going on in this: what the FSA were doing: whether the FSA was adequately satisfying its statutory obligation—and indeed commonsense obligation—to make sure that this regular dialogue would take place. I don’t think the FRC is the principal culprit here, but I was slightly shocked when we asked the question in the call for evidence, “Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008?” and the FRC’s answer was, “See paragraphs 2.9 to 2.11 of our submission for our comments on scepticism”. So I looked at those comments on scepticism and it just says, “Application of appropriate professional scepticism is vital”, and then it goes on with a lot of waffle. There was not one mention of banks, as if we hadn’t had this appalling banking crisis, which has dominated what has happened to the economy since then.

The FSA does a little bit more—as well it might, because it is the responsible authority. It says, “As a result of lessons learned from the crisis we have adopted a more intensive supervisory approach. We recognise that in the past bilateral meetings between the FSA and the auditor of a supervised firm took place on an ad hoc basis”. Those are pretty weasel words, “ad hoc basis”, so I would like to get the facts. Can you please tell me, in regard to Northern Rock, Halifax Bank of Scotland, the Royal Bank of Scotland and Bradford and Bingley, precisely how many of these meetings took place in 2006, 2007 and 2008?

Ms Dewar: Chairman, I can’t give you those statistics now but I’m very happy to put those in writing.

Lord Lawson of Blaby: Well, I don’t think that is an adequate answer to everything that I have tried to put across. However, there was a requirement in the 1987 Act—that’s a long time ago, 20 years before the crisis—to strengthen the supervision of banks by having this regular dialogue and I don’t believe this regular dialogue happened or, if it did happen, it didn’t happen at a sufficiently high level or with sufficient frequency. Although, as I say, Baroness Hogg’s outfit is not primarily responsible, I don’t believe that they were checking adequately on whether this was going on because certainly nothing at all happened.

Q179 The Chairman: So we will look forward to your note but perhaps you could answer the question now more generally?

Ms Dewar: Absolutely. So, as we’ve said in our note, and we’ve said in our lessons learned from the crisis, there was not an embedded philosophy of direct engagement with the auditors as part of an ongoing—

Q180 Lord Lawson of Blaby: But there should be. It was a requirement of the 1987 Act. Why did you ignore the legislation?

Mr Thorpe: I think the requirement is certainly on an auditor. There is a requirement both under our legislation and under European directives for auditors to inform us of anything they find, in the course of their audit, which is of material significance to us as a regulator. We get relatively few of those notifications.
Q181 Lord Lawson of Blaby: So they didn’t find anything wrong?
Mr Thorpe: No. We talked to them about that and they say that they give us relatively few of those notifications, because it is their practice to require their client to tell us of the issues that they found during the course of their audit. We don’t think that goes far enough, and in the discussion paper that we published on it with the FRC we have made it clear that we would expect them to make the notifications to us, in addition to anything that we hear from their client. We expect that to go on during a process of more rigorous bilateral discussions with them, which we’re now setting in place. But primarily, the onus is on them to inform us of issues that they find rather than on us to discuss issues—

Q182 Lord Lawson of Blaby: So it was the auditors who were culpable then?
Ms Dewar: Nevertheless, as part of our supervisory engagement programme, we absolutely should have had a two-way dialogue with the auditors. So regardless of where the onus lay the responsibility was on both sides. We have changed our supervisory approach to embed that and have made sure that that change is embedded within the framework.

Q183 Lord Lawson of Blaby: That is excellent to hear, but just going back on what happened, because it is relevant to our inquiry, which is basically into auditing and auditors, the auditors failed then? They were culpable?
Ms Dewar: The requirement was on the auditors to come to us with specific examples of—

Q184 Lord Lawson of Blaby: Do you think on reflection, bearing in mind the gravity of the banking meltdown, they did what they should have done sufficiently frequently?
Mr Thorpe: We have no evidence that there were examples of information that they should have given to us, which we didn’t get direct from their clients.
The Chairman: Lord Tugendhat, do you want to come in on this one? We will continue to pursue this.
Baroness Hogg: I am so sorry. Lord Lawson did have some challenges for the FRC as well. May I just say very briefly, Lord Lawson, that I am sorry if you thought our efforts to keep our evidence at a disciplined length left you short of what you would have desired. We were asked in the call for evidence not to repeat things that we’d recently published. I’m very happy to supply you with a copy of our paper on auditor scepticism and I hope that will fill in some of the gaps you found.
Lord Lawson of Blaby: Specifically about banks, that is what I’m talking about.
Baroness Hogg: Indeed.

Q185 Lord Tugendhat: I have a small point in addition to Lord Lawson’s point. In the year that he was off this Committee we had an inquiry into the banking crisis and I remember at that point asking, both the auditors and the banks, to what extent there were regular informal contacts between the banks and the auditors, in which the auditors talked about general issues that had arisen, points that were common across the board and points of potential danger. My recollection is that they said that these meetings had taken place quite regularly but had then fallen away. Nobody seemed clear whether they had fallen away because the FSA didn’t want them or the banks didn’t want them, but they hadn’t taken place for some time prior to the crisis but they had further in the past. Perhaps, when you answer Lord Lawson, you could also say when this regular practice fell away.
Ms Dewar: Are you referring here to the engagement between the FSA and the auditors, and not to the banks and the auditors?
Lord Tugendhat: No, I am referring to the auditors and the FSA.
Ms Dewar: Absolutely.

Q186 The Chairman: I haven’t read the paper on scepticism and the auditors but what we are talking about now, does that not require a different set of experiences and range of skills different to what auditors currently have?
Mr Haddrill: Yes, we think it does and that’s why in our paper we’re consulting on how that might be improved. The world is moving on quite significantly and the accounting standards themselves have moved a lot over recent years. Of course we’ve moved from a system based upon accounts drawn up on an historic cost basis, where the numbers are the numbers, to accounts that are much more based upon market values. Of course those market values may be there but they may also require some construction, some judgment, and the management has to exercise that judgment. Those judgments are crucial and the crucial thing is that the auditors have the ability to challenge the judgment of people who are very expert themselves, particularly in the banks. So that is an area where we think that the firms need to be very much up to speed and very current, and so on, for the future.

Q187 The Chairman: In trying to challenge management’s judgment about areas they’ve entered into and invested in heavily, and so on, are we asking too much of the auditors to bring a different judgement and a different range of knowledge to bear?
Mr Haddrill: I certainly wouldn’t ask an auditor to supplant their judgment for that of management. It is a question of challenging the judgment of the management, knowing what are the right questions to ask and being able to follow through on that when the auditor is there with the audit committee; in effect, to empower the audit committee itself to be challenging of the company.

Q188 Lord Lawson of Blaby: If I may, I will ask our two witnesses from the FSA for information and clarification. Are you saying that the auditors didn’t notice there was anything wrong with the banks, or are you saying they did notice and they didn’t tell you, or are you saying they did notice and they did tell you but you didn’t do anything about it? Which of the three is it? 

Ms Dewar: They didn’t come to us and talk through the issues that they may or may not have had regarding the firms that they were auditing. So it’s not that they brought issues to us and we didn’t do anything about it; we had very few conversations of that description.

Q189 Lord Lawson of Blaby: Did they not bring it to you, do you think, because they didn’t notice that there was anything wrong or because, for one reason or another, they didn’t feel that they should tell you? 

Ms Dewar: I think that’s impossible for us to make a judgment on.

Lord Lawson of Blaby: Thank you.

The Chairman: I know this is a very important topic but we have others to deal with so, Lord Levene, last point on this one.

Q190 Lord Levene of Portsoken: Can I just go back to my original question? We have heard evidence about who did or didn’t say what to whom, and whether they should or shouldn’t have done. I think it is undisputed that there were real problems that hadn’t been shown up by the auditors. Has any form of sanction been taken against them for giving unqualified opinions on the accounts when in fact there were these huge problems, which they had responsibility to look for and said nothing about? Was there any form of sanction against any of the auditors for not having brought that up?

Baroness Hogg: May I come back? I indicated to you, Lord Levene—and as I said, these two are in the public domain, so I can mention them—the auditors of Lehmans and the auditors of JP Morgan are already being investigated by the AADB.

Q191 Lord Levene of Portsoken: So it is work in progress?

Baroness Hogg: Exactly.

Q192 Lord Best: Returning to the issues of concentration of audit in the hands of the Big Four companies, I know that the FRC has been looking at the recommendations it made in 2007 from the audit choice Market Participants’ Group. You are now up to your fifth progress report looking at that, and in that report you say that the majority of your recommendations, which are intended to allow the audit market to work more efficiently and in the medium to long term to increase audit choice, have now been implemented. But would you accept that they haven’t achieved very much?

Baroness Hogg: As I said in my opening statement, and as we say in that report, we are very clear that market concentration is as great as ever. So we are very clear that they haven’t had an impact on market concentration.

I don’t want to brush aside some of the improvements that have been introduced through this group; for example, I think the focus on audit firm governance has been important and has been internationally leading in putting pressure on the audit firms to improve their own systems of governance. But in terms of market concentration: as I said to begin with, we believe that actions, which are beyond our ability to do ourselves, need to be taken.

There is one on which I think this Committee could have a very important immediate effect, because it’s an issue that is live at the moment and can go the wrong way: what happens to the work that was previously done by the Audit Commission? I think if that slips into the hands of the Big Four that will be, at the very least, a big missed opportunity to increase the strength of work done by the non-Big Four firms and I think action needs to be taken. We have made this point to Government, of course, but making it to you may prove much more effective.

Q193 Lord Best: Could you say a little bit more about that action? What do you think should be done to avoid that danger?

Baroness Hogg: Point one: Government have to feed the message through all parts of the body public that it is now looking to tender that work, that at the very least they should not feel it necessary to go only to the Big Four. That would be key stage one. I would rather hope that Government could be more proactive in that regard. I just want to put down a marker because I think it would be a big missed opportunity if that challenge for public procurement weren’t marked at this point.

Q194 The Chairman: So you are not suggesting that there should be firms that should be excluded from competing for that work?
Baroness Hogg: No, I think it’s better done by indicating to those concerned that, as most of them are largely domestic operations and activities, there is no reason why they need international network, Big Four, accountancy firms to carry out that work. We also have concerns about the ownership rules. We understand why the ownership rules are there, but we think they are a barrier to entry into the market. We think there is another immediate opportunity to break up the market, in the sense of enlarging it in terms of where risk committees are now being put in place, as you know, by all the major financial institutions. At least one chairman of the committee has said to me—and I hope it is becoming best practice—that the risk committee should be advised by someone who is not the firm’s auditors. That might be a route in, not just to spread the work around the same group but also around specialist firms, particularly if something was done about the ownership rules and new kinds of work to new kinds of firms that would help to break up the market at the edge. We think it would be important, both in terms of the quality of advice to companies and in terms of the nature of the audit market itself; risk evaluation work rather than the full audit story that would still be required by the audit committee. We had one other thought at this point, which I forget.

Mr Haddrill: The one other thought was one that’s already been raised in evidence to the committee, which is about the nature of bank covenants and the requirements of the banks. That is something that perhaps between us and the OFT we might explore.

The Chairman: I wonder if you could give us a more developed note on both those points, because we haven’t enough time to go into it today, but it would be very helpful if you could.

Q195 Lord Hollick: It has been put to us by Mr Hodgkinson of the Institute of Chartered Accountants in England and Wales that, if there was one measure that would assist in widening choice in the audit market, it would be to “oblige regulators to consider how regulation affects availability of choice”, and to “make it a criterion for regulatory action because it is clearly in the public interest” to do so.

Baroness Hogg: I think what we’ve said this afternoon illustrates the importance we give to the issue of choice, because we believe it would. So we are inclined to emphasise the ultimate objective, but yes we go with the flow of that argument very much. Did you want to add something, Stephen?

Mr Haddrill: Yes. I think this goes to the point that Lord MacGregor made at the beginning. I don’t think there is a difference between the position outlined by the FRC and by ourselves. We’re looking at the way in which regulation can be used as a lever, in the right way, to drive market forces and therefore to promote choice, as opposed to regulation being seen in a rather negative way, inhibiting market development.

Baroness Hogg: Exactly.

Q196 Lord Lipsey: It came as a surprise to me that, in the course of much of the evidence we have taken, there has been less focus than I would have expected on the oligopolistic nature of this market and more emphasis on the kind of standards that are imposed, particularly international standards under the International Financial Reporting Standards. People say this is a lot of box ticking rather than proper auditing; that it’s moved us away from prudence and true and fair in favour of that; that the increased complexity of the process, under these very complicated rules applied internationally, helps the Big Four maintain their grip on the market; and so on. Do our witnesses this afternoon have a view on these contentions or do you think that the problems, if there are any, lie in oligopoly essentially?

Baroness Hogg: I think we can’t get away from the problems of oligopoly, but I think we and the standards setters are looking at what role they may or may not have played in the events of the past few years. I think the protagonists of UK GAPP and IFRS are sometimes more ready to see the weaknesses in the opposite camp, than to recognise the weaknesses in their own standards. I think all standards did need reviewing in the light of what has happened, but I also think that you can’t load on to that the responsibility that should rest still with the boards of companies and their auditors, Stephen, would you like to say more about the standards point that Lord Lipsey is raising?

Mr Haddrill: Firstly, UK GAPP is not a particularly simple or thin set of standards. It runs to well over 2,000 pages, so let’s remember that. Secondly, the adoption of international standards hasn’t removed the requirement on auditors to exercise their scepticism and to challenge the management. Nor has it removed the true and fair concept, the true and fair override. But UK GAPP for listed companies was superseded some years ago by international standards. At the time that it was superseded it did not have some of the key elements it would need in order to cope with the modern capital market. It didn’t have a standard on derivatives, for example. So clearly it would have had to grow and develop and become, I fear, rather more complex in relation to a rather more complex set of financial instruments that the market has been developing. So you can’t look back to an old world and say, [qd]We must get back to that[cdq]. The accounting world has had to move with the financial world. I think we feel that there are
certainly things that need to be improved in international standards. Rather too little disclosure is being required, too much is being reported in aggregate, and we put pressure on the International Accounting Standards Board, along with others, to address that and it has responded. So I am certainly not saying that international standards didn’t require change. They do require change. I hope that they are being changed, but I don’t think that UK GAPP is a sort of nirvana we should look back to.

Q197 Lord Forsyth of Drumlean: We’ve had pretty strong evidence in this committee, particularly from Professor Stella Fearnley—I am sure you are familiar with her—which is very explosive in its view. She argues that the move towards the new standards resulted in the seeds of the crisis that we had in banking. For example, she argues that it made subprime lending appear very much more profitable in the short run than was otherwise the case. I must say, in talking anecdotally to accountants and others about this issue, a light goes on and they say, “Yes, there are problems in moving away from prudence and fair value and that the new standards did introduce a box-ticking culture”. I am just a little surprised that you seem to be playing this down very considerably, whereas the evidence we’ve had has been remarkably consistent in its view that there is a problem here and that it contributed to the crisis. It is not the source of the crisis but it contributed to it. As with sat-navs in cars, people thought that they were going on a particular journey but they were somewhere else.

Mr Haddrill: I think perhaps I was trying to balance the evidence you have had rather than say that there is no problem. Certainly if you move to fair-value accounting and mark-to-market accounting, you do have more volatility obviously because the market is more volatile. We would accept that. But also we would have concerns about an historic cost basis to accounting, where the historic number may be certain and may not move but it is no longer a reflection of the value of the assets, so we needed to move on. As regards prudence, it is there in UK law; it’s written in the standards. The words in it may not appear quite so evident but also, of course, it is reinforced by the financial regulatory system, by the work of the FSA and the other financial regulators. So, together with the other points I was making, I think there needs to be a degree of balance in the argument that has not come from just looking at the previous evidence.

Q198 Lord Forsyth of Drumlean: But going back to the questions that Lord Lawson was asking about banking, it does appear that people were in their silos ticking the boxes and not exercising prudential judgment.

Mr Haddrill: I think people were too confident that the world would carry on booming as it had been booming.

Q199 The Chairman: Is that an excuse?

Mr Haddrill: It is not an excuse. I am just trying to reflect reality, and I think what we need is an accounting—

Q200 Lord Forsyth of Drumlean: You mean they wouldn’t have had as much money if they had put up a red flag?

Mr Haddrill: I think we need an accounting world and an audit world that recognises that boom turns into bust rather earlier and that the concept of expected losses is recognised faster than it has been under the current system. So there certainly needs to be change, but I don’t think it’s the move from UK GAAP to international standards that is at the heart of the problem.

Mr Thorpe: On the point of true and fair, the discussion paper published jointly with the FRC says explicitly that we would expect auditors to do more to ensure there is sufficient information in the accounts to show a true and fair view. There are requirements under IFRS for that to be done, so we have emphasised that.

On the point that Stephen was making about the current accounting standards, the area of subprime loans is one of the few areas which is not at fair value under current international accounting standards; it is at historical cost. It is subject to an incurred-loss model and it would be better if we moved to an expected-loss model, and that is under way. But the accounting we currently have for loans is the accounting we have had for loans for the last 30 odd years.

Q201 The Chairman: Mr Haddrill, in your last answer to Lord Forsyth’s point, are you arguing that there should be more economist input into some of these issues rather than purely accountancy ones?

Mr Haddrill: I’m going to leave a much more senior economist than me to answer that question.

Baroness Hogg: I think all skills are needed to review what we have. The issue of volatility is a big challenge, isn’t it? Like Stephen, moving back to historic cost accounting, it would seem to me not at all helpful. If I look at the industry with which I was involved for many years, private equity, one of the big issues was clinging on to assets valued at cost and, as soon as companies took the view that they should move off costs, that was an important contribution to restoring confidence in the market in those assets.
Mr Haddrill: To some extent it comes back to Lord Lawson’s point, which is the need to supplement the numbers by a degree of understanding of what the macro-prudential position is and to feed that back into the market. That is part of the role of the regulator in those discussions.

The Chairman: Lord Forsyth, perhaps you would like to move on to the next topic.

Q202 Lord Forsyth of Drumlean: I gather that one of the Big Four firms has recently embarked on a growth strategy, where the key driver is the development of non-audit services to be provided to audit clients. Is that something to be approved of? Baroness Hogg: Certainly not. We made that clear in public, in the AIU report to the firm itself; absolutely not.

Q203 Lord Smith of Clifton: Would there be advantage in the audit profession centrally undertaking analysis of systemic risk, which audit firms could factor into their individual audits; for instance, into their consideration of their clients’ going concerns? Might it help level the playing field between the Big Four and the others if this happened? Baroness Hogg: Analysing systemic risk is very much the responsibility of the regulators. I think we need more input—going back to Lord Lawson’s point, with which I absolutely agree—into the macro-prudential framework from the audit firms. The paradox is that we have an oligopoly but we did not get the potential benefits from having an oligopoly, which is that they all ought to have known what was happening. Somehow we did not achieve this and we have to make sure we do in future, while at the same time addressing the oligopoly. I’m not sure it would have the effect on competition that you suggest but maybe I am missing the point you’re making here.

Q204 The Chairman: I don’t know if you have something to say on that, Ms Dewar, because I think you have spoken in public and done quite a lot of work on that subject?

Ms Dewar: Yes. We would definitely say that audit firms have a role to play in contributing to the financial policy committee debate. So in terms of macro-prudential issues, we don’t think that should be a separate routine. We think that should be part of that FPC committed environment, and that can be through either the communication channels they have through the regulator or through other sources directly to the FPC.

Equally, we think it is important that audit firms get together and we are now facilitating a forum where we and the audit firms get together. We discuss macro-prudential issues and we try to do it cross-sectorally, so we have sessions on banking and insurance separately to try to look at the bigger issues cutting across the market. So I think there are two ways that they can get into that debate.

Q205 Lord Smith of Clifton: When this suggestion was put to the professional bodies in our inquiry, they highlighted the Auditing Practices Board’s guidance on going concerns. But that guidance was issued after the crisis had occurred, and it was on the initiative of the regulation not of the profession. Doesn’t this response suggest that the profession thinks the regulator is their agent?

Baroness Hogg: No, I don’t think so. It was issued at a very critical moment and Stephen and I were talking about this just before we came in. Stephen, I think you should—

Mr Haddrill: The real fear at that moment was that the auditors would not be able to sign off the accounts of a wide swathe of British business not just the banks. Because of the problems in the banks, the banks couldn’t guarantee to continue the lending that they were giving to those companies. So, as far as we were concerned, it wasn’t just a matter of the guidance that we had to give to the auditors, it was a matter of bringing together investors in the corporate world with the audit profession to work out how on earth this was going to be addressed so that we didn’t have a horrible, unintended consequence of audit that firms were being described as not being going concerns when clearly they were healthy businesses. I feel that the strength of the FRC then was being able to mobilise the corporate world and the investment world, as well as the audit world. That is generally what we try and do.

Baroness Hogg: And alert government to the issue at the same time.

Q206 Lord Smith of Clifton: May I ask about the practicalities of mobilising the corporate world with the auditors and yourselves, and so on? What series of meetings took place?

Mr Haddrill: I will give you a more detailed response in writing because it is slightly before I joined, but we had quite an extensive set of consultations that were done between the senior staff of the FRC and people from those different bodies. We created an urgent issues group to look at the issue and come up with recommendations. Mr Collins: Obviously we think it is important that the audit firms and the regulators should get together to discuss these issues. We would obviously have concerns about the competition implications, to make sure that the scope of those discussions was appropriately restrained and was not going into other areas, which they should not be discussing, as a result of the encouragement of the regulator, from a purely competition-law point of view. Obviously, where you
Mr Philip Collins, Mr David Stallibrass, Baroness Hogg, Mr Stephen Haddrill, Ms Sally Dewar and Mr Richard Thorpe

have a tight oligopoly and a regulator meeting to discuss common issues, there is certainly a risk that the audit firms might go away with the impression that they could have other discussions on matters that were outwith that narrow subject.

Q207 Lord Smith of Clifton: How do you draw the boundary lines on that?
Mr Collins: The answer probably is that you would need to have good advice on what was and was not permissible to discuss.
Baroness Hogg: I think what Stephen is describing is our perception of an important systemic risk, on which we thought it appropriate to take action and to alert government. If most of corporate Britain had suddenly been forced by what was happening in the storm in the banks to declare themselves to be no longer going concerns it would have been a very serious systemic issue.
Mr Collins: This is the problem in other areas where government seeks to get businesses together to discuss common problems affecting an industry or a sector. We think it’s very important that, where that happens, it’s made quite clear what the ground rules are and that there are certain things that it is permissible to discuss and certain things that it is not permissible to discuss. After dialogue with us, the business department did produce some guidelines for engagement between government and business in relation to competition issues.

Q208 Lord Smith of Clifton: How do you know when these conversations are taking place?
Mr Collins: We would expect the regulator—as we would expect government departments—to be sensitive to the competition issues that arise from getting competitors together in the same room, just to make sure that they are aware of the issues, and, by and large, we find most regulators are.

Q209 Lord Forsyth of Drumlean: Chairman, I don’t want to digress from what we’re thinking of, but I am rather fascinated by that point. These rules or guidelines you have given, would they enable the banks to get together to discuss bonus policy, for example?
Mr Collins: No.

Q210 Lord Lawson of Blaby: First of all, to clarify my request for information which Sally Dewar very kindly said that she would provide us with, when I said all the meetings that took place with the FSA and the auditors of Northern Rock, HBOS, RBS and Bradford and Bingley, in 2006, 2007 and 2008, I didn’t want a composite figure for the three years, but in each year how many meetings there were with each institution. The only other thing that I would like to ask, which is in the same area, is that, right at the beginning, Mr Haddrill, I think it was, said that what you need is early warning. Once the crisis hits, if there is something said it might even make matters worse—what you need is early warning. Without making matters worse, that is certainly true if the thing is in public, if you’re talking about a qualification of the accounts or something. But there are all sorts of things that could be done privately, so I don’t think you should say, ‘Oh well, it’s too late to do anything’. But quite apart from that, I would be interested to know what early warnings did take place?
Mr Haddrill: I was talking about what was revealed publicly through the audit report and through the reports and accounts, rather than—

Q211 Lord Lawson of Blaby: Yes. But in your recollection what early warning? You said there should be early warnings and you were talking about something public. I am very ignorant; can you tell me what early warnings there were because I don’t recall any?
Mr Haddrill: No. I would agree with you. That is my point. I believe that the description of risk, in relation to the collapse of the credit markets and so on, is something that didn’t happen.

Q212 Lord Lawson of Blaby: So, in your judgment, the auditors were highly culpable because they should have given early warnings and they didn’t?
Mr Haddrill: I think a very large number of bodies and institutions were culpable of not identifying the problem.

Q213 Lord Lawson of Blaby: Yes, but this inquiry is into audit. Of course, I am not saying the culpability is solely that of the auditors or of the auditors and the FSA. The bankers themselves can’t avoid their share of the responsibility. But our inquiry is into the accountancy trade and the auditing, so that’s why I focus on that.
Mr Haddrill: Yes.
Baroness Hogg: But where these two are linked is in the nature of corporate reporting, and what is described in annual reports by companies as the risks to the business, I think that is the link, and the role of the auditors in the debate with the companies about what is said—

Q214 Lord Lawson of Blaby: I am sorry to interrupt. I thought Mr Haddrill—if I am wrong, I misunderstood him—was saying there should have been early warnings.
Baroness Hogg: That is if the risks to the business had been described in ways that identified the risk of what happened in the credit market. For example, if you...
look at what the banks before the crisis described as the chief risk they were facing over the coming year—I can’t remember which of the banks in the most difficulty the year before said this—the articulation of their greatest risk was bird flu. So we are talking about the articulation of risk and the debate.

Q215 Lord Lawson of Blaby: Okay. The banks pulled the wool over the eyes of the auditors.
Baroness Hogg: No. They didn’t articulate the risks as well as they might have done.

Q216 Lord Lawson of Blaby: Were they aware of them?
Baroness Hogg: That is the big issue, isn’t it?
Lord Lawson of Blaby: Were the auditors aware of them?
Baroness Hogg: That is the dynamic of the debate that we would like to see.

Q217 Lord Lawson of Blaby: What do you think; do you think the auditors were aware and, if not, why not?
Baroness Hogg: I think it varied between auditors.
Mr Haddrill: I think that there was insufficient recognition of the risks. Of course, there were a huge range of people, including ourselves, who did not anticipate that risk sufficiently well.
Baroness Hogg: Absolutely.
Mr Haddrill: I think we have to include auditors among everybody else in that group. Sir David Walker has identified the need for a bigger focus on risk by management through the risk committee of the bank. We obviously support that, and we would say that what we want to see in future is more of that scepticism and challenge at an early stage exhibited by the auditor. I don’t believe that challenge was there in those early years, or sufficiently early, and I think, to some extent, that’s not so much a failure of auditors but a failure of the audit system, and that is what we must put right.

Q218 Lord Forsyth of Drumlean: Chairman, I am struggling a little here. In answer to an earlier question you said that people thought that good times weren’t going to end or words to that effect. That I can understand but I am struggling to understand why auditors looking at banks’ balances sheets, seeing huge levels of gearing, seeing all kinds of complex instruments—and there were warnings in the market about it in the run up to that—would not feel it necessary to at least perhaps ring a little bell. Listening to Baroness Hogg saying, “Well, they had to rely on what they were being told”—Baroness Hogg: I don’t think I said that, did I?

Q219 Lord Forsyth of Drumlean: You said they had to rely on the information that was being provided to them. I think you said. If I have misquoted you, I apologise.
Baroness Hogg: Sorry, I don’t think I did.

Q220 Lord Forsyth of Drumlean: But I find it difficult to understand, given what auditors are meant to do, why no one looking at this—expanding balance sheets and the makings of a crisis—didn’t sound the alarm. So I am with Lord Lawson. I am puzzled.
Baroness Hogg: We are not privy to every conversation between the auditors and the companies, so I am a little reluctant to specifically allocate blame between them.

Q221 Lord Smith of Clifton: What I find unsatisfactory, my Lord Chairman, is that there is a tactic of risk spreading by saying, “Well, we were all a little bit to blame”. So who do the police charge for the crime, the lot of you? It is happening all the time with the evidence that we are getting here. No one is sneaking on anyone else but they’re not accepting any of the blame either; they’re trying to dilute it.
Baroness Hogg: I think we very specifically did just now with Stephen.
Ms Dewar: Chairman, I think one of the things that might be quite helpful is to make the comparison between what we have done, from a purely regulatory perspective, with the firms as to how you might tackle this issue. It’s a macro issue. Firm supervision was being performed at a micro level and one of the things that we have been looking at is how we make the system safer and more secure for the future. It is to create this financial policy committee, whose whole aim is to look at the picture from a macro perspective and to take the broader view rather than the firm specific view, which then feeds back into our micro supervision context. There is probably something to be said for looking at auditing and what happened there in the same context. The auditors were looking at their individual firms and not standing back and saying, “What does that tell me about this sector as a whole?” So there are probably some comparisons to be drawn.

Q222 Lord Lawson of Blaby: I’m afraid I don’t buy that. It is true that there was a failure of macro supervision but there was a failure of micro as well. Take Northern Rock, which was the first to go over. Northern Rock had a business model with an excessive dependence on wholesale funding, which
was a complete nonsense as a business model. He was taking an ever bigger share of the mortgage market. Why? Because it was taking ever bigger risks. So there was a huge failure of micro-prudential regulation there.  

Ms Dewar: Sorry, apologies, I wasn’t trying to say that there wasn’t a failure of micro supervision. I was trying to say that in the context of where the macro analysis was coming from in order to also look across a sector piece, as opposed to just being firm specific. So I wasn’t trying to discharge responsibility from the micro; I was trying to look at it from a macro context.

Q223 The Chairman: I think the inquiry into Northern Rock, you accepted, showed failings at the micro level by the FSA?  

Ms Dewar: Absolutely. My response was trying to draw away from that and say there were also failings clearly from a macro perspective, and what can you do to try and look at those.  

The Chairman: Yes, and the kind of issues that Lord Lawson was raising in relation to Northern Rock. Yes.

Q224 Lord Forsyth of Drumlean: Chairman, if we take Lord Lawson’s example of Northern Rock and the FSA and their involvement, you have come clean on that—I have no idea who the auditors were for Northern Rock but you could equally apply it to other banks—I can’t understand why the auditors did not see this hugely expanding balance sheet, this huge risk that was being created because of the reliance on wholesale funding, and why they would not ring an alarm bell. Why did that happen, because, rather naïvely, I thought that’s what auditors were meant to do?  

Mr Haddrill: I think the lesson you have to learn—and the lesson they should learn—is that they should have rung an alarm bell more strongly.

Q225 Lord Forsyth of Drumlean: But why didn’t they?  

Mr Haddrill: One gets back into the realm of spreading blame, which I don’t want to do after what Lord Smith had said. I suspect that we have a complicated system where different institutions are relying on each other. After all, Northern Rock, as Sally has mentioned, has been regulated by the FSA. I think it ended up with quite high levels of capital but they obviously weren’t adequate for the job in hand.

Q226 Lord Forsyth of Drumlean: As a matter of interest, who were the auditors of Northern Rock?

Mr Haddrill: I can’t recall I’m afraid. Secondly, there is the question of the accounting standards, what they required and whether the management was strictly following them. Then it comes down to this third issue about whether there is adequate scepticism being applied on top of that. I think that’s where there was some failure to apply that degree of scepticism.  

Baroness Hogg: There is also the issue of whether, in their annual reports, sufficient effort was made to describe—and there is greater pressure coming now—the nature of the business model and the risks involved in it, which is a good discipline for just forcing more disclosure of what the business is doing out into the public domain, and into the hands of shareholders, which is another piece of defence. You need them all.

Q227 The Chairman: If any of you would like to add a written note to what you have been saying on this issue, please do. Can I come back to the question of the substantial domination of the Big Four in the audit market, and ask you a question. Obviously this is in relation to widening choice and competition. I think the FRC has admitted that some of their earlier recommendations haven’t yielded very much, but what we—  

Baroness Hogg: We have more than admitted; we have been shouting it.  

The Chairman: Yes. Anyway, you have made it clear. Baroness Hogg: Thank you.

Q228 The Chairman: What one or key measures would you recommend for taking this further?  

Baroness Hogg: The immediate two I would focus on are the opportunity presented by the abolition of the Audit Commission and the opportunity to use the development of risk committees to develop another source of advice, which may bring into the market possibly different kinds of firms or encourage existing firms to step up on a range of work that is not quite so requiring of a global network as traditionally auditing a big international company has been supposed to do. I think it’s a real opportunity for entry into the market and/or development of a firm, below the size of the Big Four, to come into the market there. I think it is important to look at ownership rules and the banking covenants apiece. Those were our four, weren’t they? All of them could potentially make quite a difference.

Q229 The Chairman: FSA?  

Ms Dewar: I think we would look at greater rotation. We think that that is an area worth pursuing. Clearly, you need to consider the
unintended consequences of any proposal that you put forward, but certainly some jurisdictions have used it and we certainly think it’s something that should be considered as part of the thought process.

Q230 The Chairman: OFT?  
Mr Collins: Can I just go back to a comment Professor Power made in response to question 23 from Lord Moone on the first day. He talked about the opportunity to offer a differential range of assurance services to companies and, building on what Baroness Hogg has said, the idea of introducing into the regulation of auditing and accounting forms of incentive to encourage, first of all, firms to look at different sources of audit and non-audit services, and secondly, to encourage other firms to come in. I think the example she had given, for instance, of the use of different firms for risk committees, is potentially a very interesting one. I think it’s important that if you narrow the scope of the formal statutory audit, with the idea that businesses can then seek other assurances elsewhere, that has to be on a voluntary basis. But clearly there would have to be some element of regulation around that to make sure that there was consistency and appropriate standards. I would also support the other points that have been made.

Q231 The Chairman: Would any of you recommend what one witness has put to us to follow the French system of compulsory introduction of joint audits?  
Mr Haddrill: Joint audits are possible in the UK. We have been rather nervous about that approach on a compulsory basis, not least because 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. We’ve also had concerns about problems arising in the gap between the two. The French believe that they have resolved those problems. We talked to some French companies, some of whom have told us that it’s a nightmare and that the auditors spend all their time passing the buck between them and warring with each other. Others have said that their auditors have got on extremely well with each other and it’s been beneficial because they’ve had two sets of eyes. So we are concerned about the risks, but it’s something that we will look at.

Baroness Hogg: Introducing separate advice for risk committees is akin to that, but with very defined jobs. So you shouldn’t have—I bet you do have some—turf wars, but still it’s fairly defined what the two are doing with different responsibilities.

Q232 Lord Tugendhat: First, I wish to follow up on my question and on Lord MacGregor’s question. I can well believe that a joint audit would be very tedious and may well be more difficult to run than a regular audit, but coming back to this whole question of the Big Four, and if one went down then there would only be three: there is a substitute bench argument for having a joint audit not because it is good in itself but as a substitute bench. Would you buy that proposition?

Mr Haddrill: Yes, I do buy that proposition and that is one of the reasons why we don’t rule it out. My nervousness about it is that it used to happen in the UK but companies have abandoned it.

Lord Tugendhat: Yes, I remember.  
Mr Haddrill: Therefore, I think we need to explore, in a bit more depth, why companies thought it would be such a bad idea. Was it just that they were persuaded into it by the Big Four or was it causing them unnecessary cost and trouble?

Q233 Lord Tugendhat: The real question I wanted to ask you is this. Without going back over the exchanges that Lord Lawson has had with you and learning from the past, would it be helpful if one of two things happened, or perhaps even both: one is that if the regulator is concerned about a particular situation—a Northern Rock type of situation, or something less alarming than that—it should instruct auditors to probe into that particular area, or those particular areas, and report back to the regulator? In other words, the regulator would say, “We’re concerned about this. We want you to look at it and we want you to tell us what has happened”. That is one suggestion for the future.

The other suggestion is: if the auditors are worried about something, and they debate this with management but in the end they say, “Okay” and they approve the accounts, would it be helpful if it was flagged that the auditors had queried a particular point and that they had, in the end, been satisfied? It would not be a Hansard report of the debate, but just that here was a point that worried them, they queried it and they were satisfied. What do you think of those two possibilities for the future?

Ms Dewar: I will answer the first one in terms of suggestions for the future and in terms of instructing auditors or other third party advisers to do what we would in terminology terms describe as “a deep dive”. So, if we were concerned, we would go into a firm and go through a particular system, a control failing, or a particular asset portfolio, for example, as we already do. So we do it in two ways: we do it through external advisers. We don’t just focus on the Big Four for that, we cut across all the audit firms for that. We have also very much enhanced the discipline internally to enable us to have the skills to do it within the FSA. So that point was one of the lessons learnt from the crisis. Section 166, we
already used but not to the extent we do now. So we have definitely put more focus on that one. In terms of the second point, I don’t know—
Baroness Hogg: I think one way of achieving what you are suggesting, Lord Tugendhat—which I think has a lot of merit in it—is to up the requirements of audit committees to report on the dialogue with the auditors. That should have two beneficial effects: one, to ventilate some of the issues in the way you suggest; but secondly, to do key stage one, which is to ensure that the debate with management, that precedes an audit committee, is fully ventilated with that audit committee.

Q234 Lord Tugendhat: It has been suggested to me that it might be helpful if the audit committee dominance was reduced. In the past, they weren’t as powerful as they are now or had this special position. If the dialogue was reported to the whole board, things that the auditors had grown accustomed to might seem more alarming.
Baroness Hogg: I think this is a very difficult question. I have sympathy with what you say, having sat on the board of a big US company. Sarbanes-Oxley very much diverted almost all the activity in this field, and that to do with risk, to the audit committee. If you sat on that board, and you were not on the audit committee, you felt extremely exposed in terms of being isolated from the key debates.
Lord Tugendhat: Yes. That is the sort of thing I am thinking of.
Baroness Hogg: On the other hand, we think it is very important to build up the role of the audit committee, because that is where, if you get a good audit committee chairman and a good committee, you will have the real dialogue, and debate and the right level of challenge. So I don’t think we want to give up on audit committees, but I think it is very important that the reporting process from the audit committee to the board and the audit committee to investors is full and transparent.

The Chairman: I think we must leave it there. We have had a very long session covering a lot of points, which, as Baroness Hogg said at the beginning, are very timely for consideration at the moment. So I thank you all for your papers and for attending and we look forward to getting the further notes that you offered to us. Thank you very much.

Supplementary memorandum by Baroness Hogg and Mr Stephen Haddrill, Financial Reporting Council (ADT 27)

AUDITORS: MARKET CONCENTRATION AND THEIR ROLE

We are pleased to provide the Committee with this further letter following up on the issues that were raised in the course of our oral evidence on 9 November. This letter also responds to the Committee’s request for further information on contingency planning on how to respond to the withdrawal from the audit market of one of the Big Four and issues concerning IFRS and the Companies Act 2006.

1. FRC STRUCTURE AND POWERS

The regulation of accounting and audit has evolved from a self-regulatory system and today it is the Financial Reporting Council (FRC) which provides oversight of the auditing, accounting and actuarial professions. We believe that further steps are necessary to strengthen the FRC’s position as an effective, independent regulator.

In order to facilitate this transition, the FRC needs increased powers to:

— Gather information on failed companies to establish whether governance or audit failures were contributory factors;
— License auditors of public interest entities; and
— Investigate and discipline misconduct by auditors.

Legislative change is also needed to enable the FRC to rationalize its current structure and ensure that information can be freely exchanged internally.

In future we believe the FRC should have a greater capacity to be proactive in identifying and responding quickly to problems in capital markets. We currently have powers to monitor the quality of audit, and we review 300 sets of accounts each year. We also conduct investigations into potential misconduct by members of the accountancy and actuarial professions. However, we have limited powers to inquire into the accounting judgements of companies that have failed; our investigations into misconduct cannot compel evidence from, eg, directors who are not accountants and are very time consuming; and our audit inspections are established for the purpose of annual monitoring, and have insufficient powers for exploring urgent issues that fall outside our routine monitoring. This means that we are dependent upon the goodwill of the firms in helping us to
understand whether there are any lessons to be learned in other areas, for example from the collapse of a number of companies supplying the public sector.

We believe that additional measures could be taken to strengthen our independence and enhance audit quality:

**Information sharing**

The FRC believes that better information sharing across our organisation and with fellow regulators, would benefit the market and help to spot and manage risks.

There are currently restrictions on information sharing between some of the FRC’s operating boards. For example, under current legislation the Financial Reporting Review Panel (FRRP) is unable to share information on companies whose accounts it may be investigating with the Audit Inspection Unit (AIU). We would ask the Committee to support legislation which will enable effective information sharing across the organisation.

**Licensing**

The increasing complexity of global business practice and enhanced investor expectations of the auditors of public interest entities require auditors to have a greater degree of expertise and experience to manage adequately the risks involved.

We therefore propose an additional licensing regime for auditors of public interest entities. The need for this is shown by the evidence of the AIU’s 2010 Annual Report, published in July 2010, which concluded that “the number of audits assessed as requiring significant improvement at major firms is too high” and among other firms a higher proportion of audits conducted required significant improvement. We believe a new regime for auditors of public interest entities should be provided by the FRC while the professional accountancy bodies should retain responsibility for the oversight of smaller firms.

The ICAEW, in their letter to the Committee of 23 November about the audit inspection and monitoring regime, suggested that the existing regime could achieve our goals. It is correct that the Audit Registration Committee (ARC) has responded to individual reports made by the Audit Inspection Unit (AIU). However, the regime currently operates within very tight parameters. The AIU is restricted in the action it can request the ARC to take; its efforts to broaden the definition of what is a public interest entity have been challenged; as has its wish to undertake non-routine inspection work without seeking the ARC’s permission.

**Discipline**

The current professional disciplinary regime is complicated and is not as independent or effective as it should be. At present the Accountancy and Actuarial Discipline Board (AADB) is required to consult with the relevant professional body before it can begin a disciplinary investigation. It has no statutory powers to obtain evidence.

We believe that the independence of the process is compromised by the requirement placed upon the AADB to consult and seek the agreement of the professional bodies—this is the product of the previous self-regulatory system that we believe should now come to an end.

To address this issue we therefore propose the clarification and streamlining of the AADB’s discipline scheme. All disciplinary cases relating to public interest audits should fall to the AADB in the first instance.

Where the market has been misled deliberately it is important that a robust sanctions regime is in place to deal with such behaviour. We are concerned that this does not exist at present and that the sanctions available to the FRC are limited, meaning that the most appropriate remedy is sometimes not available to us. We would therefore like a more tiered sanctions regime to be put in place which, accompanied by other changes outlined in this letter, would strengthen the FRC’s independence and contribute to the better operation of the market.

Taken together we believe these measures would significantly improve the accountability of the audit profession, strengthen the FRC’s independence and put in place a robust sanctions and company investigations regime in the public interest.

**2. FRC Governance**

The governance structure of the Financial Reporting Council was significantly strengthened three years ago, reducing a large representational council to a Board of 16 members (currently consisting of a non-executive Chairman, the Chief Executive, 6 chairmen of the operating bodies and 8 independent non-executive directors). However, further changes under consideration for the coming year are intended to have the effect of increasing the majority of independent directors on the Board. These are selected to provide a wide range
of skills and experience in business, investment institutions, the professions and policy-makers, including those affected by the work of the FRC. However, as the table below shows, there are no practising auditors on the Board, nor on the boards of the bodies responsible for auditor discipline.

**Breakdown of FRC Board Membership**

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<tr>
<th>Board</th>
<th>No of members</th>
<th>Current Big Four accountants or auditors</th>
<th>Ex-Big Four accountants or auditors</th>
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<td><strong>12</strong></td>
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There are specific rules in the FRC constitution pertaining to the AADB, which must always contain a lay majority, and the POB, where no board member can be a practising auditor and a majority of members must have been out of practice for at least five years.

3. **Withdrawal from the Audit Market of One of the Big Four Firms**

The FRC has been concerned for some time that the failure of one of the Big Four audit firms would have serious implications for the stability of the capital markets. The disorderly movement of partners and audit teams to other firms could result in companies not being able to produce audited reports and accounts on the timescales expected by the markets.

The FRC has therefore put forward proposals aimed at addressing this issue and we have discussed our recommendations with both the Government and prudential regulators.

The key issues that the FRC believes need to be addressed are:

- The need for a clear statement that the government/competition authorities would break up a “Big Three”;
- A resolution regime and internationally agreed mechanism to ensure the orderly wind-up of a failing firm;
- A system for ring-fencing healthy parts of the network;
- An early warning system of significant threats to operations; and
- Living wills for accountancy firms.

Tackling this issue will require action and agreement both internationally and across a range of UK regulatory bodies and competition authorities. The FRC has written to the Financial Stability Board (FSB) and recommends that the UK Government takes up the issue with the FSB with a view to it being discussed at G20 level in due course.

The FRC does not believe that any of the Big Four should be seen as too big to fail. In particular, the taxpayer should not be expected to subsidise losses and regulators should not hold back from disciplinary action against misconduct. The value of audit depends wholly on confidence in its quality. Firms must not be disincentivised from the pursuit of quality by expectations of state protection.

The Big Four are now global networks. This gives them resilience against the collapse of one part of the network. Resources can be transferred and loss of business need not be catastrophic. However, as audit business is dependent on client and investor confidence, the networks’ strength can also be a source of vulnerability, as such loss of confidence in one country becomes contagious. The FRC believes that the networks are strong enough to survive a failure in most markets, but not in the US or probably the UK. The adequacy of response to a crisis is therefore of particular importance in both countries.
Governments and regulators have liaised closely in the past if a network has been threatened to ensure any necessary action is co-ordinated and consistent. The international nature of the firms and of market confidence requires this. Such action has been specific to the cause of the problem.

The success of such action depends on the authorities having enough time before failure becomes catastrophic. To that end, 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.

Such measures are valuable, but are not capable of ensuring against failure. Audit failure may have been so serious that the firm needs to close. Early warning depends on failing parts of the firm not keeping their problems secret from the network. News that damages confidence can have a very rapid impact, as seen in the wake of Enron.

Governments and regulators do, therefore, need to be clear what their policy and plans will be if a network collapses. This needs to cover two major issues: how is audit work to be conducted in the short term and what long term structure is proposed for the audit market?

More work needs to be done on devising a vision for a longer term structure ahead of a crisis. The audit market would face major challenges if it was shared between just three firms. Depending on which firm failed, there could be no competition for the business of large companies in some sectors, such as energy and insurance. In all sectors, conflicts of interest would arise between audit and non-audit business as the remaining three sought to pick up clients of the failed firm. We therefore believe that a market dominated by three firms is not desirable. However, in a crisis it could come about by default as the partners and teams of the failed firm would be rapidly recruited by the other large firms. To reduce the risk of this, we propose that the competition authorities, in the EC, UK and US in particular, should indicate in advance of failure how they would be likely to respond. A statement in advance that they would act to break up a Big Three would help to prevent this being created. We believe collaboration between Governments, competition bodies and audit regulators to consider market structure in the event of a major failure should be initiated.

At the point of crisis, the authorities need to act to preserve market confidence consistent with their longer term vision. If, as we believe, that vision should not foresee the creation of a Big Three, the failing firm will need to be kept as a viable operational entity until new arrangements for handling its work are put in place. Under current legislation, this is not easy to achieve. Partners and employees cannot be forced to stay with the firm, nor can clients.

Finally, whilst public authorities need to plan their actions, we believe the firms’ own plans also need to be developed fully. The concept of living wills could be borrowed from the financial services sector. 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.

It is vital that cross-border contingency plans are put in place and to achieve this we recommend that the Government engages first with the Financial Stability Board and then at G20 level to coordinate action that will lead to a plan being put in place.

4. IFRS AND THE COMPANIES ACT 2006

The FRC has studied carefully the issues raised in your letter and we hope that the following response will help to clarify the Committee’s understanding of the issues relating to IFRS and the Companies Act 2006.

The FRC has consulted BIS and shares its view that the adoption of IFRS was in conformity with the Companies Act 2006 because:

— The use of IFRS for the consolidated accounts of all groups listed in the EC was expressly mandated by the EC in 2002.\(^{45}\)

— In addition, the EU gave individual Member States the right to decide whether to require the use of IFRS for the preparation of individual accounts of listed companies and their subsidiaries, and for any other companies. Following a consultation in 2002,\(^{46}\) the UK Government resolved to permit the use of IFRS by such companies.

— The necessary changes to the legislation to reflect these, and other, changes to the UK legislation came into effect on 12 November 2004.\(^ {47}\)


We would also like to address the underlying concern that IFRS resulted in financial statements that showed a higher profit (or smaller loss) than would have been the case under UK GAAP.

Whilst it is right that the introduction of IFRS led to certain situations where profits could differ from those under UK GAAP, it is not the case that IFRS would always result in a higher profit than UK GAAP. So, for example, while the UK GAAP requirement to amortise goodwill would result in a reduction in profit as compared to IFRS, in contrast the effect of discounting financial assets carried at amortised cost when there is evidence that there has been an impairment loss under IFRS would result in a lower profit than under UK GAAP.

The FRC has consulted with BIS and shares its view that the introduction of IFRS did not give rise to breaches of sections 830 and/or 831, Companies Act 2006.

Those sections prescribe the manner in which a company must determine the profits that it has available for distribution. They provide that the profits as shown by a company’s financial statements should be the starting point for determining the profits available for distribution. They then provide for various adjustments to be made to take account of a number of factors. Once those adjustments have been made, it is for the directors of the company to decide the amount of any dividend to be paid to shareholders.

Directors make such decisions:

— 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”48; and

— having regard to their fiduciary duty to act in the best interests of the company.

In summary, whilst the accounting framework determines the calculation of the profits shown in the financial statements, the decision as to the amount of any distributable profits to be paid to shareholders by way of dividend is determined by reference to the company’s realised profits (as defined in accordance with section 853(4), Companies Act 2006).

The FRC shares BIS’ view that, for these reasons, changes are not required to either IFRS or to the Companies Act 2006 in order to reduce any possibility of illegality.

The FRC has urged the IASB to learn lessons from the financial crisis and a number of changes have been made as a result, for example to standards on the accounting for financial instruments. Other standards that have been reviewed, and where the FRC has been active in influencing proposals, include insurance accounting and leasing.

I understand that the Committee has invited Roger Marshall, interim chairman of the ASB, to give evidence to the inquiry on 18 January on the effect of changes to accounting standards and he would be delighted to expound further on these points.

5. INCREASING CHOICE IN THE AUDIT MARKET

In our oral evidence to the Committee on 9 November we set out several specific proposals to expand choice in the audit market which we feel it would be helpful to expand upon.

Audit Commission

We believe that the abolition of the Audit Commission provides an opportunity for one or more non-Big Four firms to expand into that market and grow significantly. This could be the catalyst to encourage a fifth big player in the audit market. If the existing Audit Commission was 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.

Our objective in making a recommendation in this area is to ensure that the audit market does not become concentrated still further as a result of the Government’s decision to abolish the Audit Commission. We recognise the 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.

This guidance is issued following public exposure and independent legal review.
Banking covenants
The FRC echoes concerns that have been raised by auditors from mid-tier accountancy firms that restrictive bank covenants could contribute to audit market concentration and restrict choice. We recognise that in essence the issue is a commercial one although we believe there is sufficient anecdotal evidence to require a further investigation into this issue.

The Lending Standards Board (which replaced the Banking Code Standards Board) is currently consulting on the Lending Code. However, the Code applies only to private individuals and micro-entities and so is not an appropriate vehicle for addressing the bank covenant issue. In the absence of a similar Code for larger entities, we would urge a greater level of dialogue between the British Bankers’ Association, lending institutions, audit firms and regulators to address the issue as soon as possible.

Risk committees
The FRC would encourage banks and other systemic institutions to use non-Big Four firms as a source of advice to their risk committees. This would give such firms an exposure to large companies they might not otherwise have access to and may in time provide them with the opportunity to tender for the audits of some of these entities.

Ownership rules
The FRC believes that serious consideration should be given to amending the current rules on audit firm ownership which would allow audit firms to access external capital.

In principle we believe that it should be possible to change the current rules governing the ownership of audit firms without risking audit quality. Alternative ownership structures, including the possibility of raising capital from external sources, have the potential to make it easier for firms to invest to allow them to expand into the market for the audits of the largest companies. Research carried out by Oxera has indicated that the cost of capital in a partnership was considerably higher than in an ownership model which allowed for external investment.

6. Going Concern
The FRC meets with market participants regularly to discuss their concerns and identify issues that need to be addressed. This engagement intensified following the collapse of Lehman Brothers in September 2008. During 2008 the FRC held two meetings with market participants, and a further two meetings were held in 2009. Typically, these meetings involved companies, corporate treasurers, auditors, investors and business organisations. These formal meetings are held in addition to ad hoc meetings held throughout the year.

The FRC issued guidance to the market in 2008 in response to concerns in the market that auditors would find it difficult to sign off the accounts of a large number of companies as going concerns because of the state of the credit markets.

7. Early Warning Signals
In our oral evidence we suggested that the audit process should be capable of providing an early warning signal to the market—something that was not delivered in either 2006–07 or 2007–08. We believe that the market is capable of providing more signals and the creation of a Market Participants’ Group comprising regulators, auditors, finance directors and investors would enable warnings to be identified and discussed by the market. These issues could be addressed through market information, guidance or regulatory action. The FRC would be well placed to convene such a group and we would welcome the Committee’s support for such a proposal.

8. Scepticism
The FRC believes that company boards have a responsibility to encourage a culture of professional scepticism by auditors. The Committee requested further details on the work the FRC has undertaken to encourage auditors to demonstrate appropriate professional scepticism. We attach as an Appendix a discussion paper which we published in August 2010, along with another paper published jointly with the FSA which deals with the financial sector specifically. We are currently analysing the responses to these consultations and will announce the outcomes in 2011.

The Audit Inspection Unit’s 2010 annual report also called on auditors to exercise greater professional scepticism particularly when reviewing management’s judgements relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.
We hope this supplementary submission is helpful to the Committee. As we say in our written evidence, we stand ready to play our part in implementing policies that will both enhance competition and quality in the audit market. We look forward to the Committee’s analysis and recommendations.

22 December 2010

Supplementary memorandum by the Financial Services Authority (ADT 28)

1. This memorandum is submitted by the FSA as a follow-up to the oral evidence given by Sally Dewar, Managing Director of Risk, and Richard Thorpe, Head of Accounting and Audit, on 9 November.

2. The memorandum provides further information in response to two questions that the Committee asked on:

   (a) the frequency of auditor-supervisor meetings in the period 2006–08; and
   (b) when and why the practice of auditor-supervisor meetings fell away.

3. As the FSA has acknowledged on a number of occasions over the last two and a half years (including in our evidence to this Committee), in the run-up to the financial crisis the regulatory framework in the UK and globally and our supervision of major firms were inadequate in important respects. This was also true of our engagement with the auditors of individual large firms and with the audit profession as a whole.

4. In April 2008, in response to the shortcomings we had identified in our report on our supervision of Northern Rock, we launched our Supervisory Enhancement Programme. As a result, we have overhauled both our supervisory philosophy and our capability to deliver it. The FSA is now a radically different organisation from that which existed prior to the summer of 2007. We have invested substantially in creating the capacity and capability needed to deliver this new intensive approach. For example, since April 2008 we have added 537 staff to our supervisory and specialist support areas, including accounting and auditing specialists. We have increased our engagement with auditors and investors to emphasise their role in the oversight of firms, and we now meet at least annually with the external auditors of high impact firms, and have regular high level meetings with the firms on key thematic issues.

A. Frequency of FSA Meetings with External Auditors of Individual Firms

5. The Committee asked how frequently we met with the external auditors of Northern Rock, Halifax Bank of Scotland (HBOS), Royal Bank of Scotland (RBS), and Bradford & Bingley, in the years 2006, 2007, and 2008. We had the following contacts:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Auditor</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Rock</td>
<td>PWC</td>
<td>—</td>
<td>1 meeting</td>
<td>2 meetings</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1 phone call</td>
<td>4 phone calls</td>
</tr>
<tr>
<td>HBOS</td>
<td>KPMG</td>
<td>1 phone call</td>
<td>1 meeting</td>
<td>2 meetings</td>
</tr>
<tr>
<td>RBS</td>
<td>Deloittes</td>
<td>1 meeting</td>
<td>1 meeting</td>
<td>—</td>
</tr>
<tr>
<td>Bradford &amp; Bingley</td>
<td>KPMG</td>
<td>—</td>
<td>1 meeting</td>
<td>1 meeting</td>
</tr>
</tbody>
</table>

6. In line with our improved arrangements outlined in paragraph 4 above, in 2009 and 2010, we have met these banks’ auditors with the following frequency:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Auditor</th>
<th>2009</th>
<th>2010 to date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Rock</td>
<td>PWC</td>
<td>3 meetings</td>
<td>1 meeting</td>
</tr>
<tr>
<td></td>
<td></td>
<td>1 phone call</td>
<td></td>
</tr>
<tr>
<td>Lloyds Banking Group (which includes HBOS)</td>
<td>PWC</td>
<td>2 meetings</td>
<td>3 meetings</td>
</tr>
<tr>
<td>RBS</td>
<td>Deloittes</td>
<td>1 meeting</td>
<td>2 meetings</td>
</tr>
<tr>
<td>Bradford &amp; Bingley</td>
<td>KPMG</td>
<td>3 meetings</td>
<td>1 meeting</td>
</tr>
</tbody>
</table>

B. When the Regular Practice of Auditor-Supervisor Meetings Fell Away

7. The regular practice of auditor-supervisor meetings fell away gradually following the transition from the Bank of England to the FSA as banking supervisor.
8. Until 1998, banks were supervised by the Bank of England and auditor-supervisor interactions were governed by the Banking Act 1987. One element of the Bank’s supervisory model was to rely on the work of external auditors to a greater extent than has been the case under our model. For example, the Bank commissioned auditors to undertake additional work to examine a firm’s systems and controls, or to address thematic concerns. The Bank then held bilateral meetings with the auditor or trilateral meetings with both the auditor and the bank to discuss the results of this work.

9. In June 1998, the Banking Act 1998 transferred banking supervision from the Bank of England to the FSA. The Financial Services and Markets Act 2000 (FSMA) superseded the Banking Act as our legislative framework for banking supervision from 1 December 2001. FSMA established a wider, more comprehensive “regulatory toolbox” for our responsibilities, including our supervisory responsibilities over banks. Section 165 of FSMA gives us the power to require information from firms. Section 166 allows us to require firms to commission reports by skilled persons (including, but not limited to, auditors) on areas of concern.

10. With the transition to a new regulatory framework in 2001, we also adopted a different supervisory approach. For example, we established supervisory specialists in-house, supported by further in-house specialists in policy, risk and sector-specific areas. This in-house expertise was designed to reduce the need for regular reporting by auditors on supervisory matters relating to individual firms. One consequence was that, over time, meetings between supervisors and auditors also became less frequent. There were still cases where FSA supervisors continued to meet with the auditors at least once a year, but this happened on a less structured basis. In line with our supervisory philosophy of that time, we made less use of third parties (ie use of section 166 reports) and placed more reliance on what firms told us. As noted above, we now recognise that this approach was wrong.

11. Following the crisis, we have committed to making greater use of our powers under section 166. We now form our own judgements on firms’ judgements. The table below shows our increasing use of section 166 powers, and we expect this trend to continue in the coming year.

<table>
<thead>
<tr>
<th>Number of s166 reports commissioned</th>
<th>2006–07</th>
<th>2007–08</th>
<th>2008–09</th>
<th>2009–10</th>
<th>2010–11 to date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>18</td>
<td>30</td>
<td>56</td>
<td>88</td>
<td>90</td>
</tr>
<tr>
<td>Banks or firms within banking groups</td>
<td>3</td>
<td>2</td>
<td>5</td>
<td>11</td>
<td>16</td>
</tr>
</tbody>
</table>

12. We have used our section 166 powers to commission reports from a variety of skilled persons, in addition to the “big four” accounting and audit firms, ranging from mid-tier accounting firms to compliance consultants and lawyers. The reports examine regulatory concerns, such as review of past business and quality of advice, adequacy of systems and controls, corporate governance, capital requirements, and treating customers fairly.

13. Our specialist Accounting and Auditing Sector Team, established in 2005, co-ordinates our work with the national and international bodies that represent the profession and strengthens our relationship with the major auditing firms. This cross-sector and cross-firm engagement with auditors has also intensified in response to the crisis. It now includes high-level bilateral meetings with audit firm partners, technical bilateral meetings with audit firm directors and roundtable meetings with the largest firms to discuss key financial reporting and audit issues across sectors on a regular basis. In addition, last year we established an Accounting Review Team. This group of experienced accountants undertakes detailed analysis of the published accounts and the reports from auditors to management for high impact firms. Their primary role is to support supervisors on accounting and audit-related matters.

14. We are strongly committed to engaging more effectively with external auditors, in particular in our supervision of high-impact firms. We would expect this approach to continue under the proposed Prudential Regulation Authority (PRA). We are working closely with the Bank of England to plan this and other aspects of the PRA’s supervisory philosophy and practice.

14 December 2010

Supplementary memorandum by the Office of Fair Trading (ADT 49)

1. 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.49

49 Please note that throughout this document “audit” refers to external audit only.
2. 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.

3. 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.

4. 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.

5. 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”.

6. 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.

7. 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.

8. 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.

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

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

2 March 2011
Letter from Deloitte (ADT 29)

1. We are pleased to respond to the Call for Evidence issued by the House of Lords Select Committee on Economic Affairs in July 2010.

2. Our view is that the audit profession has discharged its responsibilities with care and diligence throughout the financial crisis. In relation to market concentration, our experience has been that the audit marketplace is fiercely competitive and transparent. The quality of auditing in the United Kingdom is higher than ever and we take very seriously the trust placed in us by market participants.

3. In our view, the underlying accounting principles and the respective responsibilities of regulators and auditors are not well understood and warrant consideration. There is consequent need for reflection as part of the journey of continuous improvement. We are working closely with clients, investors and regulators towards a common objective of mitigating the risk of a future crisis.

4. The principal points which we would make are as follows:

   (i) Economic factors demonstrate the competitive nature of the audit marketplace: for example, the high levels of investment we make in winning and retaining clients and the comparable levels of profitability in our audit and non audit businesses.

   (ii) Auditing today is a demanding profession, requiring high levels of investment and commitment in order to deliver the quality expected by audit committees, regulators and other stakeholders.

   (iii) We have chosen to compete in this market, and have grown our FTSE 100 market share significantly from four clients in 1995 to 22 today. It is a dynamic market without insurmountable barriers to entry.

   (iv) It is not our most profitable market, and carries the highest levels of risk and regulation. However, it also defines our reputation and is at the very heart of our business.

   (v) We have seen no evidence of anti competitive behaviour and our experience is that the listed company audit market is one of the most competitive. The recommendations of the FRC's Market Participants Group are intended to promote greater competition in the longer term.

   (vi) We welcome the discussion regarding the evolution of certain aspects of accounting standards. We are also closely engaged with the Bank of England, the FSA and the FRC in exploring where auditors may be able to give further objective assurance.

   (vii) The accounting requirement to record losses when incurred, and not when expected, is generally not well understood. The different responsibilities of prudential regulators and auditors also appear unclear to some investors and commentators. Auditors do not write the accounting, auditing or regulatory standards, their role is to give assurance that they have been applied objectively.

   (viii) The debates around auditor competition, scepticism and ethics are all largely driven by these considerations. The issues are largely of perception and disclosure, not substance.

   (ix) The global liquidity crisis was not anticipated by companies, investors, regulators and government alike. Similarly, it is not the role of the auditor to foresee the unforeseeable.

   (x) Companies may wish to disclose the rigour applied by audit committees in assessing audit quality and value. Similarly, audit firms’ transparency reports could describe how the firms respond to that rigour and competition, and the significant investment made in winning and retaining their clients.

5. We have responded to the detailed questions raised in the Call for Evidence in appendix 1, attached.

24 September 2010
APPENDIX 1

RESPONSES TO QUESTIONS RAISED IN THE CALL FOR EVIDENCE

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1.1 Auditing large companies requires global reach, a robust approach, the highest quality, and a pristine reputation. The audits of multinational groups require networks with firms in many countries. Clients expect audit teams to comprise the best people, with technical excellence, industry expertise and an enquiring, questioning mindset. To respond, audit firms need the scale and appetite to enter a demanding and higher risk market. Such firms are also likely to be better placed to challenge their larger clients.

1.2 Over time, audit firms have variously made their decisions as to how to respond to that market, and in which segments to compete. Regulatory reporting indicates that it is now harder for smaller firms to deliver quality and respond to the needs of larger, listed companies. However, this is not a market phenomenon; it is the result of firms making different decisions regarding investment, scale and target markets. This then has the effect of driving client choices and hence firms’ market share.

1.3 There are many other markets where there relatively few participants and where no competition concerns arise. The transparency of the audit market should offset any impact of there being fewer participants. Further, the recommendations of the FRC’s Market Participants Group are intended to promote competition in the longer term.

2. Does a lack of competition mean clients are charged excessive fees?

2.1 We have not found the market to be uncompetitive. Our experience is the reverse: we make less profit from auditing listed companies than from other parts of our business. Our audit business as a whole has a slightly lower profit margin (29%) than the rest of our business (33%). We have preserved that margin during the financial crisis by investing appropriately, controlling costs and negotiating fair fees.

2.2 The margin on major listed company audits is lower than audit as a whole, showing sustained fee pressure in this market, despite the unlimited liability that such work carries. We invest significant time and costs in bid opportunities, and in relation to major listed companies, the opportunity costs of such an investment reach well into six figures and more, with high levels of attention devoted to retaining existing relationships. The fact that large companies tender their audit only infrequently reflects those intense efforts to retain clients. This evidences the competitive nature of the market.

3. Does a narrow field of competition affect objectivity of advice provided?

3.1 We have seen no evidence that the field of competition is too narrow or of a lack of objectivity from auditors. The primary focus of the auditor is the truth and fairness of the financial statements. Auditors are bound by rigorous ethical standards that preserve their independence and objectivity, regardless of market or competition considerations.

3.2 The auditor’s principal role is not to provide objective advice on the appropriateness of the business model. This would be likely to breach independence as the auditor would then be at risk of assuming a management role or of self review.

3.3 Whilst auditors will give consideration to the business model, it is not their place to tell management how best to run the company, nor to tell investors where best to invest their money. These are judgements for others, based on their appetite for risk.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

4.1 The auditors’ primary role is to audit and form an opinion on the financial statements. Any advice offered is in the context of ethical standards and not a substitute for proper governance and management by their clients.

4.2 Auditors provided an effective challenge during the financial crisis; as evidenced by increased levels of modified audit reports. This is despite the competitive nature of the market and is a function of the firms’ relentless commitment to quality and their reputations, the rigorous governance and expectations of audit committees and the presence of an effective, transparent regulatory framework.

1 http://www.frc.org.uk/about/auditchoice.cfm
5. What is the role of auditors and should it be changed?

5.1 The auditors’ role is to provide reasonable assurance that the financial statements are free from material misstatement, comply with statute and show a true and fair view.

5.2 This is fundamental to the capital markets, as it gives comfort that the numbers in use by the market are reliable, thereby avoiding a risk premium or reluctance to trade. There is little evidence that the assurance provided was flawed and we welcome discussions with stakeholders regarding further objective assurance from auditors.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition a contributory factor?

6.1 The financial crisis was unforeseen and without precedent. In our view, comments regarding auditor scepticism arise from issues of perception. The accounting requirement to record losses when incurred, and not when expected, is not well understood by some investors or regulators. It was not open to banks to provide for future losses, nor was it open to auditors to permit (let alone advise) such treatment. The different responsibilities of prudential regulators and auditors appear unclear to some investors and commentators.

6.2 See also 5.1 and 5.2. It is open to regulators and investors to consider any further information they require and the basis on which it should be prepared. That information could be sought from the company and, if appropriate, objectively assured by the auditor.

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

7.1 The responsibilities of auditors are set out in our response to question 5. The systemic collapse of the global capital markets was not foreseen by any market participants, including investors, regulators, Government and auditors.

7.2 Looking forward, there is scope for auditors to provide further objective assurance, and we welcome discussions with investors, clients and regulators as to how best to do so. Frameworks for this reporting have been in existence for many years, and we encourage investors and regulators to discuss their information needs with the profession.

7.3 We welcome the indications from regulators that they are willing to share information more freely with auditors and to engage in dialogue regularly.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

8.1 Open, ongoing dialogue between auditors, clients and banking supervisors is important to each party’s responsibilities. The points made in our responses to questions 5, 6 and 7 are relevant here as is the ICAEW’s analysis of lessons from the crisis. Prior to 1997, there was greater information flow from supervisory authorities to auditors.

8.2 Two further points: (1) financial information prepared and used for statutory financial reporting purposes may have been prepared on a basis that is not appropriate for the (different) needs of prudential regulation and (2) the auditor is available to provide objective assurance at least on some of that regulatory financial information.

9. If need be, how could incentives to provide objective, and in some cases unwelcome, advice to clients be strengthened?

9.1 Our response to 3.2 is relevant here. The existing framework of ethical standards, audit committee scrutiny, regulatory transparency, reputational and litigation exposure and firms’ transparency reporting all safeguard deliver auditor objectivity. Increased dialogue with regulators will help both the auditors and the regulators to have a fuller perspective on all of the issues surrounding the regulated entity.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

10.1 Threats to independence may arise, and are addressed by ethical standards. These have extensive prohibitions: for example, auditors cannot act as management, review their own work or act as the client’s advocate in a dispute. The standards follow a principles-based approach requiring auditors and audit committees to identify potential threats and address them with appropriate safeguards. Remuneration and objective setting for individual auditors cannot refer to the sale of non audit services to their audit clients.

10.2 Our response to the Auditing Practices Board’s consultation on this topic is relevant\(^3\). The APB’s data shows just 4% of firm’s revenues is generated from the provision of non audit services to FTSE 100 audit clients. There is a perception issue here, and we consider more complete disclosure would be helpful.

11. Should more competition be introduced into auditing? If so, how?
11.1 The audit market, particularly for listed companies, is already fiercely competitive. This is one of the principal barriers to entry. Overcoming that barrier requires significant investment, commitment and the willingness to operate in higher risk markets. There is no appreciable current demand or economic incentive for a new market participant, although we do not discount it as a future possibility, and indeed would welcome it. The market structure largely reflects the demands of that market: for quality, scale and global reach. The liability exposures faced by auditors may also act as a further disincentive.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?
12.1 The new UK Corporate Governance Code provisions relating to risk will require an element of change by internal auditors in order to respond effectively. Interaction with external auditors is addressed by existing auditing standards and works well.

13. Should the role of audit committees be enhanced?
13.1 The new Code also requires greater consideration of the risks in the company’s business model. Refinements to audit committee guidance on non audit services will assist with perception issues, but the principal interactions with auditors are effective.

13.2 Overall, the business model of the company is assessed by analysts and, indirectly, by the market. Clear disclosure of that model and of business performance is the key.

14. Is the auditing profession well placed to promote improvement in corporate governance?
14.1 Yes. The reports provided by auditors to those charged with governance (eg audit committees and boards of directors) typically contain valuable insights. Auditors are also well placed to provide industry and market contexts through benchmarking analysis.

**Letter from Ernst & Young (ADT 30)**

We welcome this inquiry from the House of Lords Economic Affairs Committee as an opportunity for an open dialogue with Parliament, regulators and the general public about the issues. We are pleased to submit evidence in response to it.

Ernst & Young is one of the largest global professional services organisations. We provide audit, accounting, tax, corporate finance and other business advisory services to businesses of all sizes in all sectors; not just financial services. Our UK activities are overseen by the Institute of Chartered Accountants in England & Wales, with further supervision over certain parts of our business by the Financial Reporting Council (FRC), its Operating Bodies and the Financial Services Authority (FSA).

In preparing our evidence, we consulted with other member firms in the Ernst & Young network.

We attach a two-page summary and an eight-page Appendix in which we set out our answers to the Committee’s specific questions.

For further information or to discuss this submission, please contact Andrew Hobbs, Director, Regulatory & Public Policy, using the contact details above. We would also welcome further conversations with you and the Committee’s advisor Professor Chambers. We would be happy to elaborate on any of the points made in this letter at the forthcoming oral evidence session.

Summary

Competition and choice

1. The UK market for audits of large listed companies is highly competitive. That said, we recognise that concentration of auditor choice is an important issue. Ideally, there should be more choice in the large listed company audit market. As we have consistently said, we are in favour of promoting the capability of the mid-tier audit firms through market-based initiatives that remove any barriers to entry or expansion that may exist. We do not share the perception that only the Big 4 networks have the depth and reach to participate in the market for large listed company audits.

How has Ernst & Young responded to the crisis?

2. Like many others, we have used the financial crisis to consider how we can improve what we do as well as to consider the role of our profession as a whole. Here are a few key examples relevant to the Committee’s inquiry.

3. To provide the highest quality audits, we believe we need to be as globally integrated as possible. Thus we have continued to move forward to integrate our organisation internationally. This is enabling us to be more effective at identifying accounting, risk and reporting issues and communicating with clients about them. We also continue to review our own internal processes to identify areas for improvement. For example, we have continued to integrate our financial services practice, have enhanced our (independent) engagement quality reviews, and deployed scarce specialist skills across boundaries.

4. Independent non-executives will join Ernst & Young’s Global Advisory Council, the highest global governance body in the Ernst & Young organisation, to advise on the public interest aspects of Ernst & Young’s decision making, risk management and stakeholder dialogue.

5. Since the crisis began we have contributed to UK initiatives to develop policy affecting corporate governance, financial reporting and the audit profession, including the Walker Review, UK Corporate Governance review, audit firm governance, FSA regulatory reform and the FRC’s various guidance on going concern.

What needs to change?

6. All stakeholders need to reflect on the crisis and challenge the status quo. The audit profession is no exception.

7. Global coordination is a necessity, not a luxury, in today’s interconnected and interdependent markets. Regulators and standard-setters need to continue to work together to achieve global consistency. Effective audit oversight is an important part of this. With more than 140,000 people working in more than 140 countries, Ernst & Young would welcome much greater connectivity and coordination between national audit oversight bodies. In financial reporting, the lack of progress in achieving a single set of high quality global accounting standards has been particularly disappointing.

8. Strong corporate governance is fundamental to a company’s health and to the well-being of our economy. Seeking to strengthen the corporate governance framework holistically, rather than focussing on some of its individual components, should be at the heart of any proposals for change.

9. We have also turned our minds specifically to the question of corporate reporting and auditing. Financial statements are prepared by companies and the accounting judgments are the responsibility of management and the directors. They are a historic snapshot of a company’s financial health. A statutory audit is an examination of a company’s financial statements carried out in accordance with independently prescribed auditing standards. After the audit is completed, the auditor issues an audit opinion which is published as part of the financial statements. It states whether or not the financial statements show a true and fair view of the company’s business operations and financial health during the period covered. It is designed to provide reasonable (not absolute) assurance that the company’s financial statements are free from material misstatement.

10. Except for the going concern statement, the audit does not provide any assurance about a company’s future performance because financial statements are backward-looking.

11. We believe the current reporting and auditing model delivers significant value to users. In light of the crisis, some stakeholders have questioned this value. We are always open to any positive change that enhances stakeholder confidence and which improves audit quality. We would support the following enhancements:

(a) Strengthening audit committees so they are better placed to challenge management, auditors and their respective judgements. Such strengthening would also better equip them to support the auditor’s dealings with management.
(b) Better reporting by audit committees and/or auditors about the existing value of audit and how auditors discharge their professional responsibilities.

(c) New high quality disclosures to help companies provide a fuller picture of their financial position, business model and future viability. Enhanced assurance over these disclosures would also be required. The key objective should be specific reporting which avoids boilerplate language. Liability risks present challenges to this objective. Safe harbours for management, audit committees and auditors should be explored.

(d) We also support a greater role for auditors in prudential regulation. This would include a regular dialogue between bank auditors and supervisors to share in both directions as much information as possible relevant to their respective roles; and in carrying out their prudential responsibilities, supervisors could make more and better use of auditors and other external experts using targeted risk based reporting.

12. In 2006 the global CEOs of the six largest audit networks including Ernst & Young published a vision paper which explored many of these issues. It highlighted increasing globalisation and the growth of emerging markets. It recognised that auditors could only contribute to the stability and strength of capital markets in this new world if corporate reporting and auditing standards were global; if independent audit oversight bodies became more formally coordinated; and if the large audit networks continued to improve the consistency of audits across the different countries in which they operate. This included enabling audit networks to integrate more closely. We continue to believe these are essential drivers of audit quality.

13. In the UK alone, policy initiatives are already underway in relation to many of these issues. Ernst & Young is pleased to be actively involved in all of these debates. We recognise the vital importance of ensuring there is a robust framework for corporate governance, corporate reporting and auditing that meets the developing needs and expectations of our stakeholders.

27 September 2010

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS

For more information about our organisation, please refer to our UK transparency report. It provides insights relevant to the Committee’s specific questions.

Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1. Concentration through consolidation has been driven mostly by the staggering growth in number, size and reach of multinational companies, the need for scale to build effective global networks to audit these companies, increasing litigation risk and the demise of Andersen in 2002. A 2006 Oxera report on competition and choice in the UK audit market provides more detail.

2. The audit market for large listed companies in the UK is concentrated among the Big 4 audit firms. Outside this, the UK audit market is much less concentrated. As at September 2010 Ernst & Young’s share of FTSE350 audits stands at 17.4% (61 audits). Our share of FTSE100 audits stands at 18 audits.

3. Only the very largest global companies require the geographic reach and industry specialisation of the Big 4. However, there is a widespread misconception that only the Big 4 networks have the depth and reach to participate in the market for listed company audits. As we have consistently said, we are in favour of promoting the capability of audit firms outside the Big 4 through market-based rather than regulatory initiatives.

4. By way of a specific example, the six largest global audit networks including Ernst & Young recently wrote to the OECD arguing for the removal of Big 4 only clauses in loan agreements. We do recognise though, that in the short to medium term, it will be difficult for audit firms who do not already have the capability to enter the market for large listed companies for a number of market-driven reasons including: (i) significant investment required for market entry; (ii) the long investment horizon; (iii) liability risks; and (iv) audit client inertia.

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Does a lack of competition mean clients are charged excessive fees?

5. No. The largest audit firms are extremely competitive. Auditors are subject to reappointment by management and the shareholders every year, during which process audit fees are negotiated. The company can choose to switch auditor if satisfactory terms cannot be agreed.

6. Listed companies also run competitive tenders for both audit and non-audit services. However, companies do not change their auditor very often because running tenders and changing auditors is costly. It takes time for auditors to build up knowledge of the company and to form strong relationships with the audit committee, both essential factors in ensuring audit quality. When audit tendering does occur it is highly competitive, and the incumbent is typically retained in only a third of cases.

Does a narrow field of competition affect objectivity of advice provided?

Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

7. We do not accept the premise that there is limited competition. In any event, in our experience, concentration in the UK audit market is not linked to the objectivity of advice. Objectivity is driven by personal qualities, reputation, professional training, industry codes of ethics, ethical and independence standards, auditing standards, and continuing professional development; not to mention positive reinforcement in the workplace, including tone from the top. At Ernst & Young these drivers are supported by a detailed system of internal quality control.⁶

8. The UK is also recognised as a global leader in the regulation and oversight of the audit profession. The drivers of objectivity are reinforced by independent oversight, disciplinary schemes, and potential civil and criminal liabilities.

9. Ernst & Young’s client acceptance and continuance policy establishes a rigorous process for determining whether to accept a new client or continue with an existing relationship. This policy is fundamental to maintaining quality, managing risk, protecting our people and meeting regulatory requirements. A company’s propensity to “opinion shop” or to exert unreasonable pressure on its auditors is a highly relevant factor to client acceptance and continuance.

10. Auditors and accountants are highly regulated; ethics is integral to the sector and ingrained in its qualifications and working practices. At Ernst & Young, our culture of ethics and integrity is embedded in our training programmes and internal communications. As part of our approach to professional values, our employees are expected to follow a strict Code of Conduct.

11. The requirement to maintain independence and objectivity is one of Ernst & Young’s ten principles of quality and risk management which apply globally across our organisation and against which our people are evaluated and rewarded.

What is the role of auditors and should it be changed?

12. Auditors play an essential role in the functioning of the global capital markets and add value to the roles played by other stakeholders such as preparers, investors and regulators. We are committed to promoting and enhancing transparency to instil confidence in financial markets. Transparent financial information facilitates the allocation of capital to its highest and best uses, which in turn drives economic growth and rising standards of living.

13. Financial statements are prepared by companies and the accounting judgments are the responsibility of management and the directors. They are a snapshot of a company’s financial health at a particular point in time. A statutory audit is an examination of a company’s financial statements carried out in accordance with independently prescribed auditing standards. After the audit is completed, the auditor issues an audit opinion which is published as part of the financial statements. It states whether or not the financial statements show a true and fair view of the company’s business operations and financial health during the period covered. It is designed to provide reasonable (not absolute) assurance that the company’s financial statements are free from material misstatement.

14. Except for the going concern statement, the audit does not provide any assurance about a company’s future performance because financial statements are backward-looking.

⁶ More details of this system are contained in our transparency report at http://www.ey.com/uk/en/About-us/About-EY-Transparency-Report
15. Independent assurance of that information by the external auditor builds trust among stakeholders that the information can be relied on, thereby instilling investor confidence. Independent research, recently published by Maastricht Accounting, Auditing and Information Management Research Center (MARC) provides strong support for this.

16. We believe the current reporting model delivers significant value to those who use it. However, the audit profession and other market participants need to reflect on the crisis and challenge the status quo. Working with professional bodies, regulators, investor groups and the audit profession, we have been developing our thinking on how corporate reporting and audit for all companies may be enhanced. Our views are as follows:

(a) There is a need to increase awareness of how auditors discharge their professional responsibilities.

(b) A coherent framework needs to be developed to enable listed companies to provide high quality disclosures that provide a fuller picture of their financial position and future viability. This would include better (not necessarily more) information about business models and the risks to it; internal controls; and management judgements and estimates. Such enhanced reporting will likely also require assurance.

(c) The key objective should be specific reporting which avoids boilerplate language. New disclosures by companies about their business should be meaningful and auditors should provide assurance statements which provide better information about what the auditor has done. Unfortunately liability risks present challenges to the objective. Safe harbours for management, audit committees and auditors should be explored.

(d) To maximise the benefit for all stakeholders, these improvements need to take place within an internationally consistent framework which includes a single set of high quality global accounting standards.

Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

17. While Ernst & Young audits many banks outside the UK, we did not audit any of the major UK headquartered banks during the crisis. Our UK perspective on this question is therefore limited by this fact.

18. A challenging mindset is a key driver of audit quality. Accordingly, the application of professional scepticism is a fundamental auditing requirement. It is important that we have an open discussion about the concept because it will enhance stakeholder understanding of and confidence in the auditor’s work. We therefore welcome the Auditing Practices Board’s paper on the topic.

19. Concerns about professional scepticism in the audit of banks have been raised by the FSA in its joint Discussion Paper with the FRC and more generally by the Audit Inspection Unit of the Professional Oversight Board (AIU) in its latest round of reporting. We have seen no evidence which suggests there is a pervasive lack of scepticism in the audit profession. Moreover, as shown by successive AIU reports the fact remains that the quality of listed company audits in the UK is good. We recognise that improvements can always be made and Ernst & Young continues to make significant investments in training and processes to achieve this.

20. There is also room for new and alternative ways for auditors to better demonstrate the application of scepticism to investors and regulators. In this regard, we believe that a professional judgment framework for preparers and auditors, which encourages a critical, reasoned, rigorous, thoughtful and deliberate approach to decision-making, would strengthen financial reporting and audit quality and contribute to the exercise and demonstration of professional scepticism.

21. We do not believe that audit market concentration has any impact on professional scepticism. The key drivers of objectivity and professional scepticism, including the significant reputational, regulatory and financial risks for auditors, exist regardless of the number of market players.

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8 http://www.frc.org.uk/apb/publications/pub2343.html
9 http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf
What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

22. We support the Committee’s findings from its 2nd Report of Session 2008–09:

“We have seen no evidence that bank auditors failed in their statutory duty to make a going-concern judgement on their clients. Bank auditors should not be required to make a more general judgement on the quality of their clients’ strategies. In any event, it is unlikely that auditors would be more able than financial supervisors to identify structural problems in the financial sector”.¹⁰

23. Audits are focused on individual entities. However, the risks giving rise to the financial crisis were market-wide and not confined to a single entity or geography. Accounting standards and the audit profession played an important role in bringing some realities of the banking crisis into sight quickly. Although painful, this enabled investors, management, creditors and policymakers to recognise problems or opportunities on a timely basis so they could make informed decisions and take appropriate corrective actions.

24. The financial crisis presents all stakeholders with an opportunity for positive change. In this regard, auditors and prudential supervisors are examining how auditors might contribute to better supervision of banks. In June 2010, the ICAEW published its report on how the audits of banks might be enhanced.¹¹ It provides a good explanation of how auditors might contribute to better bank supervision. We support its recommendations including the increased use of section 166 reports and increased interactions between prudential supervisors and auditors. On 29 June 2010 the FSA and FRC published a Discussion Paper on the topic.¹² If the Committee would like a copy of our response, please let us know.

25. The six largest UK audit firms have recently joined a working group comprising representatives from the FSA, FRC, ICAEW and chaired by the Bank of England. Its purpose is to consider how the relationship between auditors, firms and regulators can be more clearly defined to permit more useful and comparable disclosures about judgment issues and the sensitivities around material valuations. The working group will also seek to define ways in which the relationship between auditors and prudential regulators can be enhanced in practical terms.

How much information should bank auditors share with the supervisory authorities and vice versa?

26. Regular exchange of information between auditors and bank supervisors enables both parties to perform their duties more efficiently and effectively. We therefore welcome the FSA’s new consultative approach and the recent improvements in both the frequency and quality of dialogue. Ernst & Young now meets with the FSA and the other five large audit networks on a regular basis. This year the FSA has sought meetings with us on a bi-lateral basis every six months. We meet with individual supervisors about certain individual institutions around twice a year.

27. There is still room for significant further improvement. In particular, discussions between the FSA and auditors must be a two-way process for sharing as much information as possible. This includes information about individual entities and market-wide information held by prudential regulators. In the short term, the FSA needs to find ways within its legal constraints to notify auditors of relevant concerns, with a review of the current legal constraints in the long term.

28. Tri-lateral engagement (FSA, auditor, financial institution) is equally important. The FSA should also increase its interactions with audit committees.

If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

29. The existing drivers of objectivity explained in paragraph 7 of this Appendix provide a good platform for the provision of objective advice to clients. In many ways the most important driver of objectivity is talented professionals. For this reason, regulators need to help ensure that the audit profession continues to be able to attract and retain talented individuals with the requisite diversity of skills.

Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

30. Conflicts of interests, which can arise between the provision of audit and non-audit services to the same client, are just one of a number of potential threats to auditor independence. The UK regulatory regime adopts a “threats and safeguards approach”. This provides that such threats can be managed by audit committee oversight, transparency, the implementation of safeguards and in some cases prohibitions.

¹⁰ http://www.publications.parliament.uk/pa/ld200809/ldselect/ldconaf/101/101i/pdf para 211
¹¹ http://alturl.com/jgref
¹² http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf
31. Responses to a recent APB consultation indicate that there continues to be widespread stakeholder confidence in this approach.  

32. Audit firms operate in a highly regulated environment with strong independence requirements both for audit firms and individual auditors, who also subscribe to robust ethical codes. Audit firms also have to operate a strong system of independence controls and are subject to significant independent oversight. That said, we accept there can be situations where it would be inappropriate to provide certain non-audit services to an audit client. 

33. Greater transparency about the nature and amount of non-audit services auditors provided to audit clients should address any remaining perceptions among some stakeholders that objectivity and independence is impaired by their provision. We seek to achieve this through our transparency report, as well as statutory public disclosures, which outline revenues attributable to different segments of our firm. This information provides companies and investors with the relative size of the non-audit practice as compared to the audit practice. 

34. There also needs to be better disclosure in company annual reports of the audit committee’s policy on non-audit services together with clearer information of how non-audit services are categorised (many non-audit services are actually integral to the audit) plus additional guidance for audit committees. In 2010, we were pleased to assist the Institute of Chartered Accountants of Scotland to develop recommendations for the FRC and the Department for Business on this issue. 

35. It is worth noting that the majority of our non-audit services are provided to non-audit clients. They made up 62.4% of our UK revenue for the financial year ended 2 July 2010 as opposed to 13.4% of total UK revenues for non-audit services provided to audit clients. Assurance services for audit clients made up the remaining 24.2%. 

36. Auditors at multi-disciplinary firms can further increase their business acumen and technical skills by working at non-audit clients. The opportunity to develop multi-disciplinary skills encourages the recruitment and retention of high quality professionals; an essential component in audit quality. 

37. The terms audit concentration, audit competition and choice are sometimes used interchangeably when they refer to different issues. Audit concentration is a small number of audit firms, such as the Big 4, performing audits for one particular market (eg FTSE100); audit choice means the number of audit firms available for companies to choose; and competition refers to a fair contest for market share among any number of audit firms. 

38. A robust, competitive, listed company audit market positively impacts on audit quality and innovation. It is therefore in the best interests of investors and the capital markets. 

39. There continues to be healthy competition in the audit market but we recognise that there could be greater choice. We therefore welcome sensible efforts to increase choice in the listed company audit market and support recommendations that might help to increase choice without compromising audit quality. Regulators and other capital market participants should encourage market-based initiatives to encourage auditor choice of the kind identified by the FRC’s Market Participants Group. Imposing solutions that are not market-based are likely to lead to unintended consequences. 

40. The risk of catastrophic liability for auditors of large listed companies can serve as a barrier to entry for some of the smaller audit firms. Catastrophic liability itself could create further consolidation in the larger listed company audit market. Policymakers need to take steps to ensure that choice is not further eroded by the disappearance of one of the remaining audit networks. 

41. Consistent with our view that policymakers need to examine the governance framework holistically, options for enhancing the role of internal audit should also be investigated. This is particularly relevant in financial institutions where failures in organisation-wide risk management were a key factor contributing to the crisis. In this respect, we support the prevailing FSA view that internal audit in financial institutions should focus on systems of governance, risk management and internal controls. We would support stronger reporting
lines by the Head of Internal Audit to the Audit Committee Chair with a dotted line to the CEO/CFO rather than the CRO. There is also a need for internal audit to shed its traditional image as a monitoring role. It should be seen as a function that rigorously audits an organisation’s policies and processes to ensure they are properly implemented and effective.

42. Internal and external audit serve different purposes. They have different responsibilities, different accountabilities and are independent of each other. Nevertheless the roles are complementary at times. It is important they are aligned when planning their respective work to avoid duplication of effort and to maximise the total assurance that they provide.

Should the role of audit committees be enhanced?

43. Yes, this is extremely important. High quality reporting requires audit committees, as representatives of shareholders, to be strong, dedicated and thoroughly engaged.

44. Audit committees could be strengthened by looking at: (i) their composition; (ii) their experience, skills and training; (iii) their resources; (iv) greater audit committee accountability for the selection and oversight of auditors; (v) better audit committee reporting about the financial reporting process; (vi) more regular meetings between audit committees, boards and auditors; (vii) auditors reporting to the shareholders’ meeting; and (viii) better engagement between investors and audit committees.

45. Enhancing the audit committee’s role will help reinforce auditor independence and support the auditor in exercising professional scepticism. Stronger audit committees will be better placed to challenge management, auditors and their respective judgements. Such strengthening will make them better equipped to support the auditor in their dealings with management.

Is the auditing profession well placed to promote improvement in corporate governance?

46. Yes. By way of an example, Ernst & Young has extensive financial reporting and corporate governance knowledge and experience, gained across all markets and geographies. In order to promote best practice in corporate governance, in the UK we operate programmes such as the Independent Director Programme and the Audit Committee Chair Forum. Internationally, Ernst & Young convenes a series of audit committee leadership networks in conjunction with Tapestry. Their purpose is to promote positive change in corporate governance, improving the performance of audit committees and enhancing trust in financial markets.

47. We also believe firms like Ernst & Young have an opportunity to be exemplars of good governance. Strong governance has been fundamental to the integration of our organisation and to strengthening our ability to provide consistent, high quality service worldwide. In recent years we have embraced many changes to audit firm governance such as independent regulation and the separation of management and governance functions.

48. In January 2010, the FRC and ICAEW issued the Audit Firm Governance Code. Its purpose, whose origins preceded the financial crisis, is to promote confidence and choice in the UK audit market and provide a benchmark of good governance.

49. At Ernst & Young, we see the publication of the Code as a real opportunity. Over the past few years, we have moved to integrate our organisation and strengthen our ability to provide quality audits. For us, much of our ability to do this depends on strong governance and tone from the top. For these reasons, for the first time we will appoint independent non-executive representatives will join our organisation. They will join our Global Advisory Council, the highest global governance body in the Ernst & Young organisation. Their role will be to advise on the public interest aspects of our organisation’s decision making, risk management and stakeholder dialogue.

Memorandum by KPMG LLP (ADT 31)

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

1.1 Independent reports from Oxera and London Economics to the UK Government and regulators and the European Commission underlined that the drivers to concentration were greater capacity/international coverage to serve global/complex organisations; technological innovation; need for industry knowledge/expertise to serve clients, reputation and liability risk. Concentration was exacerbated by the regulatory response to the problems of Arthur Andersen which led to its collapse.

16 For more information go to: http://www.tapestrynetworks.com/networks/net_auditor.html
1.2 The market pressures continue today. The world’s major companies continue to expand both through organic growth and consolidation demanding an ever increasing international audit capability. At the same time diverse national regulatory requirements continue to increase—including registration, annual returns, inspection, disclosure and ethical standards. This means significant investment in processes, infrastructure, expertise and technology but most importantly in people who are essential to quality. These factors create economies of scale which do help firms to expand and drive a virtuous circle with the best people joining those firms that are successful, reinforcing that success thereby attracting the best people.

2. Does a lack of competition mean clients are charged excessive fees?
2.1 No. Cost is an important factor in the consideration of the appointment of auditors. A KPMG survey of Audit Committee Chairs puts cost as the fifth highest factor in the appointment of auditors behind issues like auditor communications, robustness and perceptiveness. In our experience when audits are put out to tender there is fierce competition, including on price, across all sizes of company. Even for those companies which do not go out to tender the audit fees are often benchmarked and in our view an appropriate balance is normally struck between cost and quality.

3. Does a narrow field of competition affect objectivity of advice provided?
3.1 No, we haven’t seen any evidence that suggests that audit quality has declined since the consolidation to fewer large firms. Quality of opinion is paramount to the reputation of audit firms. This is backed up by rigorous training, strong ethics and enhanced by the multi-disciplinary nature of the UK profession.

3.2 The Snyder-Myners Report, Professional Services Global Competitiveness Group in 2009 recognised the world leading position of the UK profession, “The UK accountancy profession is well respected and influential internationally. The resilience and strength of the UK multi-disciplinary model and the emphasis on judgement and principles are internationally recognised.”

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?
4.1 No. Although it is possible that this may have happened, we have not seen any evidence that supports this argument. In our view the more important factors have been the profound and welcome changes to the profession in recent years—indeed independent oversight, public reporting, the role of audit committees and the introduction of a code of governance for the major audit firms. These have all enhanced the independence of auditors and underpinned improvements in audit quality.

5. What is the role of auditors and should it be changed?
5.1 The auditor is currently responsible for auditing the financial statements—prepared by management—to provide reasonable assurance to the investors that they are fairly stated in all material respects. The financial crisis has challenged all the key players in the global capital markets to re-examine their roles and effectiveness and the business reporting and the assurance framework should be part of this re-examination.

5.2 We believe however that it is essential to retain the existing division of responsibilities—the company reports and the auditor provides assurances on those reports. Within that framework KPMG is keen to engage in the debate and find solutions that carry broad support. This might include expanding both the nature of assurance reporting and extending its scope beyond the financial statements and even perhaps beyond the annual report to other forms of corporate reporting. There might, for example, be some form of risk reporting for which auditors may not be the exclusive provider of assurance. We have also made suggestions as regards reporting to financial institution regulators in our response to the recent consultation paper from the FSA and FRC, we set out some of these ideas in our answers to question 7.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributing factor?
6.1 In our experience auditor were sufficiently sceptical in the run-up to the financial crisis. We disagree with recent assertions to the contrary by some in the UK regulatory community. Such assertions of a lack of scepticism do not accord our engagement with regulators at the time. In any event, even if our view on professional scepticism was to be challenged we see no obvious connection with concentration.
6.2 As the House of Lords Select Committee on Economic Affairs Report said in June 2009 “We have no evidence that bank auditors failed in their statutory duty to make going concern judgement on their clients. Bank auditors should not be required to make a more general judgement on the quality of their clients’ strategies.”

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

7.1 In our view whilst the auditors can contribute to an improved regulatory and micro-prudential regime, they could not themselves have “mitigated” the banking crisis. Banking as an industry is heavily impacted by the general economic environment and asset prices in particular. This environment is shaped primarily by politicians, policy makers and central banks across the world. The need for change in this area is also recognised. As the Governor of the Bank of England said recently “We let it slip…the crisis was caused not by problems in the real economy; it came out of the financial sector.” We welcome the new focus in the UK on financial stability and better macro and micro prudential supervision—as auditors we stand ready to play our part in that.

7.2 In the UK we support a new transparent and coherent process with a clear set of principles for a good working relationship between regulators, financial institutions and auditors. KPMG welcomes the debate that has been started by the FSA and the FRC on this and the parallel dialogue with the Bank of England. We have discussed in our response to the recent FSA and FRC consultation paper how a framework of dialogue between those charged with governance, auditors and regulators might work. The table below summarises our proposals.

<table>
<thead>
<tr>
<th>Meeting Type</th>
<th>Objective</th>
<th>Attendees</th>
<th>Timing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Micro prudential</td>
<td>Covering culture, risk appetite, business model, what can go wrong, key judgements and decisions, effect of macro prudential issues</td>
<td>Tri-lateral: Regulators, Audit Committee and Auditors</td>
<td>Semi-annual</td>
</tr>
<tr>
<td>Micro prudential</td>
<td>“Safety valve” meeting between auditor and regulator</td>
<td>Bi-lateral: Regulators and Auditors</td>
<td>Annual or as required</td>
</tr>
<tr>
<td>Micro prudential</td>
<td>Discussion of key accounting judgements and disclosure</td>
<td>Tri-lateral: Regulators, Audit Committee and Auditors</td>
<td>Pre-issuance of financial statements—could be expanded to half year/quarterly reports</td>
</tr>
<tr>
<td>Micro prudential</td>
<td>Cross border regulator issues</td>
<td>Tri-lateral: Relevant Regulators, Audit Committee and Auditors</td>
<td>Annual</td>
</tr>
<tr>
<td>Macro prudential</td>
<td>FSA and auditors market issues—may require hot topic sub groups to continue discussions</td>
<td>Large audit firms and regulators</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Macro prudential</td>
<td>Financial Stability Board/G20 agenda</td>
<td>Large audit firms and regulators</td>
<td>Semi Annual</td>
</tr>
<tr>
<td>Supervisory</td>
<td>Performance of audit firm (see comments on monitoring arrangements below)</td>
<td>Audit firm, FRC and FSA</td>
<td>Annual</td>
</tr>
</tbody>
</table>

8. How much information should bank auditors share with the supervisory authorities and vice versa?

8.1 We do not believe that there should be any significant limitations on the client information that could be shared between regulators and auditors and financial institutions as part of the trilateral process that we advocate.

8.2 The difficulty is in filtering and identifying the key issues from such a volume of information. This requires a structured reporting framework and communication mechanism setting out what information is required, when and in what format. This whole area might benefit from a code of conduct or a set of protocols which formally recognises the respective roles and responsibilities of all the different parties.
9. If need be how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

9.1 We believe the incentives are already very strong. It is critical to the reputation and hence success of the audit firms that they provide objective advice, which in some cases will be unwelcome to clients. This is supported by clear ethical and professional standards and is an area on which the FRC already has a clear focus with their central objective of market confidence in high quality financial reporting and corporate governance.

9.2 Audit committees also play a key role in this dialogue and we have commented on their role further below.

10. Do conflicts of interest arise between audit and consultancy roles? If so how should they be avoided or mitigated?

10.1 In our view the issue is more one of perception than reality. We fully accept however that it is important to deal with this perception, but we believe this is best achieved through the triple lock of strong corporate governance; a clear Code of Ethics and the threats and safeguards approach. In addition, the recent agreement to a Code of Governance by the larger UK audit firms and the appointment of independent non-executive directors will further reinforce the public interest nature of the profession. The APB has been looking at reforms of non-audit services and in July 2010 published the results of consultation and reported that the “overwhelming view” was that there should be no outright prohibition of non-audit services but further consultation on stronger guidance to audit committees; extension of the threats and safeguards approach and a specific look at a small number of service areas like restructuring advice. KPMG support this approach whilst agreeing with the view of the Synder-Myners Report that “strong provision of other services like tax advice is critical to the competitiveness of the corporate sector.”

11. Should more competition be introduced into auditing? If so, how?

11.1 Our Joint European Chairman John Griffith-Jones wrote in the FT 15 September 2006, “We agree that in an ideal world there would be more than four ‘big’ audit firms. Greater realistic choice for companies can only be a good thing….the solution lies in the creation of a successful fifth firm not the destruction of the existing four.”

11.2 In the UK the FRC—through a Market Participants Group reporting in 2007 set out 15 recommendations to increase choice in the audit market whilst maintaining quality and independence eg a code on corporate governance for larger firms and guidance to audit committees re use of larger firms. In Europe, Commissioner McCreevy studied a variety of reforms and recommended in 2008 that there should be liability reform across the EU to improve choice and competition. These approaches which “encourage” rather than “require” and consider, for example, cost/benefit and regulatory burden are consistent with the emphasis of the new UK Coalition Government.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

12.1 The internal auditor is only one, albeit important, way in which the directors and management control a company. The range of companies and their activities is in our view too great to set any general mandatory internal audit requirements. In addition, within the regulated financial sector the FSA already review whether the level of internal audit within individual institutions is appropriate.

12.2 As regards the relationship between internal and external auditors this is governed by the International Standards on Auditing which in our view strike an appropriate balance between the desire to prevent unnecessary duplication (and hence inefficiency) with the need for the external auditor not to rely unduly on a function which is by definition not independent. These arrangements are subject to both company review (Audit Committees) and regulator oversight (AIU inspections and APB review).

13. Should the role of audit committees be enhanced?

13.1 In the UK Audit Committees have a powerful role and we have not identified any areas which need enhancing. The UK Corporate Governance Code (which defines the role of the audit committee) and the associated FRC Guidance for audit committees is kept under regular review by the FRC and already goes well beyond the recent requirements introduced by the EC Statutory Audit Directive. It was last updated in 2008 in response to MPG recommendations to require disclosure of how the audit committee reached its recommendation re the appointment of the auditor (including information on tender frequency, tenure of the incumbent auditor and any contractual obligations that restrict the audit committee’s choice).

13.2 However, it is key that investors in particular have confidence in the those appointed as their agents and we remain open minded as to how this might be enhanced for example through being more involved in the selection of non-executives.
14. Is the auditing profession well placed to promote improvement in corporate governance?

14.1 In our opinion the knowledge gained during an audit and the experience auditors have through auditing many businesses ensures they are well placed to promote good corporate governance (both in the round and for their audit clients). EU Directives (and International Auditing Standards) require external auditors to report to the audit committee (or others charged with governance) on key matters identified during the audit including deficiencies/weaknesses in internal control.

14.2 Audit firms have taken the lead in promulgating good governance practice. For example, long-before Sir David Walker’s recommendations stressed the importance of training and development for non-executive directors, KPMG set up the Audit Committee Institute (now operating in 30 countries) to provide complimentary guidance and a variety of resources designed to assist audit committee members (and other non-executive directors) update and refresh the skills and knowledge which are essential to their role. This is a serious commitment with around 50 seminars, workshops and other colloquium provided each year in the UK.

28 September 2010

Memorandum by PricewaterhouseCoopers (ADT 32)

1. Auditors make an important contribution to the economic health of the nation through the role they play in corporate governance and the functioning of the capital markets by providing independent assurance on the financial statements of companies. Furthermore, the largest audit firms are important employers and developers of talent in their own right. However, we recognise that, in the aftermath of the recent financial crisis, stakeholders and policy makers are questioning whether auditors could make a greater contribution to the strength of the capital markets. The Committee’s inquiry will be an important contribution to this debate.

2. In developing our evidence, we have reviewed the questions set out in the Committee’s “Call For Evidence” and have concluded that they can be summarised as addressing the following broad topics:

— The impact of concentration in the audit market (questions 1, 2, 3, 4 and 11).
— The role of the auditor during the financial crisis and potential areas for future development (questions 5, 6, 7, 8 and 9).
— The potential for conflicts of interest between audit and consultancy roles in multi-disciplinary firms (question 10).
— The relationship between sound corporate governance and the external audit function (questions 12, 13 and 14).

We address each of these issues below.

3. The issues addressed in this inquiry are complex and we note that many of the topics set out above are already the subject of detailed consultations in the UK and elsewhere. We will be responding to each of these consultations, where appropriate in conjunction with other firms in our global network. In particular, we believe it is important for any legislative action taken by the UK government or regulators to recognise the key requirement for the UK to remain competitive in a global environment.

4. We would be happy to provide further information in support of our evidence and to provide oral evidence at subsequent hearings if the Committee would find this helpful.

Summary of our Views

5. We believe that the audit market is an effective and competitive market. Since 2002, the auditing profession has made a significant number of changes to improve audit quality and to provide greater transparency around their own internal governance, partly in response to the recommendations by the FRC’s Market Participants Group in 2007. Some of these recommendations have only just been implemented and it is therefore too early to assess whether they have been effective in implementing both supply-side and demand-side measures to increase confidence in the profession. We believe that these initiatives should be monitored and their impact assessed before any further action is taken.

6. More immediately, action could be taken to make the audit process more transparent through better communication of the dialogue between audit committees and external auditors; and through more regular dialogue with stakeholders and regulators. At the same time we would welcome a wider debate about corporate reporting, focusing on a more integrated model that provides a more coherent, and less complex, picture of a company’s performance and exposure to risk. Any such debate should include a discussion of the role that independent assurance can play in enhancing public confidence in the reporting model.

The Impact of Concentration in the Audit Market

7. The introduction to the “Call for Evidence” states that “audit is dominated globally by the Big Four”. This situation was created primarily by a process of consolidation during the latter part of the 20th century which reflected the needs of capital markets in both geographical spread and complexity, leading to the creation of five large global networks in 1998, subsequently reduced to four with the demise of Arthur Andersen. These mergers arose in response to market demands for audit firms with the necessary networks, people, methodologies and reputation to deliver quality audits for the largest multinational corporations.

8. In the context of the UK audit market, the concentration of audit appointments on the four largest firms is only true for the audits of companies listed on the main board of the London Stock Exchange. Below this level there is a wider range of firms supplying audits. For example, in February 2010 56.6% of the audit of companies quoted on the Alternative Investment Market (AIM) were audited by firms other than the largest four firms. For this sector and for unlisted companies, the audit market remains highly fragmented.

9. The European Commission acknowledged the importance of size when it determined that:

“audit and accounting services to quoted and large companies form part of a separate product market: the necessity for such companies to have audit and accounting services provided by a firm with the necessary reputation in the financial markets (in the case of quoted companies), the geographic breadth to cover the companies’ needs worldwide (in the case of multinationals), the depth of expertise in the particular sector (large companies in general and, in particular, regulated sectors such as banking and insurance) and significant resources (all large companies) … All these features are only provided by one of the large global audit and accounting networks”.

10. The relationship between audit quality and the relative size of the audit firm is acknowledged by the Audit Inspection Unit of the Financial Reporting Council which stated that:

“The AIU continues to find that a higher proportion of audits conducted by smaller firms require significant improvement.”

11. We are aware that some commentators are concerned that the practical restriction, at least in the short term, of a segment of the audit [and accounting] services market to four rival suppliers, may mean that the intensity of competition is reduced; and that, if this was indeed the case, it might result in outcomes inferior to those that would be expected in an effectively competitive market—lower efficiency, higher prices, less innovation and reduced quality.

12. We believe that these concerns are without foundation. There is intense competition between the four largest audit firms to win and retain the audits of large companies and these appointments are subject to independent governance. Such competition ensures that PwC and its competitors have every incentive to offer the quality global audits demanded by the large corporate clients, to be efficient and innovative, and to pass on the benefits to clients through the lowest possible prices. Delivering value to our clients whilst ensuring we do not compromise on the quality of our audits is the key priority of our own assurance business.

13. Critically, the reason why having four large firms competing for the supply of audits to the largest UK companies is sufficient to engender fierce competition is that the UK audit market is a “bidding” market. When choosing an auditor, large companies use a competitive tender process. It is recognised by economists and competition authorities that bidding markets have different characteristics from other markets, leading to intense competition even where there are relatively few suppliers.

14. In its investigations of the audit market when considering the merger of Deloitte & Touche and Andersen (UK), and earlier the merger of Price Waterhouse and Coopers & Lybrand, the European Commission acknowledged the bidding nature of the audit market and how this imposed competitive constraints on the audit firms. In particular, it noted that:

“launching an invitation to tenders imposes a competitive constraint on the incumbent auditor, often leading to a re-negotiation of the fees” and that “any of the Big Five could possibly win or loose (sic) a competitive tender, without any clear link towards its existing market shares”.

19 Case No COMP/M.2810—Deloitte & Touche/Andersen UK, Merger Procedure Article 6(1)(b) Decision, Commission of the European Communities, 1 July 2002.
21 See 1 above.
23 Deloitte & Touche/Andersen UK, see footnote 1.
15. Because of the expense involved in the tendering process itself, as well as the dislocation, cost and quality risk involved in bringing in a new auditor, large companies do not choose to put their audit out to tender very frequently. There are other mechanisms for companies to ensure price competitiveness. For example, we are aware of situations where clients have used the statutory requirement for auditors to be reappointed annually as a tool in negotiations over the level of fees.

16. Furthermore, since the typical length of an auditor-client relationship can extend over many years, the incumbent auditor is aware that its competitors would make a serious investment in attempting to win over its client for what would be a long-term relationship. Competitive pressures are thus brought to bear on auditors, without the need for frequent costly tender processes which would themselves raise the costs of both the audit firms and their clients, without necessarily improving the quality of the audits provided.

17. That there has been no new entry since the five large firms became four is itself indicative that competition in the market is working successfully for the large company audit clients, and that the market is not sufficiently attractive to other potential suppliers of large audits in terms of the investment-risk-reward payoff to encourage investment. This is an indication that the market is working effectively, and that prices are not excessive in relation to the costs and risk of supply.

18. This pressure on prices leads to a need to ensure efficiency in the provision of audits. This in turn has to be balanced with the regulatory focus on the continuous improvement in audit quality. This was recognised in the AIU’s 2010 public report on PwC24 which stated:

“The firm’s strategy includes quality as one of its main priorities. The leadership of the firm and audit practice continues to focus on initiatives to improve or maintain audit quality, whilst also aiming to achieve efficiencies on audits. Although there is no evidence to suggest that this has detracted from the focus on audit quality, continued care is needed to ensure the emphasis on efficiency does not adversely affect audit quality.”

19. Following the collapse of Arthur Andersen in 2002, there have been a number of significant regulatory initiatives to improve the quality of audits, including the independent monitoring of auditors of public interest entities by the AIU and the development of rigorous ethical standards to ensure that auditors remain objective in their relationships with their clients. Further regulatory initiatives have addressed the need to provide additional transparency around the governance of audit firms, culminating in the adoption in the UK of an audit firm governance code25 which incorporates the appointment of independent non-executives by the eight largest audit firms.

20. These initiatives are relatively new and it is too early to demonstrate how effective they are in developing market confidence in, and thus enhancing the competitiveness of, the next tier of audit firms. We believe that it would be helpful to monitor the implementation of these initiatives and to assess their impact before any further action is taken.

THE ROLE OF THE AUDITOR DURING THE FINANCIAL CRISIS AND POTENTIAL AREAS FOR FUTURE DEVELOPMENT

21. Following the financial crisis, all participants in the capital markets have a responsibility to reflect on the causes of the crisis and to examine the potential for changes in the way the markets operate in future. In this context, the role of the auditors was addressed by the House of Commons Treasury Select Committee26 which stated:

“We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after receiving unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is.”

22. In response to this challenge, we are taking steps towards changing the role and responsibilities of auditors. [For example, we have committed to a closer working relationship with the banking supervisors and are actively participating in a number of other initiatives in conjunction with the FRC and the UK professional accounting bodies].

23. More recently, there has been a suggestion by the FSA and FRC in a joint discussion paper27 that auditors may have been insufficiently sceptical in their audits of banks in the run-up to the crisis. We do not accept this assertion.

24. Professional scepticism is fundamental to what auditors do. It is defined in auditing standards as “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.” Whilst practical application of this requirement is judgemental and will vary according to circumstance, it is hard to evidence. Scepticism is inevitably applied in real time and is a cultural and behavioural issue. To reinforce the culture of scepticism, we have a robust system of internal quality control reviews and consultation procedures. We believe that this is working. It is our experience that, in the vast majority of cases, audits give rise to changes in the financial statements prior to issuance.

25. It is the job of the auditor, as established by internationally agreed auditing standards, to challenge management’s assertions and ensure that they are backed with evidence that is appropriate, supportable and capable of independent verification. It is not the auditor’s job to develop alternative views and then try to persuade management to adopt them in preference to theirs.

26. As indicated above, however, the recent financial crisis has raised questions about the role of the auditor, particularly in the context of the audit of banks. We are already taking steps to address these questions. In the context of banks, we recognise that more regular bilateral and trilateral meetings with the supervisors of our audit clients will enhance both the supervisory and audit processes by encouraging greater dialogue and information sharing by all parties. We were active participants in the development of the proposals set out in the ICAEW Financial Services Faculty report which also addressed the need for improved risk reporting by banks and the potential for increasing the level of assurance over these disclosures. We will continue to participate in developing more specific proposals in these areas in conjunction with other stakeholders.

27. More generally, we recognise that there is a need for significant improvements in corporate reporting and consequential changes in the role of the auditor. As a first step, we recognise that how auditors currently discharge their professional responsibilities is often opaque. To ensure investor confidence in company’s financial statements we believe that it is essential that the audit process is made more transparent, One way to achieve this would be for audit committees to disclose more details about the dialogue between them and the external auditors. At the same time, there should be a wide-ranging public debate about the future of corporate reporting to identify ways in which the reporting model can be more integrated and less complex. This debate should include all stakeholders, including investors, government and regulators, and should incorporate a discussion of the role that independent assurance can play in enhancing public confidence in the reporting model.

28. The UK audit profession has operated for many years largely through the medium of multi-disciplinary practices providing a range of taxation, advisory and consulting services in addition to assurance services. It is important to recognise, however, that the growth of these other services is not dependent on the provision of non-audit services to audit clients.

29. Where non-audit services are provided to audit clients, there is an effective principles-based ethics regime requiring the analysis of the threats to objectivity and the application of appropriate safeguards. This has worked effectively both in the UK and elsewhere in the world. This regime recognises that there are circumstances where no safeguard can be established, resulting in strict prohibitions.

30. The effectiveness of this regime, combined with the key oversight role played by audit committees in considering and determining the appropriateness of the appointment to provide non-audit services, has been an important factor in increasing the level of independent scrutiny and thus increasing confidence in the regime. It was notable that very few respondents to the October 2009 consultation on the topic by the Auditing Practices Board identified significant concerns about the effectiveness of the current system.

31. An analysis of the annual reports of major listed companies indicates that there has been a significant reduction in the proportion of non-audit fees to audit fees in recent years. At the same time, audit firms have recorded significant growth in revenues from services to clients where they are not the auditor, illustrating that this growth has not been generated from their audit client base. Consequently, we do not believe that the continued growth of multi-disciplinary firms represents a conflict of interest with, or a threat to the objectivity of, the audit services provided by the same firms.

28 International Statement of Auditing (ISA) 200, para 13(1).
32. In contrast, we believe that the ability of auditors to operate within the framework of multi-disciplinary practices is important for the following reasons:

(a) A profitable growing firm is in a better position to invest in the continuous improvements in audit quality necessary to allow it to respond to the increasing demands of business, shareholders and regulators.

(b) The existence of a range of skills and breadth of experience within an audit firm allows for greater insight into market issues and can significantly augment audit quality, particularly in the audit of complex business transactions. This was acknowledged by the AIU in their 2009–10 Annual Report which stated\(^{31}\):

“The increasing use of internal specialists, especially by the major firms, to evaluate valuations performed by client specialists and to assist in the audit of other complex audit areas such as taxation and pension balances contributes to improving the quality of audit evidence obtained in these areas.”

(c) Multi-disciplinary practices have a significantly enhanced ability to recruit and retain the highest quality professionals. A working environment where employees have the ability to learn and develop skills beyond audit and accounting is more attractive to recruits.

(d) Secondment opportunities to work in specialist areas, such as valuation and business recovery services, provide auditors with new skills and they return to audit better equipped to challenge management and to apply the level of professional judgement necessary in today’s complex financial reporting environment.

(e) Profitable, growing multi-disciplinary firms are less dependent on the fees from any one individual audit client. As a result they are better able to deal in an objective and unbiased way with potential conflict with management over issues that arise in the course of the audit.

(f) The co-location of other professional services with a regulated audit business ensures that the culture of objectivity and professionalism pervades all of the firm’s activities.

THE RELATIONSHIP BETWEEN SOUND CORPORATE GOVERNANCE AND THE EXTERNAL AUDIT FUNCTION

33. The key organs of corporate governance are the board of directors and the audit committee which set the tone for the organisation as a whole. As such, their relationship with the external audit function is important to ensure public confidence in UK companies. Internal audit is intentionally an internal function of a company which is established to respond to the needs of management.

34. Audit committees have a vital role to play in promoting sound corporate governance and in challenging management. There is already provision for dialogue between the audit committee and the external auditor but we recognise that external investors would welcome greater insight into the nature of that dialogue. Audit committee reports to investors currently focus primarily on procedural issues but they could be expanded to address the significant issues raised by the auditor in their report to the audit committee. This could embrace the significant risks of material misstatement in the financial statements, alternative accounting treatments and the principal matters of judgement discussed with the audit committee and would provide stakeholders with greater insight into the external audit function and the way in which the audit committee is discharging its role.

24 September 2010

Turning to the financial crisis, a topic you've been addressing, I do believe that auditors performed well in the highly complex circumstances of the financial crisis. We did draw the attention of regulators and Government to going-concern issues on high impact clients but there are important learnings and we particularly support the positive steps being taken by the Bank of England in respect of banks and other financial institutions in going back to what is described as the 1990s approach of trilateral meetings between supervisors, clients and auditors. All of our firms are actively involved in trying to deliver that change.

We do support the current relook at accounting standards relating to the timing of loss recognition. A final point; I do think the focus on non-audit services is somewhat misguided. I believe there are very tough safeguards in place already. This is evidenced by the most recent consultation paper put out by the Auditing Practices Board, which did not show that, in the last year, there were management consulting fees paid to the Big Four by FTSE 100 audit clients. Where non-audit fees are paid, typically these are for audit-related pieces of work such as half-year reviews and independent opinions on financial information, again particularly in investment circulars. Thank you.

Q236 The Chairman: Thank you very much. We'll be covering all of these issues and I should say, of course, that we've all read the written evidence that you've given to us for which we thank you very much indeed. That's been very helpful. Can I start with the first question. It's been clear from a lot of the evidence that we've received that there is a great deal of concern about the present audit concentration in the Big Four and particularly, of course, if you look at the FTSE 100 or the FTSE 250, nearly almost all the audits in the FTSE 100 are now carried out by the Big Four by FTSE 100 audit clients. Where non-audit fees are paid, typically these are for audit-related pieces of work such as half-year reviews and independent opinions on financial information, again particularly in investment circulars. Thank you.

Mr Connolly: I'm not sure “happy” is quite the right word. It is the way it is. I know you've had a lot of evidence that it was eight, then it was six and then it became four. I think it's fair to say that concentration is the natural order of events in our industry. It's a very technical industry. There are many other industries in the world where you get maybe not four but a limited number of players who play at the top of the league and then quite a diaspora underneath them. I think the natural tendencies to
globalisation, the skill set required and the amount of investment required to keep the audit process up to date and a sort of magnet like approach to getting the best people to come and work for us naturally reinforces the arrangements, which is why we need a regulator to prevent it getting any more concentrated than it is at the moment. I wouldn’t say it was a good thing and if you ask us whether we would prefer that there were six and we didn’t have to sit here answering this question, I think we’d all be very happy to be in that position.

Mr Powell: It’s worth adding to that as well that the concentration that’s there is the result of market choice. I think that it is a very complex product and I think the market does look at the scale and reach of the services that it needs, so as our clients have become more global, as they become more multinational, they look for that sort of degree of coverage from the audit firms that service them. I think when you start to look at the level of investment that’s required across the world, I guess it is understandable that it has come down to a relatively few firms that can afford that level of investment. Just to give you an example, at PwC, our new audit approach has cost something like $400 million to roll out across the world. The UK share of that is about £40 million. So to be able to service clients that are very complex, that cover so many different territories, with real quality—and that is the ultimate focus of everything that we do, the quality of the audit—then I think you do need this sort of scale of operation to be able to make that investment.

Mr Halliday: If I could just add from a competition standpoint, there’s a great deal of competition. I think the question is, is there enough choice in the market. I would argue that the profession would improve itself by having increased choice in the market and I think there are some things that this Committee is considering that could help that. For example, removing the only Big Four clause from any banking agreements would be a positive step. I think also encouraging audit committees to really step back and take a look at the complexity of the audit that they need to have executed by the firm and challenge themselves whether a second tier firm could really be well positioned to execute that audit versus one of the Big Four firms. Part of the solution also has to be for the second tier firms to really rise up and continue to invest to build the global network that the four of us are privileged to be a part of. With the Big Four firms, they need to continue to invest and scale up their business globally. 80% of the FTSE 100’s revenues are earned outside of the UK and, therefore, their desire is to really have a firm that can serve them around the world.

Mr Connolly: If I can add one small point to the obvious question of whether another firm could emerge as a competitor, there’s no doubt that it won’t happen quickly but in the case of my own firm, if I go back just 15 years, my own firm had 4% of the FTSE 100 audits and now we have over 20%.

Q237 The Chairman: I was going to ask you about that. I think it is 22%, from what you said in your evidence. How were you able to bring that about?

Mr Connolly: First of all, a small amount, but only a small amount, relates to the action we took when Arthur Andersen imploded around the world and we did hire in this country, and in a number of other countries, but in this country, we didn’t buy the business but we hired all of the partners and all of the staff. That did facilitate some of the clients, not all of the clients, that they’d had previously, joining us. That added four or five FTSE 100 clients to the roster we had. Mostly, it has been about significant investment every time an opportunity has arisen to compete for a new client and having some success in doing that.

Q238 The Chairman: So would it be fair to say, if content is not the right word, you do share the general unease about the fact that it could be four coming down to three?

Mr Connolly: No, I don’t share that. I would be uneasy about it going down to three; I don’t see that is on the horizon at all.

Q239 Lord Tugendhat: Perhaps I may ask a supplementary before the main question. You are only four, as we’ve just been saying, and you are fulfilling an absolutely vital function. I just wondered whether you would regard your relationship with your clients as being much the same as any other commercial relationship between a buyer and a seller or whether you would feel that because of the nature of the service you’re providing and the very small number of people providing it at your level, that this is something in the nature of a public good from which benefits and dis-benefits flow to all citizens; not just your clients but the whole investment community; anybody who buys stocks and shares however small. Would you regard your service as a public good that should be judged on that basis?

Mr Connolly: Certainly the relationship is different for the reasons you’ve outlined. The stakeholder community is very wide. Conventionally, if you have a customer and supplier relationship, then there’s a narrowness about who the customer is and who you’re acting for, whereas in the case of audit, we have to recognise that, first of all, the primary client is not the management who might hire you but is the investor, the owners of the company. But we also have to recognise that the relevant interested parties are very wide indeed. Speaking for my firm, and I’ve no doubt this would apply to each of my colleagues here,
we believe that our responsibilities go well beyond serving just the team of people who might hire us when we talk about the client.

Q240 Lord Tugendhat: Thank you. Then to come to my own question; the ABI wrote, and I do emphasise it was the ABI in 2006, “We are not comfortable with a position where large firms could determine the shape of regulation by threatening to withdraw from the audit market”. Obviously they feel that you do threaten, or you did threaten, to withdraw from the audit market. Do you regard that, first of all, as a reasonable assessment and secondly, would you agree that since you are only four, any threat to withdraw could be said to be an abuse of a statutorily privileged position?

Mr Powell: Certainly from PwC’s perspective, we see audit absolutely at the heart of our brand. We see it as fundamental to what we do. We have no intention of withdrawing from the audit market. We see the investment we make and the people that we recruit, the development of the procedures and systems that we have, are all really designed to get better and better quality of our audits into the future. So we don’t see it as a threat from a PwC perspective.

Mr Griffith-Jones: It would be highly irresponsible to threaten it if we didn’t mean to go; of that there is no doubt in my mind. Ultimately, if the job became impossible to do and we really were going, I suppose we have a duty to tell people we’re going, but we have no such duty and while I don’t know what the ABI reference was to, certainly my firm, as far as I am aware, has never played chicken with the ABI, or indeed for that matter, anybody else about leaving the audit.

Q241 Lord Tugendhat: Can I just come back to Mr Powell’s answer? You said audit is absolutely central to what you do. I wonder if you could just give me your descriptor, as it were. I notice in The Financial Times on 15 November, they were reporting some of your activities and they describe PwC as the “professional services firm”. Is that the way in which you would describe yourselves?

Mr Powell: We would, yes. We offer a wide range of services to our clients, but right at the heart of the brand—and really the brand has been built on a high quality audit practice for the last 160 years effectively—as an organisation, while we believe it is important to invest in other areas of the business, we also see audit as absolutely fundamental to what we do.

Mr Halliday: Can I just add from Ernst & Young’s standpoint, we are deeply committed to the audit market share. We would have no intention to exit it and it defines our brand around the world. It is what we are at our core.

Following up on your question about the relationship, it is very different. One of the cornerstones of our profession is that we maintain an independence from our clients both in fact and in perception and also that we ensure we maintain a healthy degree of professional scepticism as we go about executing our audit work. I do think the relationship is very different from a typical vendor/customer relationship.

Mr Connolly: Can I just confirm for the record that Deloitte has never threatened to withdraw from the audit market, so I don’t know what is being referred to in the remarks that were made.

The Chairman: Please don’t feel that you need to reply to every question, Lord Smith.

Q242 Lord Smith of Clifton: How competitive can the large company audit market really be when it is so highly concentrated and tendering and switching rates are so very low?

Mr Powell: Just to kick off on that one; fiercely competitive. Every audit that comes up for tender, I think my competitors would also agree, is ferociously fought. I think that the costs of a major audit tender are significant for all of us and I think that the evidence of this is that although there’s only four of us in this marketplace, any marketplace that you are in a bidding situation, a bidding environment, the audit is a tender. So where you have at least two people starting to bid against each other, I think you are going to get a ferociously competitive situation. Certainly if you look at the pricing of audits over recent years, if you look at the competition that there is between certainly the Big Four firms on every audit tender, it is significant.

The only other thing I would add on this as well is that really the appointment of auditors is undertaken on an annual basis and so, at the end of every year when the audit is reviewed, it is the role of the audit committee to look at the efficiency, the way that the audit is being done, the quality of the audit and that is a tough discussion. It’s not as though there is an automatic rollover of audit appointments at the end of every year. There is a responsibility on the audit committee to review the audit and there is an extensive debate on the quality of the audit at that point before the re-appointment.

Lord Smith of Clifton: Presumably audit committees vary in the assiduity with which they carry out their duties.

Mr Powell: I think the guidance that’s been given to audit committees by the FRC is pretty stringent. The way that the audit committees have to report in terms of their report to the AGM, their report in the annual report is well laid out and so I think there’s quite a lot of focus on the audit committee. So overall, audit committee quality is good. I’m sure it would be the...
case that different audit committees operate at different levels but broadly, the quality of audit committee debate is intense.

Q243 The Chairman: I declare an interest as a member of audit committees in the past. Is there really that ferocious a debate in most of them? It is the one item in the AGM that passes without any comment ever I think. I noticed from Oxera’s Consulting Report in 2006 that more than 70% of the FTSE 100 has not held a competitive tender in the last 15 years. That doesn’t sound like a very lively competitive tendering market.

Mr Powell: Certainly speaking to our audit partners and the discussions that are undertaken with audit committee chairs each year end, these are professional, businesslike discussions and debates. As regards the rotation of auditors or the changes in auditors, I guess that also reflects the fact that there is a cost to a company of making that kind of change. Also, there is the discussion that’s ongoing about the overall quality of the audit as they perceive it. So if a client is happy with the quality of the audit and is happy with the provision of the services, then that is the depth of the discussion in reaching the decision whether they want to go out for an audit tender or not. It is important that the audit choice is the choice of the client as to whether or not they want to go out for tender.

Q244 Lord Forsyth of Drumlean: I don't want to press you on this but just on the Chairman's point about Oxera. I must say I find it very difficult to take this argument that it's really competitive when, according to their figures, which I see you're not really disputing, the switching rates for a FTSE 100 company are every 48 years; for a FTSE 250, every 36 years and for all listed companies, every 25 years. How can you possibly argue with a 4% churn every year that that's a competitive market?

Mr Griffith-Jones: I think it’s important to understand what happens before it actually gets as far as a tender. Let us assume that there is unhappiness or relative underperformance, which is the most common cause of potential tender. We as a firm obviously would take such circumstances very seriously and basically offer to either change the team or improve the procedures or essentially to be given another year to sort ourselves out. If you look at it from the audit committee’s perspective, it seems like a logical decision to say, “Okay, let’s see: either yes or no”. Very frequently, they decide pragmatically and they decide, I hasten to add, not us. It doesn’t happen all that often, but it does, of course, happen, that they decide whether to go for a tender or for rotation. Now, you also have to bear in mind that audit partners since, I think, 2005 or 2006, have had to rotate every five years and the team under them, by natural affluxion, rotates as well. So it’s not as though the same people are doing the audit year after year.

Lord Forsyth of Drumlean: In 48 years, they’d all be dead; long since retired.

Mr Griffith-Jones: But seriously, you have a new team. From the public good angle, you have a new team looking at the audit on a rotation basis every five years without changing firm and given the loss of corporate knowledge by changing, and you weigh up the respective advantage and disadvantage of that, I can only tell you that is my perception of why it is the clients that decide to keep us because it’s certainly not us who have the right, as it were, to stay there indefinitely.

Q245 Lord Hollick: I want to take up Mr Powell’s point about the cost of moving from one auditor to another. It would be interesting for the Committee to know, as a percentage of the annual audit fee, what is that cost and would it not be the case that in a truly competitive market, the incoming auditor, the winning auditor, if you like, would ease the path and sharpen their pencil to remove this problem?

Mr Powell: I would guess that it would be the cost of disruption to a company as well in terms of the need to be involved with a new team. That loss of corporate knowledge that has just been referred to would also be an additional cost. We did some work on this as a firm to try to just evaluate what the potential cost of a move could be and the estimate was between £500,000 and £1 million in terms of the disruptive cost. I think it’s fair to say that might not be substantial in the overall context but I think in terms of a cost that might not need to be incurred because people are satisfied with the quality of the work that is being done, that is something people take into account.

Mr Halliday: I would offer to the Committee a couple of thoughts on this because I think it’s an important area around audit committees. I apologise for my voice; I’m fighting off a cold. One of the things that we see in some countries around the world is that there’s a statutory reporting relationship between the external auditor and the audit committee. So it is by law clear that the audit committee is hiring the firm. I would offer that as something to think about as well as requiring that all fees paid to the external auditor are approved by the audit committee. Together with that you might consider a report that was externally issued by the audit committee that talked about the duties that are carried out in performing this important governance function. So I would offer those things for the Committee to reflect on.
Mr Connolly: Can I just add a point that I think is relevant. Increasing the rate of change in auditors, at the end of the day, is up to the companies. That, in itself, doesn’t necessarily deal with this concentration issue. There are a small number of countries in the world, not many, where there is mandatory rotation but it doesn’t lead to a change in concentration. In Italy, for example, there is mandatory rotation and the Big Four still dominate the audit market. So that, in itself, doesn’t lead to change. I think requiring audit committees formally, making it a legal requirement, for them to record and report in some detail how they arrived at the decision to appoint, reappoint or not reappoint the auditor would be helpful because that would cause the audit committee to focus explicitly and that might lead to consideration, particularly in the light of the sort of statistics you referred to.

The Chairman: We must move on because we have a lot to cover. Lord Hollick.

Q246 Lord Hollick: We’ve received a number of suggestions about how to address the concerns about the dominance of the Big Four including breakup, prohibition on consulting for audit clients, joint audits, abolition or relaxation of the statutory requirement for audits, and the appointment of advisers to board risk committees, independent of the auditor. It would be interesting to know your views on the feasibility of these measures. Do you think they would be desirable?

Mr Connolly: First of all, 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. I really don’t see that some of the other options that are referred to would be feasible. I’ll just pick on one of them and perhaps colleagues would pick on others. When we talk about the concept of breaking up the Big Four, firstly it’s a fairly artificial thing to seek to achieve but clearly, if the law said in this country that we had to divide ourselves in some way, then we would have to do that. We do have to remember that doesn’t solve the situation globally because we have big global networks and if we divided, my firm illustratively, into two, then one of the firms perhaps would have a global network and the other one wouldn’t. Now, if in fact we said, “Well, what we’ll do is you can both use the same global network”, then you ask the question, “Well, has that really achieved anything if the same firm outside of the UK is continuing to do all of the work for each of these two firms that have been broken up?” particularly recognising the comment made earlier that 80% of the business of FTSE 100 companies anyway is outside of the UK. So I really don’t see the feasibility of that.

Mr Powell: Just to add on the breakup point as well, to break up the firms would restrict the amount of investment monies that would be available in order to continuously improve the quality of the audit service and to serve increasingly complex and multi-national organisations.

Q247 The Chairman: What about the prohibition on consulting? What impact would that have; what effect?

Mr Powell: From PwC’s perspective, less than 10% of our consultancy business is spent on audit clients, so it’s a relatively small amount. Interestingly as well, this is a highly regulated and reviewed area. The AIU review this as part of their annual procedures in looking at the audit services that we’ve offered. Also there’s been quite a lot of consultation on this. I think the APB have had consultation papers out twice in 2009 and again in 2010. There was a lot of response to those consultation papers with overwhelming views that the way that things are organised at the moment is working and that the discretion that’s left with audit committees, and is left with clients and with the audit firms as well to review our relative independence in terms of the provision of those services, seems to be working.

Mr Halliday: One of the things our firm is very focused on is globalising our network. If you look at the activities that we’ve undertaken across the Americas and also across the Asia-Pacific region really to accelerate the globalisation of our firm they really had two main drivers. One is what the market was asking for, to be able to serve them on a seamless, consistent and cross-border basis, but also at the heart of it was to improve the quality of the audits that we would execute. When you think about a company that has far flung operations somewhere on the other side of the world but they’re headquartered right here in the UK, we will undertake, in this effort to globalise the firm, strengthen our processes to be able to best serve those clients around the world. That’s why the scale in size, coming back to your breakup point, is so important for the firms to be able to continue to execute high quality audits for companies that have far flung operations around the world.

Mr Griffith-Jones: Shall I deal with joint audit? I think you’ve had evidence from Mazars, but the only country really that has a major interest in joint audit is France. I think it’s important to realise that part of the reason the French had joint audit was to protect the French national auditing profession from what they regard as the Anglo Saxons and by having joint audits, they had one of the big firms and one French firm. Over time, this has condensed down. Now, if you take the CAC 40, which is the top 40 companies in France, there are five, not four. In fact, Mazars’
market share is pretty much identical to KPMG’s in France but it hasn’t led to any broadening. There was a sixth, which was called Salustro, which merged with KPMG three years ago. So joint audits, per se, don’t enhance competition. What they do question is whether they improve quality. I know the French argue that the system works, as far as they’re concerned, perfectly satisfactorily, but we have had various examples in the UK, while not necessarily joint audits in the sense of being joint at the top, but having more than one audit firm involved where fraud, and particularly fraud, has deliberately got through the cracks by playing the two firms off against each other in different jurisdictions or different year ends. I refer particularly to BCCI which was probably the most famous example, and without prejudicing my colleagues around the table, Parmalat is another example. While there is no strong evidence either way that two firms are better than one, there is some evidence that two firms can lead to a weakening of the audit relationship where someone is deliberately trying to commit fraud; not, I may say, where there’s an accidental error.

Q248 Lord Lawson of Blaby: May I follow on from what Mr Powell said? I think I heard you say that it’s only 10% of cases where you do internal audit or other consultancy type stuff for clients for whom you are the external auditor.  
Mr Powell: Yes. Not internal audit but in terms of our consulting business fee, only 10%.

Q249 Lord Lawson of Blaby: How about internal audit? What is the percentage for internal audit for external audit clients?  
Mr Powell: As a firm, we don’t outsource internal audit functions at all to audit clients.

Q250 Lord Lawson of Blaby: So, in fact, since this is so small for you, all this stuff, it wouldn’t be of any great concern for you if that were prohibited.  
Mr Powell: I think there’s a wider discussion about this as well, which is around the capacity, if you like, of firms to recruit the very best people and to develop those people as well. For example, if you are recruiting great graduates, they come to our firm because they want to gain great business experience across the whole gamut of the business. So they want to work in audit, they want to work in consultancy and over the years, as they develop their experience, because we’re a firm that can offer those of kinds of experiences, 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. I’d argue that we are better auditors because of the other services that we offer as well.

Q251 Lord Lawson of Blaby: But you don’t need to offer them to the same client; that’s the point. Of course you can offer these services. The question is whether you should offer them to the same client. As I understand it, it’s pretty small beer, the extent to which you do this and, therefore, you wouldn’t be greatly exercised if that was prohibited.  
Mr Powell: But it would be an artificial restriction if we couldn’t offer those services to all of our clients. Ultimately, it’s the client’s choice as to whether they buy those services from us or not and it is heavily regulated. It is reviewed. We review our own independence. We take this very, very seriously in terms of whether any of the work we undertake for our audit clients could ever be prejudicial to our independence. I think it is highly regulated. If our clients buy services from us, and I’m sure that you’ve seen the trends as well, generally non-audit services to audit clients over the last few years have reduced and I think that generally, our clients look to buy from their audit firms when they feel as though they can get the very, very best from their audit firms. I think if we said, “Look, we won’t sell any services to our audit firms”, that would be a restriction on the choice of clients. Also, it would prevent them from making a decision as to whether they’re buying the best services or not.  
Mr Halliday: I think one of the areas on this subject that’s being looked at is the disclosure of the non-audit services. The Auditing Practices Board is looking at improving that and adding more transparency to the nature of non-audit services.

Q252 Lord Hollick: Is there not a conflict of interest though at the heart of this because you’re providing advisory services, let us say, on taxation and tax planning, which is a major part of the professional services you supply, and then another group from your firm come along and audit the same thing? Doesn’t that present you with a real conflict of interest?  
Mr Powell: No because the independence rules are very strict on this. They’re reviewed by the audit committees; they’re reviewed by ourselves in terms of the provision of those services. We would not put ourselves into a self review situation where we had to audit a work that was undertaken by the firm in a different way. So the independence rules are very strict on this. As I say, we apply them and so we are very careful not to put ourselves into a conflict situation.  
Q253 Lord Hollick: Who would audit that work then?  
Mr Powell: The question is whether that work, as it’s done, needs to be subject to audit. It really works the other way. If we are the auditors of an organisation,
if we review, let’s say, a piece of tax planning and say, “We can’t do that piece of work because we would bring ourselves into a conflict situation”, that piece of tax work would be done by someone else. That piece of work wouldn’t be allowed by the company; it wouldn’t be allowed by the audit committee; and we wouldn’t take it anyway.

Mr Connolly: I think this is the point because there are explicit rules already in existence that fundamentally say that you cannot audit your own work and there’s then a whole range of very specific exclusions. To the point that Lord Lawson made, as a matter of fact, the APB’s recent paper, as I referred to earlier, did not show that in the last 12 months, FTSE 100 companies paid anything to their auditors for management consulting services. Where you get into some difficulty from the perspective of the companies, if you just have a blanket elimination of doing anything other than the audit, is those areas of work where the client concludes that because of the special knowledge and experience that the auditor has, there are certain things that they would have a preference for the auditor to undertake and it might be because of security, confidentiality and speed; but they can still only select things that would not cause there to be an independence issue for the auditor.

Q254 Lord Levene of Portsoken: In effect, the audits that you are doing are reports to the owners of the businesses, which are the shareholders. To what extent do you have a dialogue with large shareholders of the principal companies in the FTSE rather than just talking to the companies themselves?

Mr Griffith-Jones: At the moment, very rarely, if at all and that’s through convention and the way it is. The audit committee is taken to represent and act in the interests of the shareholders. The shareholders are not very active in coming to general meetings with our firms. We offer to meet them on a general basis. The issue of meeting on a specific client is clearly confidentiality because what they want to know is something of market advantage to themselves and clearly, unless you had all the shareholders in the room at the same time, to talk to one group of shareholders in advance of another and to give qualitative views on one’s clients would not fit comfortably into the rules in the way they are operated at the moment.

Mr Powell: It is going to be interesting under the new audit firm governance code as well because one of the requirements of the code is to facilitate the dialogue between investors and between the auditors. There’s not much guidance in the code as to the best way to do that. We’ve put together our public interest group, which is five senior people. We are working with them to decide what is the best way to try to meet that requirement of the audit firm governance code. I think there will need to be some dialogue between investors. We just need to design what the best way to do it is. This is a brand new code. It’s only just at the point of being rolled out during the current year ending 30 June 2011. As we’re working through that, that is going to be an interesting area as to how we stimulate that level of discussion between auditors and investors.

Q255 Lord Levene of Portsoken: Would you welcome the opportunity to have that dialogue?

Mr Powell: Yes, we do; very much.

Q256 The Chairman: Are there any other comments that any of you want to raise on all the different alternatives and suggestions that have been put to us and that Lord Hollick referred to?

Mr Griffith-Jones: Can I just come back, very briefly, to this question of risk committees? I think it possibly goes into the banking agenda which I suspect we may get to later. I personally believe that the auditors have an important potential role to play around the risk area and to mandate the auditors out of the loop because the risk advisers have to be, as it were, not the auditor would be a mistake; we need to be careful with the definitions that we use. I quite accept that they shouldn’t be advising but if the consequence of having a separate set of risk advisers is that the auditors do not get involved in risk, I think that would be to miss a major learning from the financial crisis and that we must be careful how we structure those rules. I also think that the chances of a risk adviser being another audit firm are by no means 100% and it’s certainly not a way of increasing competition. It may be a better way of auditing banks put forward as a solution to competition, I do not think it’s a particularly valid argument.

Mr Halliday: I was just going to offer that is a really important area for the Committee to reflect on because I think trying to better identify systemic risks that exist in different sectors is one of the learnings from this. If you look 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. I think there’s more that can be done in that area including the use of—I think they are referred to as 166 reports in this country—and more of a dialogue going both ways with auditor and the regulators. One of the things FRC has done is that next week, or the next two weeks, we’re going to be visiting with them on what are the systemic risks going into this year end reporting season. I think those are healthy discussions because all of us are going to come at from a little different place but I think if we sit down and create a dialogue to occur, we’ll have a better opportunity to identify the systemic risks that are in those sectors.
Thank you. You were just Mr Scott Halliday, Mr Ian Powell, Mr John Griffith-Jones:

Lord Tugendhat: Just coming back to the market concentration and their role: evidence if we could move a little swifter, it would be helpful. one part of our inquiry. I think on the next questions, this question because it is very much at the heart of the insurance argument has some strength. The only answer I can give is that it hasn’t created a substitutes bench in France. There’s one more but they were always there and they were there because of the way it was structured originally. So the other mid-sized firm is not on their substitutes bench any more than it is on the UK substitutes bench; at least at the top end of the market.

Lord Lipsey: Thank you. You were just referring on risk committees to the evidence given by Baroness Hogg and it led me to reflect that a few years ago, the FRC put forward a number of proposals which it said would be a market-based solution to the problems of concentration. When she appeared before us, Baroness Hogg— and I don’t like to summarise her too briefly— said that these had not worked and came up with the suggestion, for example, which you just made with regard to risk committees. My question is this. The new publication from the FRC jointly with the ICAEW, the audit firm governance code to which you also referred a minute ago, Mr Griffith-Jones, that came in in January 2010 possibly with similar sets of objectives. I wondered if there was any chance that would be any more effective than the last FRC market based solution. Mr Griffith-Jones: I sat on the body that generated the code, so I declare an interest in it as well. I think it’s an excellent idea. Mr Powell said they’ve just announced their public interest group; we’re on the cusp of announcing ours. Benefits will be felt and I would hope it would promote confidence in all the firms that adopt it. It includes the next four down the list. I do have to say that then you will have eight firms all complying with the code. So whether it will be a point of major differentiation, I can be less certain, but I think it will lead to an absolute improvement in overall quality.

Mr Halliday: The UK should take great credit for the production of the UK governance code. It’s being adopted and looked at across the globe right now. As a result of it, our global board has decided to implement the UK audit firm governance code at a global level and we are in the process of putting independent, non-executive directors on to our global governance code. Obviously one will also be domiciled here in Britain but one will be from the Americas, one from the continent of Europe and one from the Far East. It will really be consistent with the global nature of the firm in which we operate to have those independent directors up at the global level evaluating and overseeing what we’re doing. This is a huge step forward for the profession and I think the UK should take credit in driving this.

Lord Lipsey: One big advantage of this, having had the benefit, if you like, of the very first meeting of our public interest board, is the quality of people that are prepared to act on these bodies. They’re not the sort of people who would put their names to something that wasn’t likely to have real teeth and to work. The real big advantage of this is transparency because one of the big reasons for having independent non-executives, on the audit firms is also to look after the public interest as well. So as we analyse the code and as we decide the best way to apply that, working with our public interest board, one of the key areas, as we...
referred to earlier in terms of the discussions with investors, is going to be around transparency. That will be one of the big benefits.

Q259 Lord Lipsey: So just to be clear, it will deliver quality, you hope. It will deliver transparency. It is not particularly about widening choice and dealing with the widening choice issues.

Mr Powell: Only to the extent that, as the audit firms are more transparent, people can look at the way that the firms are run and make a decision as to whether they want to move to a wider choice.

Mr Halliday: If there was an Andersen moment involving one of the Big Four firms, having independent non-executive directors who could step in and assist in that situation would be very helpful.

Q260 Lord Best: It has been suggested that audit is implicitly a form of insurance, even though obviously it isn’t formally that, and we have heard the views of Professor Joshua Ronen of New York’s Stern School of Business. Do you think there is any merit in Joshua Ronen’s financial statements insurance approach? Is there anything in this?

Mr Connolly: I have to say I’m not an expert in the detail of what he has proposed but I did, in the light of this prospective question, spend some time looking at it. I am aware that this has been around for seven or eight years as an idea and that it has explicitly been examined in the US by the SEC and rejected as something that is not practical. When you look at the detail of the proposals I think one of the key features is the assertion that audit quality would be improved if the auditor was doing the work for somebody or is hired by somebody other than the company.

Again, even when you read the detail, there is a suggestion that the intensity of the auditors’ work would change. I find it very difficult to appreciate why that is a platform for the new idea. But it also is extremely costly. It introduces, again as far as I can see, a new layer of activity. It talks about each company having underwriting reviewers who would examine the entity and their control environment and the probability that there could be an accounting error. So another raft of activity would take place which would have to be paid for. The audit still has to be done, so the audit cost doesn’t change, and you then get right down to the heart of it and that is: is the insurance going to be available? Now, when we look at the insurance that is available for firms like our own in respect of audit failure, it is very, very limited indeed. 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.

A final point that I would just make, which I did find fairly odd, was that companies would pay their insurance premium as well as all of these other costs and if the auditor qualified the financial statements and then there was a failure, the insurance doesn’t pay out because the accounts were qualified. They only pay out if a mistake is made when the accounts weren’t qualified. So it just seemed to contain a lot of very impractical features to me and it does seem that experts, much more expert than me, have examined it in some detail and rejected it as being practical.

Mr Powell: I would also disagree with the statement that an audit is an insurance. I think there is quite a distinct difference between insurance and assurance and I think that audits add a lot more value to the development of businesses, and to giving assurance as regards trust in capital markets, than just underwriting a loss.

The Chairman: That is a fairly comprehensive demolition, so we can move on.

Q261 Lord Levene of Portsoken: Would you agree that by about the middle of 2007—and I am talking about the banks now—the writing was sufficiently on the wall about the global financial crisis for auditors to have sounded serious notes of caution well before their report on the 2008 year-end statements? Was this a failure of the audit and, if there are lessons learned from that, what changes are going to be made to try to avoid it in the future?

Mr Powell: Can I pick up on the last point first, which is that I think there are lessons to be learnt from this. I think everybody has lessons to learn, including us as auditors. One of the key elements for me is, when you look back at the Banking Act 1987, there was real encouragement at the time for a dialogue between regulators and auditors. That seems to have slipped away with the FSMA Act and we referred to it a little bit earlier in terms of the discussion that is ongoing with the Bank of England and the regulators as to how we can rebuild that communication between auditors and regulators to try to make sure that there is a sharing of information as we come into more difficult times.

Q262 Lord Lawson of Blaby: If I may come in on that particular point that you raised—I was the author, as you know, of the 1987 Banking Act and the provision for there to be a regular dialogue between auditors and regulators was something that I attached enormous importance to. To begin with, that happened. But, as you say, it slipped away; it stopped happening. Can you explain why?

Mr Powell: It didn’t transfer across as compulsory into FSMA.

Lord Lawson of Blaby: No, it stopped happening.
Mr Powell: I think you would be reassured by the discussion that we had with the Bank of England, with the other regulators. There is a working party on this between the six big audit firms and the regulators at the moment to see how we can develop that and get that back into being an automatic part of the relationship between regulators and auditors.

Q263 Lord Lawson of Blaby: May I pursue this further, Chairman? I was slightly surprised. In his opening statement, presumably on behalf of all of you, Mr Connolly explicitly said—and I think I took this down right; if I didn’t I’m sure he’ll correct me—that, so far as the question of auditing the banks is concerned, the auditors performed well. That seems to me to be extraordinarily self-satisfied in the light of what we now know to be the case. How do you justify that statement?

Mr Connolly: First of all, let me say I wasn’t representing my colleagues when I made that statement.

Lord Lawson of Blaby: All right. On behalf of yourself then.

Mr Connolly: So on behalf of myself—

Lord Lawson of Blaby: You would know about it because you were the auditor of the Royal Bank of Scotland Group, weren’t you?

Mr Connolly: That’s right.

Lord Lawson of Blaby: Which went belly-up within a few months of your giving it a clean bill of health.

Mr Connolly: Yes. Well, of course, it didn’t go belly-up. It was supported and that’s—

Lord Lawson of Blaby: No, it went belly-up. That’s why it was supported.

Mr Connolly: There is a difference. No, there is a very important difference. But, first of all, in terms, the question that Lord Levene asked and which you are pushing back on now is, “Was there a failure of audit?”, and I don’t think there was. I think that the environment was such that the complexity of the financial environment at that time caused there to be a hugely intensive effort from auditors, recognising the onerous nature of their role. As a consequence of that, we dealt with very significant complex audits and had very important decisions to make around our audits.

I think that it’s relevant to note that the independent inspectors who look at the work of auditors have generally found, from their reviews of all of the firms, that the bank audits were of a high quality. That is what they reported. In no case has there been a requirement to restate the financial statements, which would have been required if the financial statements had been incorrect. On the point you’re making about “Did it go belly-up?”, one of the vitally important issues we all faced was how we dealt with the going concern question.

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. The management of the banks, first of all, who make the initial decision as to whether they conclude they are still a going concern, had to take into account all circumstances, including the likely availability of support, in concluding that they were a going concern. We had to take into account all the available evidence in reaching that conclusion. I think it was a proper and appropriate act from the four firms to seek to understand the likelihood of support being forthcoming and I can only say that had we concluded—and I assume had management of the banks concluded—that there was not going to be support, then a different audit opinion would have been given.

Q264 Lord Lawson of Blaby: I find that absolutely astonishing.

The Chairman: So do I.

Lord Lawson of Blaby: Absolutely astonishing. It seems to me that you’re saying that you noticed that they were on very thin ice but you were completely relaxed about it because you knew that there would be support; in other words the taxpayer would support them, so there was no problem. That’s what it seems to me you just said.

Mr Connolly: No, not at all. What we were aware of, very aware of, was that the consequences of reaching a conclusion—had that been the proper conclusion to reach—that a bank was going to go—

Lord Lawson of Blaby: Belly-up.

Mr Connolly: Belly-up, to use your term. The impact that that could have had was huge. The requirement of the auditor is to satisfy itself—the requirement first of all starts with management—that that will not occur; however it might not occur, that that will not occur.

Q265 The Chairman: But I think you said at one point, “likelihood of support”, and then at another point, “availability of support”. What conversations did you have with Government to enable you to come to that conclusion; that it was likely to happen?

Mr Connolly: We had conversations that sought to understand the likelihood of support being forthcoming.

Lord Lawson of Blaby: At what point?

Mr Connolly: I believe the initial meetings we had were—was it December?

Mr Griffith-Jones: December 2008.

Mr Connolly: December 2008 and later again in January.
Q266 Lord Forsyth of Drumlean: Are you saying that, looking at the position, you thought that the bank was likely to be in trouble but you couldn’t possibly say that because that might precipitate the crisis and, therefore, by giving assurance you took the view that the accounts were okay?

Mr Connolly: I think it would be wrong to say we couldn’t possibly say it if it had to be said.

Mr Powell: I think, just in general terms on this—personally I wasn’t at that meeting although my firm was represented—the reason that banks got into real difficulty was the closure of the wholesale markets, and the closure of the wholesale markets in the second half of 2007 created real difficulty for many banks. As the auditors, one of the things that we have to do is look forward—and it’s the same whether it’s a bank or whether it’s any other type of firm—at the liquidity that is available. One of the key questions around the banks in signing off the audit opinions at the year-end 31 December 2007 was, “Is there adequate liquidity available to this bank to enable us to form the view that the bank is a going concern and we can sign off a going-concern audit opinion?”

The discussions that have been referred to were around, “Is there adequate liquidity or is there likely to be liquidity provided to these banks to survive?” That was the depth of the discussions, as I understand it, in 2008. Based on the assessment that we took as the four large audit firms, and based on the assessment of the availability of that liquidity, we then had to go away and our auditor partners had to form a view as to whether or not we could sign off a clean going-concern opinion on those facts. That is the process that we went through to enable us to form that opinion.

Q267 Lord Lawson of Blaby: But the question of liquidity in the wholesale market and so on was only one of the elements. It wasn’t the only element. There was also extremely risky business being undertaken which was a threat to solvency. They were not insolvent at that time but there was a threat to solvency there and that is clear. So I am still astonished. I am still not clear, first of all, whether you thought that, as Mr Connolly says, it was perfectly all right because there would be a bail-out or whether you didn’t notice there was anything wrong or whether you did notice something wrong but you thought you shouldn’t say anything to the regulators. As far as I can make out you didn’t say anything to the regulators at that time.

Mr Powell: No. Can I just talk you through the Northern Rock situation?

Lord Lawson of Blaby: Yes.

Mr Powell: Just a little bit of history on Northern Rock: we signed off the audit opinion on Northern Rock, which was for the year ended 31 December 2006 on 25 February 2007. At that point the wholesale markets were open. Commercial paper in Northern Rock was heavily oversubscribed. As the year went on, I think one of the early signs in this was when BNP Paribas, I think it was, issued a statement that there were liquidity issues. That was on about 9 August 2007.

Now, in the early part of September 2007 we spent time with Northern Rock and we formed the view that there was something that we needed to report to the FSA. So our contact with the FSA was on 11 September 2007 when we called the FSA to say that we had concerns about the going concern of Northern Rock. That was followed up by a letter and then quickly followed up by meetings with the FSA. So I think it is wrong to say that we didn’t say anything to the regulator. I know that is just the Northern Rock example. I can’t speak for what—

Q268 Lord Lawson of Blaby: You say you did that with Northern Rock. What did the FSA do when you did that?

Mr Powell: Well, we reported it to the FSA. I think the Bank of England were involved as well at that point and so Northern Rock asked for emergency support from the Bank of England on 13 September 2007 and were granted that.

Q269 Lord Lawson of Blaby: So it was at the last minute. Since we’re talking about specific banks, may I ask a question? It’s very dangerous to ask a question to which you don’t already know the answer, so I am laying myself wide open, but did any of your four great companies audit either Allied Irish Banks or the Bank of Ireland?

Mr Powell: I’m not sure. I’d have to get back to you on that one. We didn’t audit Allied Irish but I don’t know whether we audited Bank of Ireland.

Lord Lawson of Blaby: So you don’t know?

Mr Powell: Well, it would have been audited—

Lord Lawson of Blaby: Your colleagues don’t know whether they did?

Mr Powell: I know we didn’t.

Mr Halliday: I know they’re not us.

Mr Powell: Which would tend to imply it was probably us.

Q270 Lord Lawson of Blaby: Yes. That sounds circumstantial, yes. So did you notice anything wrong?

Mr Powell: I can’t speak on Bank of Ireland, to be perfectly honest. I mean, whether that was one of our audits or it was audited by our Irish firm as well, as opposed to the UK firm—
Q271 Lord Lawson of Blaby: Your Irish firm is wholly owned, isn’t it?
Mr Powell: No, it’s not wholly owned.
Lord Lawson of Blaby: It’s wholly separate, is it?
Mr Powell: Well, the structure of an organisation like PwC is a series of network firms—local partnerships. But I can look into the Bank of Ireland situation if you would like a written response on that to give you more detail on it.
Lord Lawson of Blaby: I think it would be of some interest, yes.
Mr Powell: Okay.

Q272 Lord Tugendhat: I was going to ask the Irish question but that’s been asked, so I shall ask a different question. The situations that arose at the Royal Bank of Scotland and HBOS, for that matter, and Northern Rock were all, at the time that they arose, unprecedented. Nothing like it had been seen in the professional lives of the people concerned. If I might ask you this: do you feel that at the top of your own firms you were sufficiently abreast of the potential dangers at RBS, at HBOS and at Northern Rock or was this information of a very unusual nature kept too close within the audit teams responsible for those banks?
Mr Connolly: Speaking in my case, I have a reasonable degree of confidence that knowledge that was possessed by those undertaking the audits would not have been retained with those partners who were undertaking the audit, primarily because there was an awareness of the significance of the complexity of the market—in our case, particularly recognising that the lead partner responsible for the Royal Bank was one of our most senior partners in the top leadership team.

Q273 Lord Tugendhat: In the case of HBOS and Northern Rock?
Mr Griffith-Jones: Certainly in our firm—and I am aware of this—there were very intensive and weekly telephone calls between the senior bank auditors over the 2007 year-end. So I think we were completely aware of what was going on in the world but, like most other people in the world, didn’t appreciate what was going to happen, especially to Lehman Brothers, in September 2008.

Q274 Lord Forsyth of Drumlean: Just on that point, can I ask a question? I have asked it a number of times during the course of this inquiry. I don’t understand; seeing balance sheets being so extended, seeing the kind of growth that there was at Northern Rock, seeing the multiples that were being lent—why would that not sound alarm bells among the auditors at an earlier stage and some questions about “Is it really sensible to be lending 39 or 40 times?” or whatever the number was? Why did that not happen?
Mr Griffith-Jones: With hindsight, it is, of course, a pretty good question and I’m sure people have struggled to answer it.
Lord Forsyth of Drumlean: But when we discovered the extent to which the balance sheets were extended we were all shocked.
Mr Griffith-Jones: The first point is that the auditor’s primary role is to count the score at the end of the accounting period and that they do. It is a look-back exercise. Sure, it has this obligation to look forward on a going-concern basis but not a look-forward other than that. So we are not trying to forecast next year’s profits.

Q275 The Chairman: Maybe I am getting the wrong impression but I got the feeling that you were suggesting that there was sufficient concern at the top levels of your firms and also in relation to the possible viability of support from the Government that you were raising these issues before you signed off, which suggests that you were having concerns about it being a going concern.
Mr Powell: I think that was—
Mr Griffith-Jones: That was 2008—it is rather important, that—not 2007.
Mr Powell: It was for the year ended 31/12/2007. So as we moved into 2008 we were looking at the audit opinions on those banks that had year ends of 31 December 2007. Clearly the market had moved at that point. Everybody was aware of it. At the tops of our organisations at that time, we didn’t have
hindsight either. But we were heavily involved as soon as we realised just the scale of the issues and what the issues were. Sorry, just to complete the point as well on Northern Rock—when you’re undertaking an audit you do look at the market conditions that were extant at the time of signing off of the audit. As I said earlier, the wholesale markets were open. Northern Rock was able to finance itself at that point in time. It was only the closure of the wholesale markets later in the year that really brought Northern Rock into the difficulties that it had.

Q276 Lord Levene of Portsoken: I think I may have missed something here. You said that your job primarily is to look back and report on what has happened and not look forward. But how can you give an opinion on whether it is a going concern if you’re not looking forward?

Mr Powell: Well, I think Mr Griffith-Jones did add as well that while you look at a snapshot of a balance sheet and a business at that point in time, you do have to do the look forward. We look forward at liquidity as a minimum of 12 months but if a company, for example, produces forecasts that go forward 18 months or two years, we look as far as we can into the future.

Q277 Lord Lawson of Blaby: But following on from Lord Levene’s point, Mr Connolly said that the likelihood of there being official support was a factor in his thinking. The likelihood of official support implies that, without it, it wouldn’t be a going concern. So I don’t see how you can answer Lord Levene’s point when that is a factor.

Mr Connolly: It certainly was a factor and I think the key thing to recognise is that the judgement, first of all, that the management and the directors have to make is that their organisation is going to continue for a period of at least 12 months and the auditors have to reach a similar conclusion or modify their audit opinion. The mechanisms that are going to be adopted in order to provide that confidence can be varied and, in the environment we were in, there was absolutely no doubt at all that one of the key features of giving assurance that the banks were going to continue was the likelihood of Government support.

Q278 Lord Hollick: Speaking on the going concern point, if we go back to the end of 2006, I think you said, when you did the audit for Northern Rock, in order to form a judgement about a going concern—not just the scorekeeping element of your job—you would have to form a judgement about the business model. As Lord Lawson said, Northern Rock was financed on one side by hot money and on the other side was making some fairly adventurous loans or high-risk loans. At the time did it occur to the audit team—was there any discussion within your firm or other firms—that there was a danger in this model? It goes to the heart of the going-concern judgement; frankly, as an investor that is what we hang a great deal of faith on. That is the assurance that we are looking for.

Mr Powell: It’s not the job of the auditor presently to look at the business model of a business. That is the job of management. It’s not the auditor’s job to give a view as regards the actual model that is put together.

Q279 Lord Hollick: How do you form a judgement about the going concern?

Mr Powell: I wasn’t a member of the audit team on Northern Rock but I think that the way that the audit was undertaken at the year-end was: you would look at the business model; you would look at the liquidity effect of that business model; and you would make an assessment as to whether or not the markets would support that liquidity into the business in forming your view. Our audit team did extensive work in auditing the year ending 31 December 2006 to make sure, assuming that the markets would continue as they did—and there was no evidence at that point that we were going to go into a wholesale global meltdown of the financial services sector—that that model would be sustained for the next 12-month period by the markets and by the continued rolling of the commercial paper. Then, of course, it comes down to the disclosure that goes into the accounts of Northern Rock. So we formed the view that there was adequate disclosure of the financial position of Northern Rock for the users of the accounts on Northern Rock to take a view, whether they be investors or whether they be other users of the accounts.

Q280 Lord Lipsey: I have an increasing Alice in Wonderland feeling about this discussion, quite frankly. I’m a naïve amateur in this field but I expect “going concern” to mean that a business can pay its debts as they fall due, but you meant something quite different. You meant the Government will dip its pockets and give the company the money and then it can pay its debts as they fall due and you gave an unqualified audit report on that basis. If you had said, “We are satisfied that support will be available from Government that will enable it to continue as a going concern”, of course you wouldn’t be subject to this criticism. But instead, where your duty is to report to investors the true state of the company, you were giving a statement that was deliberately designed to mislead markets and investors as to the true state of those banks.
That seems to me to be a very strange thing for an auditor to do.

Mr Powell: No. The reason that I disagree with that statement is that I think when you look at the audits at the two-year ends—so let’s look at 31 December 2006—nobody could perceive the crisis that was coming. So on the assessment that was made at that point on the availability of liquidity, you have to assume that when you’re trying to form a view as regards the going-concern nature of an organisation, it’s not just going to run completely into a brick wall at some point during the next 12 months. You make an assumption, a realistic and educated assumption, as regards the market conditions—the way the market is likely to go. So that is the year-end 31 December 2006, before the financial crisis.

Post the financial crisis the assessment that the auditors then need to make is whether or not there is going to be adequate liquidity going forward, wherever that liquidity might come from. In the audit considerations in relation to the year-end 31 December 2007, the view that we formed as auditors was that there would be adequate liquidity available to enable us to sign off the financial institutions that we were auditing at that year-end. Those were not misleading statements. They were statements that gave full disclosure and were based on an assessment of the liquidity at that point in time.

Q281 Lord Lipsey: How is that full disclosure?

Mr Powell: I think you have now gotten on to another interesting point, which is about how do we get more transparent in terms of the audit work that we undertake; in terms of the debate and the discussion that goes on behind the doors, if you like, in forming a view as regards the going-concern nature of a set of accounts, and not just publishing a binary audit report. It was pretty clear that, as we came through that year-end, the amount of time that was spent in looking at going-concern, and whether clean-audit reports could be signed as regards those financial institutions was absolutely intense. So the real question was—as a reader of a set of accounts at that point you would look at the audit report. You would see a binary audit report and you would not know the level and degree of challenge that had gone on behind the scenes or how the auditors had gained comfort. Maybe that is another one of the key lessons going forward: how do we improve the transparency of the debate that the auditors have undertaken in forming their going-concern view.

Q282 The Chairman: Can I just raise a point here because you know that it’s been put to us, and we’re very interested in this, that going forward auditors should have more dialogue with the Bank of England in its regulatory role. In fact we had a discussion with the Governor about this particular point last week. If this does go forward—and one can see very much the advantages from the bank’s point of view and from the global knowledge and so on and impending problems—what problems does that create for you as an auditor, because you will sometimes be talking to the bank about issues, issues that we have already discussed this afternoon, that do cause worries about going concern and that’s a dialogue with the banks that the investors are not aware of?

Mr Halliday: That’s why the Bank of England has formed this committee—to look at the competition laws and make sure we’re not afoot of any of the competition laws and also to begin to think through some protocols because I think we need to have an open, transparent discussion with our bank clients around how this will operate and get those things on the table and get some protocols laid out up front. Mr Powell: So the working group on this is ongoing at the moment to try and help us work through the thought process as to what conversations we can have; how do we satisfy client confidentiality, for example. That is the remit of the working group at the moment.

Q283 The Chairman: But it includes issues about worries about going concern.

Mr Powell: It does.

Mr Griffith-Jones: I think there is no getting away from this dilemma that the banking industry is, to an extent, built on confidence. It borrows short and lends long and it always has done. Full disclosure is absolutely fine in a stable environment and everyone asks for transparency but, come a crisis, the Government of the day and the Bank of England of the day may prefer for the public not to know. With respect, it’s not our role or we’re not powerful enough, put it whichever way you want to put it, to control events in those circumstances, which is why the working party has this somewhat sensitive issue thought process as to what conversations we can have, how do we satisfy client confidentiality, for example. But would a dialogue have been useful, with hindsight? It most certainly would have.

Mr Halliday: I think it’s important that it’s two-way as well. It’s not just the firms coming to the Bank of England but it’s also the Bank of England sharing with the firms their concerns of risks as well.

The Chairman: We’ve obviously not been able, this afternoon, to spend as much time as we would like on this issue but you can see how critical it is to our thinking in relation to our report. So if you would like, on reflection, to submit another note to us about this—because I realise that there are some remarks you may have made which you would prefer to work through more carefully—that would
be very helpful. Lord Forsyth, do you want to raise one more issue on this before we move on?

Q284 Lord Forsyth of Drumlean: It’s related. We’ve heard evidence from Professor Fearney, Timothy Bush and others who suggested that the introduction of less prudent IFRS standards was a key factor in the banking crisis. The question really is: do you think IFRS accounting standards led bank auditors to a tick-box approach instead of scepticism and prudent judgement on client banks as going concerns? The argument is that under the old UK GAAP system there was a degree of prudential judgement required and that the effect of IFRS has been to mean that you could say, “Well, we’ve done the audit but we haven’t looked beyond it”; exactly the discussion we’ve had. How much has the change in accounting standards contributed to this problem?

Mr Powell: Okay. Just to kick off on this one as well, ultimately accounting reflects a business. It’s not the other way round. So whichever accounting model that you go for, it’s going to have to reflect exactly what happens. I think if you look back to UK GAAP say 10 years ago, obviously things needed to change. UK GAAP didn’t, for example, have a standard on “How do you account for derivatives?” So there were new businesses and new business models that were starting to be introduced. Then IFRS came in and the new rules were applied. I think overall IFRS probably helped in the actual recognition of some of the problems earlier than maybe they would have been recognised under UK GAAP. But IFRS is not perfect and I think it is reassuring that the standard setters are now reviewing IFRS, particularly as regards recognition of when loan impairment should be recognised.

Q285 Lord Forsyth of Drumlean: I’m sorry to interrupt you but I am interested in the specific point that IFRS introduced a box-ticking culture rather than the old requirement to take a prudential view and also, for example, it’s been suggested that IFRS meant that the banks could delay recording actual losses while booking paper profits. There are specific criticisms of the rules but the broad philosophical attack is that we’ve moved to a box-ticking practice rather than a judgement and that is what most people would expect from an audit.

Mr Powell: I don’t think that is a fair reflection of the work that is done by auditors in that IFRS is a set of standards. The application of it has a judgemental element to it as well.

Q286 The Chairman: So you say that they’re wrong?

Mr Powell: Pardon?

The Chairman: You say that that evidence is just wrong?

Mr Powell: This is obviously a pretty complex area and I think that there are some areas about IFRS that are good and that I think have helped and I think there are other areas that need review, which is exactly what the standard setters are doing at the moment.

Mr Connolly: I think you are trying to get specifically to, “Is it box-ticking?” I think it would be quite a simplification to suggest that was the case. I think at the heart of the specific issue that is now under review—and I think we would all support that review taking place and it probably will result in a change—was that for many years there was a view held that the fact that judgement could be applied to decide what kind of provisions might be required against the value of assets and you could look forward and contemplate what the ultimate value of those assets would be in doing that.

A view that was held that resulted in change was that that was too lax and, as a consequence of that, there were all sorts of suggestions, particularly in financial institutions but not just financial institutions around the world, that the inability to understand quite how that—whether that judgement was one that was very conservative or the opposite—led to failure to be able to make proper comparisons and understand the financial results more effectively. The change that came in was to say that a loss has either occurred or it has not occurred. It is not a question of “might it occur”. It is “has it occurred?” and only if the loss has occurred were you able, under IFRS, to recognise the loss. Now, if we say, “Isn’t that box-ticking?”; if that is what you mean, then that was the case; the loss had either been incurred or it hadn’t been incurred. I think it was the G20 who recommended, and there is now a review that will perhaps lead to, a move back to need to recognise losses if you expect they will occur. That definitely will require much more judgement but will be open to more latitude in terms of the exactness.

The other feature of IFRS that is more often picked upon and used as a, “Wasn’t this”—or some have even said, “Didn’t this cause the crisis”—which, I think, again, would be unfair—was those assets that had to be mark to market and there was criticism. I mean the clarity was that you had to value these assets at market value. Often the market was disrupted by the conditions and the view was held, “Well, it is the market—we accept that—but isn’t this a distorted market? So shouldn’t you be using something different?” I am advised, and I’m not an expert on banks or auditing banks, that that has been very significantly exaggerated as a feature
because the relative proportion of assets that are dealt with in that way is very low.

Q287 Lord Forsyth of Drumlean: Chairman, I'm conscious that there isn't time to do this now. I don't know whether you've had a chance to look at the evidence that came to us, but there was one piece of evidence that went through each of the banks and explained how the change in the accounting rules made the system worse. It would be very helpful to have your written comments on that—perhaps the clerk could send it—because it does seem to be a very important factor. In talking to finance directors and people outside, there does seem to be some concern that the old prudential judgement has been undermined as a result of the move to IFRS and that is purely anecdotal. But you seem to be saying that that isn't an issue.

Mr Halliday: I think one of the keys here is to get one consistent global accounting policy globally, one standard, and we believe that is IFRS—that IFRS should be applied consistently around the world. I also think it's important to step back and challenge ourselves on the heels of this Committee and say there weren't a lot of restatements or errors noted in valuation through this crisis. What can be done maybe to increase the financial reporting and the disclosures of these things? What needs to change in the financial reporting model in addition to get one globally consistent set of accounting policies?

Q288 Lord Forsyth of Drumlean: Where my question is going, to the evidence we've had, is that people were too concerned to do that—to get a global system of accounting agreed—and not concerned enough about the effect that that would have on telling people what was going on in these banks. That's the accusation.

Mr Powell: We will set out our views in writing on this as well but it's very clear, given the depth of review that is ongoing by the standard setters at the moment as regards IFRS, that maybe things did go a bit too far and took out some of the judgment that should have been in there.

The Chairman: This is clearly another area of great interest to the Committee and, therefore, I would strongly support Lord Forsyth's suggestion that you send us a written note.

Q289 Lord Lawson of Blaby: I will ask one more if we've got time on a different matter, although I think this is the key issue—this whole question of auditing the banks. Indeed my question links up with that. It is about one of the things that I introduced in the 1987 Banking Act, as part of the requirement for there to be a regular dialogue between the regulator—at that time the Bank of England and it's now going to be the Bank of England again—and the auditor. As one of you said, it should be a two-way thing but a regular dialogue. I am still puzzled and dismayed by the fact that that went into disuse. It was never repealed. It just stopped happening, to all intents and purposes. But one of the things that buttressed that was that I provided in the Act that auditors would not be liable in any way for any adverse consequences that flowed from telling the regulator that there was something wrong with this particular bank's accounts. I know that at the time the auditing firms felt they needed that protection and the Act gave them that protection. Now, are there occasions when, today, you are inhibited from saying publicly, in any qualification to the accounts or whatever it is, that you have any reservations because of the fear of litigation—that, even though you think in your heart that there ought to be a qualification, the concern for litigation, which could be extremely expensive, inhibits you? Do you think, if that is so, that there might be a case for some kind of provision which would limit the damages to which you would be subject in the event of litigation going against you?

Mr Conolly: If I could offer a view first: first of all, I do agree with your observations about the circumstances that prevailed with the Bank of England and that did enable special pieces of work to be undertaken without risk. They were specific pieces of work and that was valuable. I certainly believe that we live with the risk, in the risk environment we're in, and we develop our opinions in a way which is appropriate, recognising that that risk is there and not in any way interfered with by the level of risk we run. We recognise that we have unlimited liability but I'm very confident that at no point does the existence of that risk cause there to be an opinion other than the appropriate opinion.

In most cases, of course, I would suggest that failure to give the right opinion is more likely to lead to litigation because litigation mostly arises where a company has failed and you really don't want to be in a position where you had not given the right audit opinion in those circumstances. But to the general point—would we prefer there to be more protection?—yes, of course we would. I think also if there was more protection it would encourage, potentially, an extension of the market.

For some of the medium-sized firms at the moment, the horror of dealing with clients of a scale that could wipe the business out at a stroke if they happened to have a problem must be a barrier to entry. But even more valuable perhaps, if there was more protection then it is more likely to create an opportunity to extend the role of the auditor to report on things that we don't have to report on now.
but might be valuable. I think a dialogue around what further things could we report on that we don’t have to report on now would be very valuable. But you could only entertain those if there was a measure of protection.

Q290 Lord Lawson of Blaby: Could you let us have a note on what things you think it might be a good idea if you were able to report on that you don’t report on at the present time?
Mr Connolly: Yes, absolutely.
The Chairman: Are there any other comments on the liability question?
Mr Griffith-Jones: Only the rather obvious one that, in the matter of protecting us from going from four to three, the litigation risk is, certainly in my firm and I’m sure in all the others, the biggest risk on our risk register. Without the protection and without the insurance market it’s probably the single most likely cause of there only being three of us in front of you at another time.

Supplementary memorandum by Mr John P Connolly, Deloitte (ADT 33)

I am writing in response to your letter of 1 December 2010 following my appearance before the House of Lords Economic Affairs Committee on 23 November. I have set out below the answers to each of the questions set out in your letter. For the avoidance of doubt, my response is on behalf of Deloitte LLP and I am not speaking for the other firms who appeared at the same hearing.

Q283. Going concern judgments as part of the audit of banks before and during the crisis

The Committee asked for details as to how going concern judgments were made for the years ended 31 December 2007 and 2008. Before explaining the judgments taken for these years, it is worth looking at the definition of going concern as set out in paragraph 25 (then paragraph 23) of International Accounting Standard 1 Presentation of Financial Statements:

“When preparing financial statements, management shall make an assessment of an entity’s ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern.”

The wording used in the equivalent UK GAAP standard, FRS 18, is slightly different but this has no effect in practice.

IAS 1 refers to liquidation and cessation of trade. It is frequently the case that the companies require access to finance that is not guaranteed for a year from the date of approval from the financial statements, eg a simple manufacturing company that is dependent on annual renewal of an overdraft. The job of directors in considering whether or not there is an uncertainty as to going concern, and of auditors in auditing going concern, is to consider whether such finance will, in all probability, be available if required. For banks, the same considerations apply—banks have always lent long but borrowed short (whether through wholesale funding or deposits by retail customers)—and the requirement is therefore to consider the availability of that finance to them. This includes the likely state of the wholesale markets, retail markets and other sources of funding which would include, for example, the Bank of England’s liquidity scheme and the Treasury’s credit guarantee scheme.

In forming our opinions on financial statements, we consider not only whether to draw attention to a significant uncertainty as to going concern, but also whether the disclosure within the financial statements is appropriate. For example, if we concluded that there was concern, but not significant concern, we would not
be required by auditing standards to include an emphasis of matter in our opinion. Indeed, doing so might make a minor concern result in a run on the bank, thereby creating a self-fulfilling prophecy. We would, however, expect to see adequate disclosure of the facts and circumstances and assumptions made by directors, and to be able to see evidence to support these. If we were of the opinion that the disclosure was inadequate, or the disclosures were unreasonable, we would qualify our opinion. In considering the adequacy of disclosure, we have regard to the guidance issued by the Financial Reporting Council following consultation with all interested parties including companies, investors, auditors and the FSA. It is worth noting that the financial statements of banks for the years ended 31 December 2007 and 2008 have been subject to reviews by many organisations, including the FSA and the Financial Reporting Review Panel, and no material misstatements have been identified, nor have any been restated.

Audits for the year ended 31 December 2007

During the early months of 2008 we carried out our audits of the financial statements of our banking clients for the year ended 31 December 2007. At that time, audit teams on our banking clients considered going concern having regard to the above definition. We concluded that, based on conditions in the market at that point, 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. In addition to auditing going concern, we audited the disclosures made by such clients and, for example, the financial statements of The Royal Bank of Scotland Group plc contained extensive disclosure to the shareholders around risks including the risk of steep falls in perceived or actual asset values accompanied by severe reduction in market liquidity, dislocated markets, recent market volatility and illiquidity and the further write downs that may adversely affect the group’s future results, together with detailed numerical analysis of the liquidity position.

At this point in time, nobody (including the Bank of England, other central banks, governments, regulators, economists and analysts) had predicted the total market dislocation that would occur later in 2008; particularly the sudden and unexpected demise of Lehman Brothers on 15 September 2008 brought about within a few days a total meltdown in global liquidity for banking institutions.

We did, however, identify concerns around one of our “monoline” banking clients (those banks where the majority of their business was concentrated in narrow markets). We had discussions with the FSA as to the judgments being made by the directors and ourselves and managed to obtain sufficient evidence that the directors’ assessment of going concern was reasonable in the circumstances, supported by judgments as to what was reasonably probable, and by disclosure as to the extent of the factors taken into account and the liquidity position of the entity. Subsequently this entity was the subject of a merger and in its merged form continued to be a going concern.

Reviews for the half year ended 30 June 2008

We continued to have regard to these risks in carrying out half-yearly reviews for the period ended June 2008. For example, the half yearly report on The Royal Bank of Scotland Group plc for the first half of 2008 on which we reported drew attention to significant losses and credit market write downs, the difficult operating environment, unprecedented market conditions, the dislocated trading environment for credit markets and equities and the anticipation that the credit environment would become more challenging and that the difficult conditions in the financial markets look set to be compounded by a deteriorating economic outlook. The bank was nevertheless operating within its capital adequacy requirements.

Audits for the year ended 31 December 2008

Following the global liquidity meltdown which occurred following the demise of Lehman Brothers, the state of the banking market had changed dramatically. We recognised that forming a conclusion on going concern, and the degree of uncertainty, would be hard for the directors of the banks when they approved the financial statements for the years ended 31 December 2008. We did not soften the standards that we applied in considering going concern, because the accounting and auditing standards remained unchanged. We were, naturally, concerned that if we modified or qualified our auditors’ report on going concern grounds that this would have brought about a banking collapse within a few hours as a result of the inevitable response of speculators and depositors, and therefore felt that it was important for the government to be aware of our concerns and of the need for the directors of the banks to be able to consider carefully the evidence of potential government support, given the virtual closure of the wholesale markets. The Big 4 firms approached the government in November 2008 and asked to meet Ministers to discuss the extent to which action was being taken to support the going concern position of UK banks. A meeting took place between the CEOs of the Big 4 and Lord Myners, the then City Minister, on 16 December 2008 at which the Minister 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.

As auditors, we also considered the evidence obtained by the directors of our banking clients. This included an assessment of the recapitalisation scheme, the Bank of England’s Liquidity Scheme and the Treasury’s Credit Guarantee Scheme. Based on this evidence, the directors, and we as auditors, concluded on the majority of our clients that it was sufficiently likely that the support would be available to avoid uncertainty as to liquidation or cessation of trade, and hence, having regard to the definition in IAS 1, significant uncertainty as to going concern. Nevertheless, in doing so, we did audit the disclosures made by those banks in their financial statements around risk and liquidity. For example, the financial statements of RBS contained extensive disclosure of the liquidity provided by central banks in a number of jurisdictions and the support from UK Government on which the bank owed its continuing independence. The annual report also included a going concern statement which referred explicitly to the UK Government’s support for the group.

We had one client where there was concern as to the availability of support. In that case, we felt unable to give an unmodified opinion without an emphasis of matter as to a significant going concern uncertainty. We initiated a call to the FSA to meet our duty to report to them. When it became clear that support would not forthcoming, the directors concluded that there was significant going concern uncertainty and the tri-party authorities instigated the special resolution regime. As a result of this, we were never required to issue an audit opinion on the entity in question.

Q287. The impact on bank audits of IFRS accounting standards

We do not agree with the assertion that the loan loss impairment and fair value accounting (“marking to market”) requirements in IFRS were a cause of the financial crisis. Both accounting conventions were well understood and were established ways of measuring financial assets, including those assets of banks, at a particular point in time. In the case of loan loss impairment requirements they illustrated at the balance sheet date how much losses have been incurred by the bank in lending money. With respect to marking to market it showed clearly the value of a bank’s trading positions and value of its more complex structured investments. Both conventions were transparent in the accounting policies of financial statements and their application consistently portrayed to investors the state of play at the balance sheet date. It is entirely right that emerging from the financial crisis questions have been asked by the G20 Countries and other constituents whether the accounting conventions could be improved in order to make the information at the balance sheet date more relevant.

The two key questions that have emerged that need answering by standard setters and all stakeholders, including investors, regulators, preparers and auditors are firstly, should all financial assets be measured at fair value, and if not, which financial assets should be measured at amortised cost (and therefore subject to impairment accounting), and secondly, can the impairment model be improved? We are entirely supportive of the IASB and the U.S. FASB working jointly to finalise their reforms by June 2011. Much progress has already been achieved. IFRS 9 Financial Instruments, issued in November 2009, simplifies and improves the distinction between what should be at fair value and what should not. Further, we support the IASB and FASB’s current work in proposing amendments to the impairment model so that it is more forward looking in capturing expected losses, not just currently incurred losses. It is right that accounting standards are subject to continuous improvement to ensure that the financial results that flow from applying these standards are more relevant. The completion of these reforms by June 2011 and, it is hoped, the speedy endorsement of IFRS 9 by the European Parliament will ensure UK banks and their investors can take advantage of these reforms as apply as early as is practicable.

Q290. Other possible assurance services

In Q290, Lord Lawson asked us to provide a note of other areas which wider audit reports might address. We believe that it should be for regulators, banks and auditors to discuss which areas should be the subject of additional work by the auditor, bearing in mind that the risks may be different for different banks. Clearly some of the areas covered by the annual report are matters of subjective judgment for investors to take decisions based on whether they agree with management’s views. However, other areas are ones where there is objectively verifiable information on which auditors might report, given a suitable framework for management to prepare their reporting and for auditors to audit it. This could include the outcome of management’s stress testing exercises, accuracy of reporting of large exposures, accuracy of regulatory capital ratios and liquidity reporting and information on mortgage lending practices.
Questions Not Reached through Lack of Time

In recent years the share of non-audit fees in the Big Four's total fees has fallen sharply, partly because fees for “audit-related work” (including “extended audit services”) are reported as if they were fees for auditing. So that we can have a clearer picture of how much fee income you earn for work you do for audit clients which is not essential in order for you to provide your audit opinion, could we please have a breakdown of the proportion of total fees earned from:

(a) essential audit work
(b) “audit-related work” excluding “extended audit services”
(c) so-called “extended audit services”, and
(d) consulting and other services?

We do not allow clients to report fees for “audit-related” work as fees for auditing. Whilst the existing disclosure rules are unhelpful (for example, by categorising fees for the audit of subsidiaries as fees for non-audit services), we believe there is an important distinction to be made between “audit-related fees” and other non-audit services. This distinction is not made in the current law, although it has been recommended by the Auditing Practices Board (APB) in their recent consultation draft on non-audit services. We believe that it is important to distinguish between audit-related services and non-audit related services. For example, audit-related services include the interim review of a listed company’s half-yearly report, work on regulatory returns to the FSA and (for those entities with a listing in the US) auditing of internal control under Sarbanes-Oxley. These are services which can only be provided by law from the auditor or would normally be expected of the auditor. This is appropriate, as they are all independent assurance services and all require the same standard of independence as is required for the audit of the financial statements. In particular, the role of “extended audit services” is minimal in driving the fall in non-audit fees. There are occasional requests from clients that fall into this category, but we do not actively target such opportunities and it is not part of our growth strategy which focuses on the sale of non-audit services to non-audit clients.

We do not separately collect data on “extended audit services” as part of our financial reporting systems as there is not currently a requirement to separately disclose such amounts; our systems collect the information based on the categories required by law. However, we did carry out an exercise for the Audit Inspection Unit’s review of this issue which formed part of their 2009–10 inspection cycle which provides information as to the scale of the issue. During the most recent year, our fees to the FTSE 100 were as follows:

<table>
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<th></th>
<th>£m</th>
<th>£m</th>
<th>% of audit fees</th>
</tr>
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<tbody>
<tr>
<td>Audit fees</td>
<td>90.587</td>
<td>100.0</td>
<td></td>
</tr>
<tr>
<td>Other services pursuant to legislation</td>
<td>13.830</td>
<td>15.3</td>
<td></td>
</tr>
<tr>
<td>Pension fund audits</td>
<td>1.779</td>
<td>2.0</td>
<td></td>
</tr>
<tr>
<td>Other non-audit services:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>— Extended assurance</td>
<td>0.075</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>— All other services</td>
<td>37.031</td>
<td>40.8</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>143.302</td>
<td>158.2</td>
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We identified only £75,000 of “extended audit” services (less than 0.1% of audit fees) which comprised two engagements: independent assurance on sustainability disclosures for one client and independent assurance carried out for the audit committee (rather than management) of another client. Neither of these amounts was disclosed as audit fees. The remainder of other non-audit services were primarily tax and corporate finance services. We had no fees for internal audit, valuation or litigation work.

We attached a copy of our submission to the Auditing Practices Board’s recent consultation on non-audit services to our original submission in response to the Committee’s call for evidence. This submission contains more detail of our thinking in this area. In particular, we commend to the Committee our thoughts on reforming the disclosure regime for non-audit services (as we believe this to be an issue of perception, rather than reality); that restricting the choice of advisors that may be used when there is no independence threat may increase costs for British businesses, harming recovery and growth. It should be borne in mind that non-audit services supplied by auditors can be very much in the public interest. For instance, companies subject to hostile takeovers may be unable to issue timely defence circulars without the involvement of their auditors to provide independent verification of their contents; bringing in a new provider would take too long as that firm would not have the existing knowledge of the company. Similarly, companies in distress would be less likely to secure additional or continued finance without the rapid involvement of their auditors to challenge the assumptions underlying cash flow forecasts supplied to banks. Without such services, UK job losses could be much larger than would otherwise be the case.
Should audit firms be free to provide internal audit services to their audit clients? If they do, isn’t it extremely unlikely the external auditor would ever tell the audit committee that the internal audit is rubbish?

We do not agree that audit firms should be free to provide internal audit services to their clients. The existing APB Ethical Standards for Auditors prohibit us from doing so when either we would place significant reliance on the work of internal audit as part of our external audit or we would undertake part of the role of management. We support these standards and believe they provide adequate safeguards such that it is very unlikely that as external auditors we would be commenting on the quality of our own internal audit work.

Please do not hesitate to contact me if you require any further clarification of the answers above.

17 December 2010

Supplementary letter from Mr Robin Heath, Managing Partner, Regulatory & Public Policy, Ernst & Young (ADT 34)

Thank you for your letter of 1 December 2010 addressed to Scott Halliday. Ernst & Young is pleased to submit further evidence to the Committee.

I attach an 8-page Appendix in which we set out our answers to the Committee’s specific questions. In so doing, we are mindful of the underlying issues in the Committee’s inquiry, notably the relevance and future role of audit. In that respect, we have sought, where appropriate, to highlight recommendations which we made in our original written submission and in oral evidence.

22 December 2010

APPENDIX

RESPONSES TO SPECIFIC QUESTIONS

“A note on how going concern judgments as part of audits of banks were reached before and during the financial crisis of 2007–09 (Q283). The Committee is particularly interested in how auditors reached unqualified going concern judgments on banks for the year ending December 2007 only for some of them to collapse in 2008. The Committee would also like to know what was the basis for going concern judgments on banks’ financial statements in December 2008, when some banks were already in trouble”.

1. Financial statements are prepared by companies and the accounting judgments are the responsibility of management and the directors. They are a snapshot of a company’s financial position at a particular point in time. A statutory audit is an examination of a company’s financial statements carried out in accordance with independently prescribed auditing standards. After the audit is completed, the auditor issues an audit opinion which is published as part of the financial statements. It states whether or not the financial statements give a true and fair view of the state of the company’s affairs and of its profit or loss for the period covered. It is designed to provide reasonable (not absolute) assurance that the company’s financial statements are free from material misstatement.

2. Although preparation of the financial statements requires the directors to make certain assumptions about the future (indeed directors of listed companies are required to make an explicit statement that the company is a going concern), financial statements do not provide a forecast of future performance because they are a snapshot of a company’s financial position at a particular point in time.

3. In December 2010, the Financial Reporting Council made the following comments in its response to the European Commission’s Green Paper on Audit Policy. They provide a good explanation of what it means to prepare financial statements on a going concern basis.

“There is evidence of an expectation gap between the actual scope of an audit and public perception of the information an audit should reveal. Some stakeholders continue to believe that auditors provide an independent opinion on the financial health of a company when in fact they prepare an opinion on whether their accounts show a “true and fair” view. This particular expectation gap was evident in commentary following the financial crisis, with many people querying how a bank could have received an unqualified audit report, only to collapse a few months later. Specifically, it was questioned whether the risks and uncertainties facing the banks were adequately described and/or it was correct for the financial statements to be prepared on a going concern basis. In this context it is important to appreciate that a conclusion, based on reasonable assumptions about the company and the markets in which it operates, to prepare a company’s financial statements on a going concern basis is not the same as reaching a definitive conclusion that the company will in fact be a going concern some 12 to 15 months later.”

32 http://tiny.cc/1s0mp at page 8.
4. While Ernst & Young audits many banks outside the UK, we did not audit any of the major UK-headquartered banks during the relevant period. We do not therefore have sufficient knowledge to comment on how the directors and auditors of UK banks made judgments on going concern for the financial years ended 2007 and 2008.

5. That said, we believe that the following recommendations could help address the “expectation gap” to which the FRC refers:

   (a) expanding corporate reporting by developing standards that require companies to provide investors with information that goes beyond historical financial statements and management analysis to include improved and more relevant disclosures (eg, business model, risks, controls, management estimates and judgments, and sustainability);

   (b) strengthening the role of audit committees to include issuing a report to investors providing greater transparency into discussions with management and the auditor on key financial statement risks and critical judgments and estimates;

   (c) requiring the auditor to provide some level of assurance or attestation—or have other involvement with—certain information outside of the financial statements, including a company’s narrative reporting, as well as any enhanced business reporting that may evolve; and

   (d) a greater role for auditors in prudential regulation including a regular two-way dialogue between bank auditors and prudential supervisors. Prudential supervisors could also make more and better use of auditors and other external experts using targeted risk based reporting.

“A note on the impact on bank audits of IFRS accounting standards (Q.288)”

Recommendation

6. The comments we make below reinforce the importance of global adoption of a single set of high quality accounting and auditing standards, namely IFRS and ISA.

Effect of switch to IFRS on financial reporting by banks

7. Like UK GAAP, IFRS is a principles-based set of accounting standards that require the application of judgment and professional experience by the directors when preparing the financial statements. Since IFRS has been applied, a body of supporting literature has been developed which seeks to ensure consistency of application globally and prevent abuse.

8. The relevant standards, guidance and accounting by banks for loan loss provisions and fair values were not significantly different under UK GAAP compared to IFRS. Pre-IFRS, UK banks were subject only to the Statements of Recommended Practice (SORPs) on loan provisioning, hedge accounting and securities measurement. These were developed by the British Bankers’ Association and “franked” by the Accounting Standards Board. They were only recommended practice and less rigorous than IFRS.

   (a) Loan loss provisions—there is no major difference in the requirements of the SORP on Loans and Advances, which represented UK GAAP on the topic, and IAS 39 under IFRS: both are incurred loss models.

   (b) Fair value—IFRS standardised existing accounting practice by UK banks to record trading book positions and derivatives at fair value.

9. In relation to distributable profits, Mr Bush’s evidence is based on the assumption that solvency requirements for financial institutions are determined largely by reference to the financial statements. This has not been the case for some time, irrespective of whether UK GAAP or IFRS is used.

10. Distributable profits are (and were) based on retained earnings as shown in the financial statements, but are adjusted (typically downwards) to arrive at distributable profits using the guidance in Technical Releases issued by the main UK accountancy bodies. This recognises that not all profits recognised under IFRS (or UK GAAP) are sufficiently realised to be distributable.

11. Moreover, no well-managed organisation would seek to pay a dividend if the effect would be to reduce its capital below that which it needed to operate its business. This is where regulatory capital requirements for banks are relevant. In calculating regulatory capital under Basel 2 UK banks had to include amounts for expected losses beyond those recognised in the financial statements together with amounts for unexpected losses. This regulatory capital regime was also designed to cover the “stress test” referred to by Mr Bush. In practice it meant that the profits available for distribution would always be less than those recorded for accounting purposes.
12. Regulatory capital requirements under Basel 2 are now recognised as having been set too low, but that was nothing to do with IFRS.

13. It is also worth pointing out that 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.

14. However, we recognise that IFRS accounting standards are not perfect. Accounting standard setters are seeking to develop improved principles-based standards, especially for financial instruments, which respond to the criticisms made following the crisis. We also welcome the considerable progress made by banks in the quality of their disclosures on the financial instruments they hold and the risks they are exposed to.

Effect of switch to IFRS on banks audits

15. Like UK GAAP, IFRS are a principles-based set of accounting standards that require the application of judgment and professional experience by auditors when auditing financial statements prepared by directors.

16. The move from UK GAAP to IFRS should therefore have had limited impact on how audits of a bank’s financial statements are performed. Auditors have had to make similar sorts of judgments about the directors’ financial reporting of loan loss provisions, fair values and distributable profits, whether the financial statements were prepared under UK GAAP or IFRS.

“A note on the areas which wider audit reports might address (Q.290)”

17. In looking at what wider audit reports might address, it is important to distinguish between a company’s responsibility to report its annual results to the market and the responsibility of the auditor to provide assurance on that information.

Recommendations

18. We believe the following proposals should be considered for all public interest entities, not just banks:

   (a) Strengthening the role of audit committees to include issuing a report to investors providing greater transparency into discussions with management and the auditor on key financial statement risks and critical judgments and estimates;

   (b) Expanding corporate reporting by developing standards that require companies to provide investors with information that goes beyond historical financial statements and management analysis to include improved and more relevant disclosures (e.g. business model, risks, controls, management estimates and judgments, and sustainability); and

   (c) Requiring the auditor to provide some level of assurance or attestation—or have other involvement with—certain information outside of the financial statements, including a company’s narrative reporting, as well as any enhanced business reporting that may evolve.

19. For further information, please refer to our original written submission to the Committee dated 27 September 2010, and in particular our answer to the question “What is the role of auditors and should it be changed?”

20. The UK audit profession has done some detailed work on the future of bank audits. In June 2010, the ICAEW published its report on how bank audits might be enhanced. In relation to auditor reporting, it identified that insufficient information is provided under the current framework about the work that underpins an audit. This makes it difficult for investors to assess the performance of bank auditors or to understand the key areas of challenge. To address this gap, banks should confirm that key areas of judgment discussed with auditors are set out in the critical accounting estimates and judgments disclosures in the financial statements. It also said that auditors should have more involvement in reporting on the front sections of annual reports.

21. The six largest UK audit firms are also part of a Bank of England-chaired working group comprising representatives from the FSA, FRC and ICAEW. The purpose of this working group is to consider how the relationship between auditors, firms and regulators can be more clearly defined to permit more useful and comparable disclosures about judgment issues and the sensitivities around material valuations. The working group is also defining ways in which the relationship between auditors and prudential regulators can be enhanced in practical terms. In respect of the latter workstream, a working protocol has largely been agreed.

33 http://alturl.com/jgref
22. On 29 June 2010 the FSA and FRC published a Discussion Paper looking at similar issues and asking, among other things, for views on bespoke reporting by auditors to prudential supervisors and whether auditors should audit Pillar 3 and prudential information in annual reports. We enclose a copy of our response to that Discussion Paper and refer you in particular to our answers to Questions 10 to 15.

In recent years the share of non-audit fees in the Big Four’s total fees has fallen sharply, partly because fees for “audit-related work” (including “extended audit services”) are reported as if they were fees for auditing. So that we can have a clearer picture of how much fee income you earn for work you do for audit clients which is not essential in order for you to provide your audit opinion, could we please have a breakdown of the proportion of total fees earned from:

(a) essential audit work
(b) “audit-related work” excluding “extended audit services”
(c) so-called “extended audit services”, and
(d) consulting and other services?

Recommendations

23. The comments we make below reinforce the importance of:

(a) strong active corporate governance including improved disclosures in company annual reports of an audit committee’s policy on non-audit services and its reasons for approving significant non-audit engagements;
(b) clearer information in company annual reports about how non-audit services are categorised; and
(c) policy makers considering whether to require audit committees to pre-approve significant permissible non-audit services.

Comments

24. Transparent information about the nature and amount of non-audit services auditors provided to audit clients should help address any perceptions among stakeholders that objectivity and independence is impaired by their provision. We seek to achieve this through our transparency report which outlines revenues attributable to different segments of our firm. It also provides information about the relative size of our non-audit practice as compared to the audit practice.

25. We have sought to answer the Committee’s question as best we can by setting out figures taken from our transparency report for the year ended 2 July 2010. Although we do not analyse fees centrally using the Committee’s categories, these numbers indicate the relevant financial significance of different types of services.

<table>
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<tr>
<th>Service</th>
<th>Amount (£m)</th>
<th>Percentage of total revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory audit</td>
<td>303</td>
<td>22.3%</td>
</tr>
<tr>
<td>Other assurance services provided in respect of audit clients</td>
<td>23</td>
<td>1.7%</td>
</tr>
<tr>
<td>Other non-audit services provided to audit clients</td>
<td>183</td>
<td>13.5%</td>
</tr>
<tr>
<td>Services provided to non-audit clients</td>
<td>847</td>
<td>62.5%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>1,356</td>
<td>100%</td>
</tr>
</tbody>
</table>

26. The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (“the Regulations”) also require companies to disclose a breakdown of fees paid to their auditors, albeit not in the same categories as those used by the Committee.

27. The Regulations provide a general picture of what a company asks its auditor to do but they could be improved. Accordingly, we support better disclosures in company annual reports about how non-audit services are categorised.

34 http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf
35 Not published here.
28. Under the Regulations, many services categorised as non-audit are services which are integral to the audit eg audits of subsidiaries or internal controls reporting required to be performed by the auditor under the US Sarbanes-Oxley Act. In 2010, we were therefore pleased to assist the Institute of Chartered Accountants of Scotland to develop recommendations\(^3\) for improvement to the FRC and the Department for Business on these issues. We are encouraged that, as part of a comprehensive review of the provision of non-audit services by auditors to audit clients over the past two years, the Auditing Practices Board (APB) and Department for Business are taking forward the principles underlying these recommendations. This includes amending the Regulations. We would very much welcome a recommendation from the Committee that this work be expedited by APB and BIS.

29. Over the last ten years there has been a robust debate about the range of non-audit services an audit firm may provide to an audit client. Countries like the UK have adopted detailed regulations in this regard. In our view, delivering the most complete range of permissible services increases an audit firm’s knowledge of the audited company, its risks and processes, all of which contribute to audit quality. An “audit-only” firm could be detrimental to audit quality as such firms would encounter difficulty in hiring high quality specialists (eg, in tax and valuations) that are fundamental for a quality audit. Existing professional standards and regulations set appropriate parameters for the scope of permitted non-audit services to audit clients.

30. The decision about which permissible non-audit services are obtained from a company’s auditor should remain with the audit committee. In many countries, including the UK, the audit committee already plays a key role in this regard.

31. We support enhanced disclosures by audit committees about their policy on non-audit services and their reasons for giving approval for significant non-audit engagements. Policy makers might also consider requiring audit committees to pre-approve significant permissible non-audit services. By enhancing pre-approval and disclosures, such as the nature and amount of permissible non-audit services provided by the auditor and the fees, audit committees can best select the most appropriate firms and permitted services for their companies.

Should audit firms be free to provide internal audit services to their audit clients? If they do, isn’t it extremely unlikely the external auditor would ever tell the audit committee that the internal audit is rubbish?

Recommendations

32. The comments we make below reinforce the importance of:

(a) strong active corporate governance including improved disclosures in company annual reports of an audit committee’s policy on non-audit services and its reasons for approving significant non-audit engagements;

(b) clearer information in company annual reports about how non-audit services are categorised; and

(c) policy makers considering whether to require audit committees to pre-approve significant permissible non-audit services.

Comments

33. It is not Ernst & Young’s policy to perform an outsourced internal audit function for our audit clients. That said, certain limited services are permissible provided that a number of detailed conditions are met. Our policy is in line with the relevant auditor independence standards which guard against the threats of self-review and/or acting as management. These restrictions are entirely appropriate.

34. Active corporate governance also plays a very important role. Listed companies generally have audit committee policies covering the type of services auditors may or may not perform. An audit committee would have to authorise the auditor to provide any internal audit-type services. Accordingly, the scenario envisaged by the Committee’s question is unlikely to arise.

35. It is also important to distinguish internal audit from what might be described as “extended [external] audit services”. The Auditing Practices Board has looked at this very issue in its current review of its Ethical Standards. As a result it has sought to clarify the position by amending its Ethical Standards in the following ways:

(a) Improving the guidance as to what work should be treated as [external] audit work rather than non-audit services;

(b) Including extended audit services within “audit-related services”; and

(c) Giving greater guidance on what internal audit services comprise including making a distinction between “assurance activities” designed to assess the design and operating effectiveness of existing or proposed systems or controls (auditor permitted to perform) and “advisory activities” where the auditor is involved in advising an entity on the design and implementation of its risk management, control and governance processes (auditor not permitted to perform).

36. We support this move by APB which is consistent with international ethical standards in this area. It is important that an auditor does not perform internal audit-type services where it might threaten his or her independence. However, audit quality must not be threatened by restricting the external auditor to only those procedures set out in auditing standards. This would not be in the public interest. An auditor must continue to be free to perform all necessary procedures for the external audit in order to make the requisite judgments underpinning an audit opinion.

Supplementary letter from Mr John Griffith-Jones, KPMG (ADT 35)

I am now writing in relation to the remaining points in Mr Sinton’s letter and my responses, on behalf of KPMG, are set out in the Attachment to this letter. I am very much conscious that there is much material in here that I had brought with me to the oral hearing but which it was impossible to get over in the time allocated, particularly given the way the questioning developed. If the Committee would like to discuss these issues in more detail with my banking expert colleagues we would be pleased to do so.

17 December 2010

ATTACHED MEMORANDUM BY KPMG

SECTION 1—AUDIT OPINIONS ON THE FINANCIAL STATEMENTS OF BANKS FOR 2007 AND 2008

How going concern judgements as part of audits of banks were reached before and during the financial crisis of 2007–09. The Committee is particularly interested in how auditors reached unqualified going concern judgements on banks for the year ending December 2007 only for some of them to collapse in 2008. The Committee would also like to know what was the basis for going concern judgments on banks’ financial statements in December 2008 when some banks were already in trouble.

In order to address this question we have referenced the timeline of the key events as the financial crisis unfolded so that the dates that audit reports were signed can be put into context. We have also provided some general information on the auditor’s consideration of going concern and how that relates to banks in particular.

Timeline of key events

At the outset it is important to understand that events relevant to the financial statements for a particular year are those occurring up until the date that they and the audit opinions thereon are approved: in the normal course of events, for most banks this approval occurs in the months of February and March following the previous 31 December year end date.

We attach as Appendices 1(a) & 1(b) the timeline published by the Bank of England in an Annex to the Financial Stability Report in June 2009 and a summary of developments in the financial crisis contained in The Turner Review published by the Financial Services Authority (FSA) in March 2009.

As the Turner Review makes clear one of the main sources of the crisis was the development and subsequent bursting of a property asset bubble initially in the US and subsequently in the UK. The impact of the former was felt by UK banks mainly through securitised assets held whilst the latter obviously impacted their loan portfolios directly. In this context US residential property prices peaked in the first quarter of 2006 and fell only slightly during the period to June 2007. The rate of decline accelerated rapidly to about 10% in the second half of 2007 and this continued throughout 2008 by which time prices had declined by over 30% from their peak. UK residential property prices in contrast had continued to rise and did not peak until late autumn 2007. They then fell less sharply, by less than 5% through to February 2008 and only by about 20% in total by the first quarter of 2009 (and this was only about 5% less than prices in the first quarter of 2006) at which point the decline looked as if it was easing. UK commercial property prices were more badly affected and fell by about 10% in the 6 months to December 2007, a further 20% by December 2008 and again by 10% in 2009.

IESBA Code of Ethics paragraph 290.200.

Consideration of “going concern”

The requirements to assess “going concern” are set out in International Standard on Auditing (UK and Ireland) 570 Going Concern. This sets out the respective responsibilities of management and the auditors and in particular notes various aspects that both should have regard to in considering whether it is appropriate to prepare the accounts on a going concern basis. These include, *inter alia*, the business’ projected net cash generation and its ability to obtain funding (regardless of the source—ie debt or equity—or the circumstances in which the funding is required) for the next 12 months. Importantly regard will also be had to management’s plans in the event of deviations from the projections that might reasonably be expected. Following such a review management will conclude that either:

- The financial statements should not be prepared on a going concern basis—this would only be the case if they have no alternative but to liquidate the company or cease trading; or
- The financial statements should be prepared on a going concern basis, but there exists a material uncertainty giving rise to significant doubt that the entity will be able to continue as such; or
- The financial statements should be on prepared on a going concern basis and there is not a material uncertainty giving rise to significant doubt. In this event it might still however be appropriate to make disclosures on the basis of the conclusions and such (non-material) uncertainties that do exist.

The auditor’s responsibility is to assess the basis on which management came to its conclusion and the adequacy of associated disclosures. In addition if a material uncertainty exists then the auditor is required to make reference to it in the audit report—the so called “Emphasis of Matter” paragraph. Material uncertainties are not defined but, as the Auditing Practices Board Bulletin *Going Concern Issues in the Current Economic Environment* issued in December 2008 makes clear, include both the likelihood of events occurring as well as their impact.

Application to banks

The general principles outlined above clearly apply to banks. However there is one important difference which relates to the role of the banking system in the economy—namely to effect a maturity transformation between borrowers (who want certainty of funding over the medium term) and lenders (who want ready access to their funds in the short term). A major part of a bank’s financing requirements are therefore met from deposits which are not committed and rely on continuing confidence from both the interbank markets and customers. Whilst both prudential regulators and a bank’s management will set liquidity requirements, these simply cannot be designed to cope with a “run on the bank”. Such “runs” may start as a comparatively low level of concern amongst a limited number of depositors, but they can rapidly become self reinforcing and, as was the case with Northern Rock, once started a public “run” is nearly impossible to halt.

The question of “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. As a consequence, the normal system of graduated “warnings” in financial statements (initially management disclosures of concerns, moving up to an “Emphasis of Matter” in the audit report if there is a material uncertainty leading to significant concerns) is not easily operable; once such disclosures are made confidence is undermined and the prophecy becomes self-fulfilling in a short period of time. For this reason the Financial Services Authority (FSA) has made it clear to us on several occasions that issuing a set of bank accounts with an “Emphasis of Matter” paragraph in relation to going concern in the audit report is not an option. In its view the very existence of such an “Emphasis of Matter” provides sufficient evidence to conclude that the institution no longer meets the requirements for authorisation under the Financial Services and Markets Act 2000. The FSA therefore would be required to intervene to “resolve” the situation either through providing governmental support or forcing the institution into administration (or, since February, 2009 the Special Resolution Regime introduced by the 2009 Banking Act). This is not to say that auditors will not propose an “Emphasis of Matter” where it is warranted—just that once proposed those financial statements will be unlikely to be issued. We believe that this was precisely the situation facing Dunfermline Building Society in early 2009.

Audit of bank accounts as at 31 December 2007

At the time of preparing the accounts of the UK banks at the end of 2007, 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, in particular those with a strong US component given the significant falls in US residential property prices.
On the first, the liquidity issues which had threatened the interbank market were seemingly being kept under control by various central bank initiatives by February 2008, although it was clear that the business models of those banks which were heavily dependent on the securitisation market for financing remained difficult as was demonstrated by the nationalisation of Northern Rock in February 2008.

The market for securitised assets themselves remained extremely illiquid and as a consequence values were difficult to establish with any degree of precision. During our audits therefore particular emphasis was placed on ensuring we obtained adequate audit evidence as to management’s valuations. Although there were subsequent declines in the prices for such assets, this was demonstrably a feature of general market conditions which continued to decline during 2008; indeed there were concerns in the latter part of 2008 and 2009 that the market over compensated for the perceived credit problems. At the same time there was no indication that loan losses in the banks’ UK domestic portfolios were likely to increase to the extent that subsequently transpired.

In assessing the going concern question prior to approving the 2007 financial statements in February 2008 therefore management and auditors would have considered carefully the relevant forecasts and budgets for the next year, the continuing ability of the institutions to secure funding through deposits and their ability as necessary to raise capital in the debt and equity markets. For the UK banking industry in general there was insufficient evidence to believe at that time that a material uncertainty in relation to going concern existed in this regard. Although further systemic shocks could not be ruled out it would have been premature to anticipate them at that stage.

As the Bank of England reported in its Financial Stability Report in October 2007:

“UK banks are profitable and have high capital ratios. But confidence in the robustness of the financial system, in the United Kingdom and internationally, has been dented by recent events. And as risk is repriced and balance sheets are repaired, the financial system in the United Kingdom and elsewhere is vulnerable to further shocks, whether in the credit markets that have been affected most to date or in new areas—for example, in equity or currency markets.”

Similarly in its Inflation Report in February 2008, around the time when the 2007 financial statements of banks were being finalised, the Bank of England continued to predict growth in GDP over the coming year(s) as shown in the following chart.
It is also worth noting that even in the Financial Stability Report in May 2008—some three months after the banks’ 2007 financial statements were signed—the Bank of England continued to maintain a positive, albeit cautious, outlook:

“Looking ahead, the most likely outcome for the financial system is that conditions improve gradually as measures—such as those described in Section 4— are taken to restore market functioning and to bolster confidence in the resilience of financial institutions. Low prices should induce investors to return to markets, leading to a recovery in asset values and a strengthening of balance sheets. But this is likely to take some time as the disruption in markets reflects, in part, structural factors such as information and incentive problems. While this adjustment takes place, risks to financial stability remain high.”

In addition, as late as August 2008, the Bank of England predicted an annualised range of GDP growth for the UK of +1.5% to —1.5% in Q1 09 (the lowest point of its projection for the economy). This contrasted with —0.25% to —3.75% for the same period in the November report only three months later.

Finally we note that although not directly in relation to the audit, we also had discussions in late 2007 and early 2008 on some of our key UK bank clients with the FSA as part of their regular supervisory regime. It was evident from those discussions that whilst they were aware of the extent of clients’ exposures to the UK property market in particular they did not at that stage express any significant concerns in this regard.

As demonstrated above, we were clearly conscious of the general stresses in the financial systems that existed at the end of 2007. As a consequence we had taken specific steps to ensure that our partners and staff were alert to the issues. The AIU, in its individual report on KPMG issued on 8 December 2008 in commenting on our actions in the autumn of 2007 noted that:

“In our view the firm [that is, KPMG] responded in an appropriate and timely manner to the audit risks arising from the global liquidity problems”

42 The fan chart depicts the probability of various outcomes for GDP growth. To the left of the first vertical dashed line, the distribution reflects the likelihood of revisions to the data over the past, to the right, it reflects uncertainty over the evolution of GDP growth in the future. If economic circumstances identical to today’s were to prevail on 100 occasions, the MPC’s best collective judgement is that the mature estimate of GDP would lie within the darkest central band on only 10 of those occasions. The fan chart is constructed so that outturns are also expected to lie within each pair of the lighter green areas on ten occasions. Consequently, GDP growth is expected to lie somewhere within the entire fan on 90 out of 100 occasions. The bands widen as the time horizon is extended, indicating the increasing uncertainty about outcomes.”
In summary therefore, and in so far as KPMG’s major UK banking audit clients were concerned, we believed that there was no substantive evidence to require the general use of the Emphasis of Matter paragraphs in our audit reports and therefore that the issuance of unqualified opinions in respect of the banks’ 2007 financial statements was appropriate. In particular, events which were to trigger a fundamental change in market sentiment—the troubles of Fannie Mae and Freddie Mac and the bankruptcy of Lehman—were still many months away.

Audit of bank accounts as at 31 December 2008

When Lehman Brothers entered into bankruptcy proceedings in mid-September 2008 it created unprecedented turmoil in the main global financial markets due to the uncertainty of the impact on other financial institutions—both direct and indirect. In response the UK Government announced a series of measures on 8 October 2008 to provide both liquidity and temporary capital support to the UK banking system. During the course of the oral evidence given to the Committee on 23 November this year, mention was made of the meeting that the senior partners of the largest four firms had with Lord Myners in December 2008. The background to this meeting was a letter written to the Chancellor on 11 November 2008, a copy of which is attached as Appendix 1(c). As noted in that letter and accompanying background note (also attached as Appendix 1(c)), the firms were concerned to understand better the extent and nature of the Government’s support measures, in particular whether more support might be forthcoming (both in amount and duration) if that were necessary. Whilst Lord Myners repeated certain of the general statements of support both in the meeting and in his subsequent letter of 17 December 2008 (attached as Appendix 1(d)), no assurances were sought or given on individual banks. Rather, this meeting was requested and held simply to gather appropriate audit evidence on the functioning of the banking system as a whole; this was clearly fundamental to the going concern assessment of all the UK banks and many other corporates. In this respect out of all the tripartite authorities the position of the Government was key because, as had already been demonstrated, only the Government could provide the necessary systemic support. It was neither the intention nor the result of that meeting that the audit work undertaken by KPMG on any specific bank was in any way reduced as a consequence.

Lord Myners offered a subsequent meeting in late January if that proved necessary. In the event the situation was more stable by that time and KPMG did not consider it necessary to ask for such a meeting. Specifically in concluding in February and March 2009 on “going concern” in relation to the banks’ accounts as at 31 December 2008, the following factors are particularly relevant:

— The various recapitalisation share issues undertaken by the UK banks at the end of 2008 and early 2009 were completed (or well underway) and had been undertaken against the background of severe stress tests imposed by the Financial Services Authority;
— Similar measures had been taken by other governments to recapitalise key financial institutions such as Citigroup, AIG and ING;
— Several smaller UK financial institutions (mainly building societies) had merged with stronger societies;
— The Government announced further stabilisation measures on 19 January 2009, including the formation of what has become known as the Asset Protection Scheme and extension of the credit guarantee scheme;
— The Special Liquidity Scheme seemed to be operating successfully and had brought some stability to the interbank markets. As is now public that had also been supplemented by Emergency Liquidity Assistance to HBOS and RBS;
— US Government support for the Commercial Paper market.

It was against this background that, whilst there was continuing uncertainty in respect of the future macroeconomic outlook and hence potential future loan losses, auditors in the main agreed with the management of the relevant UK financial institutions that they had sufficient capital resources and access to funding to continue as going concerns. The one significant exception to this was Dunfermline Building Society.

17 December 2010

Supplementary letter from Mr Ian Powell, PricewaterhouseCoopers (ADT 36)

I am now responding to the requests for additional information that were set out in your letter of 1 December. These are addressed in the appendix to this letter.

In response to question 271, relating to the audit of the Bank of Ireland, I would like to advise you that the Irish member firm of the PricewaterhouseCoopers (PwC) network has been the sole auditor of the Bank of Ireland group since 1990. PwC is structured as a network of separate member firms, owned and operating locally in a number of countries around the world. As a result, I am not able to provide you with further information about this audit.

If the Committee would like to discuss any of these issues in more detail with my firm’s banking or accounting experts, I would be happy to make the necessary arrangements to assist.

4 January 2011

APPENDIX 1

Q283. Going concern judgements

1.1 As requested, we address below how going concern judgements were reached as part of audits of banks before and during the financial crisis of 2007–09, including the following specific issues:

(a) In the case of Northern Rock, the basis of the unqualified going concern judgement reached for financial statements for the year ending December 2006, before Northern Rock collapsed in 2007.

(b) How auditors reached unqualified going concern judgements on banks for the year ending December 2007.

(c) The basis for going concern judgements on banks’ financial statements in December 2008.

We respond to each of these issues individually in paragraphs 1.4 to 1.13 below.

1.2 The primary significance of the going concern disclosure is in relation to the basis on which the financial statements have been prepared. The requirement for management to assess, and auditors to review, going concern is within the context of selecting an appropriate accounting basis for items within the accounts. The auditor is only required to conclude whether there is any material uncertainty that may cast significant doubt on the company’s ability to continue as a going concern and to report only if any such material uncertainty is identified. The crisis has shown that neither the purpose of these disclosures nor the auditor’s reporting duty is well understood and, arguably, that neither meet the common expectations of readers of financial statements.

1.3 At Annex A46, we attach a copy of our written submission dated January 2009 to the House of Commons Treasury Select Committee inquiry on the Banking Crisis (Session 2008–09) which sets out, inter alia, a summary of the requirements relating to the audit of going concern, including the additional considerations that are relevant in a banking environment. In particular, these involve a consideration of sources of liquidity and the adequacy of an institution’s capital, but are not a guarantee of future solvency. Our comments below should be read in the context of that submission. Auditing standards are explicit that a review of going concern is not undertaken to provide shareholders with any guarantee that a company will continue to survive.

(a) Northern Rock—financial statements for the year ended December 2006

1.4 At Annex B47, we attach the follow-up written memorandum dated January 2008 to the House of Commons Treasury Select Committee inquiry on Northern Rock “The Run on the Rock” (Session 2007–08) with respect to the audit of Northern Rock. This identifies the considerations and actions that were taken in respect of the financial year ending 31 December 2006 including the work we carried out in respect of management’s assessment of the bank’s going concern status prior to signing the 2006 financial statements in January 2007.

1.5 As indicated in that evidence, at the time of the conclusion of our audit in January 2007, Northern Rock had a history of profitable operations and had a track record of ready access to funds at low spreads over LIBOR from a wide range of sources, indicating willingness by lending institutions and investors to provide finance. In addition to these positive trading and financial characteristics, we looked at the post year end trading results, the most recent reports to the bank’s asset and liability committee and studied the bank’s operating plans. We also studied external information about forecasts for the UK domestic mortgage markets. None of the information available to us indicated anything that would constitute a “material uncertainty” that

46 Not published here.
47 Not published here.
“may cast significant doubt” that Northern Rock may not be a going concern and consequently, in accordance with auditing standards\(^{48}\) 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.

(b) Audit opinions on financial years ending 31 December 2007

1.6 Whilst Northern Rock was unable to obtain refinancing in August 2007 it is notable that other banks were still funding themselves in the short term wholesale markets at the end of 2007 and market conditions were still showing signs of easing when the banks announced their results in February 2008. Auditors, therefore, 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.

1.7 In terms of capital requirements the banks PwC audited were still profitable in early 2008 and had levels of capital well above regulatory minimum requirements. The outlook for 2008, both in terms of the banks’ internal profit forecasts and external economic forecasts, did not appear to pose any threats to capital adequacy based on the conditions prevailing in January and February 2008.

(c) Audit opinions on financial years ending 31 December 2008

1.8 In the context of the financial statements for the year ending 31 December 2008, two factors were again particularly relevant for management’s assessment of going concern status and the auditor’s review of that assessment: liquidity and capital adequacy.

1.9 On liquidity many of the banks were, post the Lehman Brothers collapse in September 2008, dependent on the Government and the Bank of England for liquidity support, given the freezing of the wholesale markets.

1.10 There were two principal schemes that were relevant in our assessment of the going concern status of banks: the Bank of England Special Liquidity Scheme and the Government’s Credit Guarantee Scheme.

(a) The Bank of England Special Liquidity Scheme

Under this scheme, first published on 21 April 2008\(^{49}\), banks could borrow from the Bank of England against various types of securities lodged as collateral. On 8 October, the government announced that the scheme would be extended and widened as part of the UK support package for banks. Full details of this scheme, including the level of support available, were published in final form on the Bank of England website by the time the relevant audit opinions were published in February/March 2009.

(b) Credit Guarantee Scheme

The second scheme allowed the banks to issue medium term debt securities guaranteed by the UK government. Full details including the aggregate limit across the industry had been announced by HM Treasury on 13 October 2008 as part of the UK support package\(^{50}\).

1.11 During this time, this firm’s banking audit partners were having tripartite meetings with the Bank of England and clients to understand how the schemes would operate and what sums were available.

1.12 All the banks which we audited had been advised of their allocation under the Government guaranteed medium term debt scheme by the time the opinions for the financial years ending 31 December 2008 were issued.

1.13 In order to support our audit opinions, we reviewed our individual clients’ forecast requirements, and the various stress tests which they carried out and ensured that their funding needs were matched by the available finance for which we had external evidence.

Q288. Impact on bank audits of IFRS accounting standards

2.1 As requested, we address below the impact on bank audits of IFRS accounting standards in the two main areas addressed by Mr Timothy Bush in his written and oral evidence to the Committee: the classification and measurement of financial instruments and the impairment of loans. References to UK GAAP relate to the standards that were applicable for UK banks prior to the implementation of IFRS for listed companies in 2005. As a general rule, UK listed banks also adopted IFRS for the individual accounts of their subsidiaries at the same time, which was permitted, although not required, under the Companies Act.

\(^{48}\) ISA 570 para 7.


Classification and Measurement of Financial Instruments

UK GAAP

2.2 Under UK GAAP only limited guidance was provided on the accounting treatment of derivatives or other financial assets and liabilities. To address this deficiency for banks, the British Bankers’ Association issued a series of Statements of Recommended Practice (BBA SORPs) which were initially best practice but which were made mandatory for banks for accounting periods ending on or after 22 June 2001 \(^{51}\).

2.3 Under the Companies Act 1985 \(^{52}\) banks were allowed to fair value financial instruments. The BBA SORPs recommended that assets carried in a bank’s long term (banking) book should be accounted for at amortised cost (including derivatives hedging positions in the banking books) and that assets carried in a bank’s trading book should be carried at fair value. Transfers between books were permitted. There was no guidance on how to determine the fair value of financial instruments.

IFRS

2.4 The relevant international accounting standard addressing the classification and measurement of financial instruments is IAS 39 “Financial instruments: Recognition and Measurement”. This requires financial assets to be classified into four categories which drive their subsequent measurement. The four categories are:

- Financial assets at fair value through profit and loss (essentially all derivatives, all assets held for trading and other financial assets that the company has elected to carry at fair value)
- Loans and receivables.
- Held to maturity investments.
- Available for sale financial assets.

2.5 Loans and receivables and held to maturity investments are carried at amortised cost. All other financial assets are carried at fair value, with fair value movements taken to the income statement for financial assets at fair value through profit and loss and through other comprehensive income for available for sale financial assets.

Impact on bank audits

2.6 The main relevant impact of the change from UK GAAP to IFRS in the context of the classification and measurement of financial instruments was in relation to investments carried for long term purposes in the banking book. In order to meet the criteria for classification as held for maturity investments and thus to be carried at amortised cost, banks needed to demonstrate a positive intention and ability to hold investments in corporate or government debt to maturity. Since many of these investments were held in liquidity portfolios, it was not possible to demonstrate such a positive intention and ability and, consequently, significant portfolios of such assets were reclassified as available for sale and carried subsequently at fair value. They were also subjected to more stringent impairment rules that required fair value losses to be recognised in the income statement if there was a significant or prolonged decline in fair value below cost.

Changes proposed to IFRS

2.7 As a result of the financial crisis, and with the encouragement of the G20, the IASB is proposing a series of fundamental changes to financial instruments accounting, to be embodied in a portmanteau standard known as IFRS 9 “Financial Instruments”. These revisions are being completed in phases, the first of which, on classification and measurement, was published in November 2009.

2.8 The new standard acknowledges the need to address the rationale for holding financial assets in determining the appropriate accounting treatment. Under IFRS 9, financial assets are classified as either carried at amortised cost or at fair value on the basis of both the entity’s business model and the contractual cash flows of the instrument. If an asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows, and the contractual terms of the asset give rise to cash flows on specified dates that are solely payments of interest and principal, they are carried at amortised cost. All other financial assets are carried at fair value with fair value movements taken to the income statement.

2.9 This simplification of the classification model is likely to result in more debt instruments held in banking books being carried at amortised cost.

\(^{51}\) FRS 18 “Accounting Policies” published by the Accounting Standards Board in December 2000.

\(^{52}\) Schedule 9.
IMPAIRMENT OF LOANS

UK GAAP
2.10 Under UK GAAP, banks established loan loss provisions in accordance with the BBA SORP on Advances. Banks made specific provisions in relation to assets for which there was objective evidence of impairment and, in addition, made general provisions (e.g., 1% or 2% of a mortgage loan book) to account for unidentified losses that were likely to exist, based on past experience, at the balance sheet date for those assets without specific provisions.

2.11 Under the recommendations of the BBA SORP, loan losses were only recognised where an impairment event had been observed or, in the case of general provisions, where past experience indicated that an impairment event was likely to have occurred even though it had not yet been specifically identified. This is known as an “incurred loss” model.

IFRS
2.12 The IFRS requirements for loan loss provisions are set out in IAS 39. This standard, like UK GAAP, requires the application of an incurred loss model but IAS 39 provides more detailed guidance than UK GAAP and does not distinguish between specific and general provisions. Specifically, IAS 39 requires banks to recognise a loss when a credit event has happened—in other words, when the payment status of the borrower has deteriorated since the loan’s origination to such an extent that the loan is impaired.

2.13 Under IAS 39, impairment is only recognised when there is objective evidence that the loan has been impaired since the date on which it was originated. This objective evidence may relate to an individual borrower (for example, a default in payment of interest or an indication that they are in significant financial difficulty) or to a portfolio of similar loans (such as an increase in the number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount). For loans that are not individually significant, the assessment of impairment is carried out on a portfolio basis.

Impact on bank audits
2.14 In practice, there was relatively little difference in the aggregate amount of loan loss provisions recognised by UK banks under UK GAAP and under IFRS. This was partly due to the fact that the two most significant differences between the two models had an offsetting effect on each other. IAS 39 requires there to be objective evidence to support the level of provisions made. This resulted in the release of excess mortgage provisions by some banks. However, IAS 39 also requires expected losses on impaired loans to be discounted to take account of the time value of money. This was not required under UK GAAP and consequently resulted in increased provisions in some cases.

Changes proposed to IFRS
2.15 One major criticism of the accounting during the financial crisis was that an incurred loss model tends to result in a deferral of the recognition of losses during an economic downturn. If losses cannot be recognised until a credit event has happened, it is not possible for banks to make additional provisions for losses which they can reasonably expect to be incurred as the cycle continues.

2.16 In response to this criticism, and with the encouragement of the G20 and the Financial Stability Board, the IASB has issued proposals as part of the second phase of its review of financial instrument accounting for a fundamental change to the accounting for loan loss provisions. The proposal is to replace the current incurred loss model with an expected loss model, that will require a bank to recognise the losses it expects to incur on the loan and to update those expectations regularly. The proposals have been issued for consultation and are now being redeliberated by the IASB. It is anticipated that this phase of the financial instruments project will be finalised by June 2011.

Q290. Audit report scope
3.1 We welcome the opportunity to respond to your request for us to address the areas which wider audit reports might address. We are in no doubt that audit needs to change to respond to the lessons from the financial crisis. We summarise below some of the initiatives we are pursuing to achieve this.
Increasing Transparency of the Audit

3.2 The way auditors communicate externally needs to be revisited to improve understanding and raise the awareness of the value added by an audit. The current statutory audit report is formulaic; there is no opportunity for the auditor to give any commentary on how they have done their work. To change the statutory audit report would take time. In any event, it may be better to leave it in its current form to preserve the clarity of its purpose. We think the most immediate way to give greater transparency to the audit would be through further disclosures in the audit committee’s report where there is greater discretion over content.

3.3 We are discussing this idea with our listed clients to see if, working together, we can agree to give public disclosure to some of the key matters which, as auditor, we are obliged to report to their audit committee. This would include the significant risks of misstatement addressed by the audit and the key judgments made by management in preparing the financial statements. The results of this initiative will be available as the next round of annual reports become available in the spring and Committee will be able to take account of this in developing their thinking further.

Extending the Scope of the Audit in Relation to Narrative Disclosures

3.4 The crisis has called into question the effectiveness of some of the narrative disclosures that accompany financial statements. These include the description of the inherent risks in a particular business and the uncertainties and judgments that underlie a set of financial statements. In general terms, the auditor is currently required to report, by exception, if they identify errors or matters where the information given in those disclosures is not consistent with the financial statements.

3.5 The clarity of some of these disclosures could be improved. We also accept that the information that can be derived from the auditor’s reporting as described above is not clear. Reporting and assurance over these matters inevitable interact; and so standards and practice for both need to be considered together in order to give clearer and better assured information:

— We think that improvement in the clarity of disclosure of these matters by companies is primarily a matter of encouraging adoption of good practice (for which there are examples). Further detailed rule making is, in our view, likely to be counter-productive. It would not be appropriate for auditors to be required to offer their own commentary or volunteer new information as such disclosures must remain the responsibility of the directors.

— However, auditors already act as agents to encourage such good practice and this could be further enhanced if they had a more explicit assurance role. We recognise that some companies have reservations about this and any change would need to be framed in a way that an auditor would be competent to do. We are currently working on proposals for how this could be made workable.

The Role of the Auditors in Relation to Financial Institutions

3.6 The Committee is already aware of a paper prepared by the Institute of Chartered Accountants in England & Wales “Audit of Banks: Lessons from the Crisis”. We support its main findings including the following which relate specifically to the role of auditors:

— Better two-way communication between regulator and auditor to enable both parties to perform their roles more effectively; and

— Greater scope for private reporting by auditors to supervisory regulators.

3.7 We also support a closer working relationship between auditors and banking and other supervisors and we are participating in the working party sponsored by the Bank of England which is currently considering this.

Written Answers to Questions Not Addressed at the Hearing on 23 November 2010

Question One—In recent years the share of non-audit fees in the Big Four’s total fees has fallen sharply, partly because fees for “audit-related work” (including “extended audit services”) are reported as if they were fees for auditing. So that we can have a clearer picture of how much fee income you earn for work you do for audit clients which is not essential in order for you to provide your audit opinion, could we please have a breakdown of the proportion of total fees earned from:

(a) Essential audit work

(b) “Audit-related work” excluding extended audit services”

(c) So-called “extended audit services”, and

(d) Consulting and other services?
4.1 The summary schedule below identifies the following analysis of the figures for the financial year ending the 30 June 2010 for PricewaterhouseCoopers LLP:

(a) Essential audit work £522.8m (57.7%)
(b) Audit related work £25.2m (2.78%)
(c) Extended audit £15,000 (negligible proportion)
(d) Consulting/other £358.0m (39.52%)

4.2 As explanation for category (a), extended audit work is essentially work carried out at the request of clients as part of the audit that is not required to support the audit opinion. A recent review carried out at the request of the AIU indicated that we only did this for one client and that the amount involved was negligible.

Question Two—Should audit firms be free to provide internal audit services to their audit clients? If they do, isn’t it extremely unlikely the external auditor would ever tell the audit committee that the internal audit is rubbish?

4.3 Under UK Ethical Standards for auditors (ES 5), audit firms are not allowed to provide internal audit services to an audit client where it is either reasonably foreseeable that the auditor would place significant reliance on the internal audit work or the work would require the audit firm to undertake part of the role of management. Consequently, as I indicated in my response to question 249 at the 23 November hearing, as a firm we do not provide any outsourced internal audit functions to audit clients.

4.4 This Standard otherwise permits the provision of internal audit services provided that the auditor is satisfied that there is informed management and that appropriate safeguards (such as the use of separate teams and the review of the work carried out by an independent partner).

4.5 The Auditing Practices Board recently consulted again on this area but is not proposing to prohibit all internal audit services to audit clients provided the threats and safeguards approach is properly applied.

4.6 The International auditing standard (Clarity ISA 265 on “Communicating deficiencies in internal control to those charged with governance and management”) that deals with this area requires the auditor to communicate in writing significant deficiencies in internal controls identified during the audit to those charged with governance on a timely basis. An internal audit function is regarded as an internal control over financial reporting.

4 January 2011
Letter from Mr Peter Williams, The Hundred Group of Finance Directors (ADT 37)

1. We are pleased to submit our comments on the Committee’s call for evidence.

WHO WE ARE
2. The Hundred Group is a non-political, not-for-profit organisation which represents the finance directors of the UK’s largest companies, with membership drawn mainly, but not entirely, from the constituents of the FTSE100 Index. Our aim is to contribute positively to the development of UK and International policy and practice on matters that affect our businesses, including taxation, financial reporting, corporate governance and capital market regulation. Whilst this letter expresses the view of The Hundred Group of Finance Directors as a whole, they are not necessarily those of our individual members or their respective employers.

OUR VIEWS
3. We welcome the House of Lord’s consultation and the opportunity to respond on these issues.
4. Due to the nature of the consultation we have not sought to answer the questions raised by the Committee. As preparers of financial statements we recognise that the ownership of the audit relationship must be between shareholders and auditors. We do not seek to comment on the requirements of shareholders, nor would it be appropriate for us to guide the regulatory requirements in this arena. However, we express in this letter our thoughts as management in so much as they may be relevant to the Committee’s deliberations.
5. In overview, we are supportive of the current role of the auditors and the value brought to our shareholders through the audit report and through other services rendered to our members. We note the common practice of investors to utilise the audited financial statements as a reference point throughout the financial cycle, the value of which is enhanced by the associated audit report.
6. We are of the opinion that the services rendered by the “Big 4” are of a high quality and that there exists sufficient competition in the market place to drive continuous improvement and breadth of choice to our shareholders. In particular we note the high level of competition demonstrated during an audit tender process. In our experience this process brings out a high degree of competition in terms of emphasis of approach and on audit fees paid.
7. We appreciate and recognise the value that we, as management, benefit from the ability to use our auditors to undertake non audit services where appropriate. We strongly believe that we must retain the ability to select service providers based on the highest standard of deliverable, including circumstances where the service provider is our auditor. We make this statement whilst recognising the importance of independence between management and auditors and the need to ensure at all times that this is not breached through appropriate safeguards.
8. We do not feel that the Audit market is unduly concentrated. Indeed, we see that in some arenas there is a “Big 6” of accountancy firms providing increased competition. For our members, however, the importance of “global reach” in an audit firm is imperative. The majority of our member organisations are global in reach and, with trade barriers opening up and market growth projections persistently dominated by developing markets we see huge growth possibilities outside the European Union.
9. Our service providers, including our auditors, are expected to be able to rise to the challenge of auditing our complex, global businesses. The barriers to entry for a global audit firm are high and require a certain “critical mass” to be effective. Current requirements under ISA600: Special Considerations—Audits of Group Financial Statements (including the Work of Component Auditors) require significant input from group auditors which is practically translated as a requirement for group auditors to audit the majority of a group’s global subsidiaries. This in turn will preclude smaller firms from competing in the global arena. Therefore our membership will almost exclusively seek an audit from one of the “Big 4” auditors. The establishment of global
networks necessarily takes time and the assembly of a critical mass which we feel would be inappropriate to force.

10. In addition larger auditing firms will, by their nature, have a broader base of experience to draw from when conducting their audits. Our membership represents companies that are fully listed, are acquisitive, raise debt, purchase intellectual property, have complex tax structures and run international treasury functions. These activities require advisors who have a broad background of experience to service us appropriately. In our experience the Big 4 are consistently and comfortably able to deliver the expertise we demand of our auditors and accordingly our members and their shareholders predominantly look to the Big 4 when considering new auditors.

11. We understand the basis for questioning the role of the auditor and the reporting requirements of the auditors to external bodies where appropriate. However, we would caution against any developments which will, either directly or indirectly, affect the relationship between the auditors and the audit committee. The frank, open and challenging relationship which is demonstrated in our audit committees is one which both management and non-executives value and is, in our view, effective at challenging management and the audit committee appropriately.

27 September 2010

Memorandum by Mr Graham Roberts (ADT 38)

1. INTRODUCTION

1.1 I am writing in a personal capacity. I am the Finance Director of The British Land Company PLC, a FTSE100 company. I am also a non-executive director and Chairman of the Audit Committee of Balfour Beatty plc, a global infrastructure business with a turnover exceeding £10 billion and operating with 50,000 employees in 100 countries.

1.2 The first 20 years of my career were spent in the auditing profession of which 12 years as an audit partner, initially at Binder Hamlyn and subsequently Arthur Andersen.

1.3 I have therefore seen many sides of the audit debate and its practical application. I also worked at the most senior level at the last audit practice to compete for global clients with what is now called the big 4 but was originally the big 8.

2. COMPETITION. Auditors are an important part of the regulatory framework. I do not however believe competition makes for better regulation or better auditing.

2.1 It is not the number of firms engaged that matters to audit quality but the number and quality of committed auditors employed and the support framework around them.

2.3 When competition in auditing was introduced in the 80s, the response from Boards and auditors was enthusiastic but destructive to the reputation of financial reporting in the UK at that time. The regulatory regime did not cope nor did checks and balances within the firms and their clients. There were lots of causes but failure to counter the negative effects of increased competition was at the heart of it.

3. QUALITY. The regulatory response to the 80s/early 90s debacle in particular the establishment of the FRC and related bodies and the development of audit committees has created a virtuous circle of open communication and checks and balances.

3.1 As a result there have been precious few “audit failures” since the mid 90s in the UK compared to other countries. None have had systemic consequences (but see banks below.) I think the overwhelming evidence is that financial reporting has been improving at a time when the number of firms has been reducing.

3.2 The increased presence and quality of audit committees improved the reliability with which the auditor’s views are heard and discussed in the right way in the boardroom.

3.3 Also audit firms became bigger and this was important because businesses going global were increasing in size and complexity. The perception of financial independence is essential and if the clients get larger so must the firms. This for me was an important driver for the merger in 1994 of my then firm with Arthur Andersen.

3.4 Any regulatory proposal arising from the Select Committee’s review should in my view ensure that the firms can at all times demonstrate financial independence.

4. PROFESSIONAL SCEPTICISM. Whilst not all auditors will be perfect all the time, I believe the firms’ cultures have moved dramatically over 20 years to be the best available framework for nurturing and exploiting the talent we have in this field. We also remain so spoilt in this country in finding that audit firms have been able to position themselves to source better quality enquiring minds direct from university than other regimes where the profession is less well established or regarded, including the US.
5. **Today’s Boardroom challenge.** The boardroom challenge, I believe, is to improve the non-financial aspects of corporate reporting and ensure in the process that boards and investors understand the risk tolerance and risk management of businesses.

5.1 Not that business should stop taking risks—that remains essential to create wealth.

5.2 The boardroom scandals in the UK of the last 15 years have not been around financial misreporting but were more to do with the failure to assess and adequately communicate business models and risk. The massive increase in disclosure obligations over this time horizon has also added to the problem of seeing the wood from the trees: an issue for preparers as well as readers of Company Reports and Accounts.

5.3 Markets can work for the good to act as a check on excessive risk taking and weak business models but both need to be visible to the market. Transparency in this area is the next Holy Grail but it is not an easy challenge. The hardest part, I think, is articulating risks that are not the day to day risks companies manage but the remoter risks which are accepted, as they are deemed remote and are uninsurable, but if they happen can be very damaging, if not fatal.

5.4 Boards probably spent more time and money assessing and protecting themselves from the notorious year 2000 IT risk than any other remote likelihood, high impact risk. That seemed to many an unnecessary expense, viewed with hindsight, but I know of no company with IT dependency that gambled and did no preparation.

5.5 Had Northern Rock articulated internally and externally the risk of wholesale funding dependency would that have driven a discussion at board level and with the regulator about a plan B? The risk of deep sea oil and gas drilling seems clear to me and should have logically led to a dialogue between BP and its peers with the US government on catastrophe risk management drilling off the US coastline well before this incident. I wonder if that happened?

6. **Relevance to auditors.** I think we have made great strides in achieving reliable financial reporting in the UK. The next step has to be improving how well business communicates on non-financial matters, specifically risk management and business models. It needs to do so in a way which is better than the boilerplate disclosures seen in US style reporting and be accessible to investors and commentators. It will not be easy, particularly with the most complex groups.

6.1 I think in the future that Boards and Audit Committees may well want more external independent evaluation of how they articulate their risk and reward strategies and profile and that audit firms may well need to recruit new skills to fully contribute by questioning the quality of disclosure rather than merely confirming management has evidence to support what they are saying. Today auditing remains a financially orientated process but should, in my view, evolve to a broader business reporting process to support boards in improving governance and transparency.

6.2 The sting in the tail of this proposal is that the investment needed to evolve in this direction can probably only be made by global giants. Access to capital is an issue as well as intergenerational profit sharing at the firms, ie investing for the future poses serious challenges to the firms’ demography and reward structures.

6.3 I believe the debate about increasing competition is the wrong discussion. Changing the mix of skills to support boards in their wider reporting responsibilities is a more valuable goal. I understand the FRC are looking into the role of auditors in non-financial reporting. I think the role of auditing should be resolved first before any conclusions are reached on auditor market concentration risk.

7. **The banks.** The most extreme corporate scandal and the most challenging for outside observers to grasp is the banking crisis. The scale and complexity of our banks clearly posed difficulties for their Boards and Audit Committees in understanding fully the risk profile of their businesses. This appears to have been the same for their auditors and regulators.

7.1 I was impressed by the clear articulation in the Treasury paper issued in July 2010 on the “regulatory underlap” between HM Treasury, the FSA and the Bank of England, which was the source of the systemic weakness in the banking regulatory model. I think a similar description would be fitting for the micro-regulatory environment specifically the interaction between auditor, Audit Committee and FSA on individual banks supervision.

7.2 I was involved in bank auditing in the early 90s under the previous regime when banking supervision was done by the Bank of England and found the bi-lateral and tri-lateral meetings very effective in ensuring the auditor’s scope of additional work for regulatory purposes covered the areas the regulator should be aware of. I understand this effective method of communication fell into disuse under the FSA.

7.3 Without good dialogue between regulator, bank and auditor it is hard to see how auditors or regulators can do their jobs effectively. The biggest risk that does not seem to have been articulated was the business model weakness around the potential loss of wholesale funding.
7.4 Yet the consequence on asset values of such extreme liquidity loss is severe. Add to that the excessive leverage of certain structured products which amplify losses to catastrophic proportions in a liquidity crunch scenario. The weaknesses of mark to market accounting did not help either, nor did the widespread failure to understand the difference between accounting for losses on an incurred basis rather than an expected basis.

7.5 Looking at the complexities of all these interlinked issues, there is a question in my mind about what reporting lines best suit bank auditing compared to other businesses that are less financially geared and so less susceptible to sudden failure through loss of creditor or depositor confidence. For example, uncertainties surrounding going concern spelt out in an auditor’s report on a bank can rapidly become an unfortunate certainty. That is not necessarily in the public, depositors’ or the investors’ interests. The risk that caused the uncertainty needs instead to be communicated swiftly and dealt with well before any annual report is signed off and through a three way dialogue between auditor, board and regulator.

Ensuring such communication works effectively is essential.

8. A repeat of Andersen? On a pragmatic basis I cannot see on a global basis how the regulatory mistakes that created four from six can be unwound, without risk to audit quality. I think instead the answer lies in a version of the “living wills” approach to banks and not in seeking the riskier rapid expansion of the smaller firms. This would of course require global coordination amongst regulators.

September 2010

Memorandum by Royal Dutch Shell plc (ADT 39)

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

Economies of scale were clearly a factor in the consolidation of the auditing industry. Increasing globalisation in recent years has given further impetus to this process as multi-national companies have sought the geographical presence and breadth and depth of technical expertise which can only be provided by truly global auditing firms.

It is difficult to see how the gap between the Big Four and the next tier of audit firms may be bridged. The level of investment required to offer a consistent high quality global service is more important than economies of scale in determining success as a global service provider. Significant costs would be incurred—for example in establishing the necessary structure and expertise and in meeting additional regulatory requirements.

2. Does a lack of competition mean clients are charged excessive fees?

The existing structure of the market does not necessarily mean that audit fees are excessive. They are subject to the same commercial negotiations between client and service provider as any other contractual arrangement. However, it is possible that if there were more firms with international reach and expertise, the increased competition would affect overall fee levels in the long run.

3. Does a narrow field of competition affect objectivity of advice provided?

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

Auditors give an opinion rather than advice. Because of the need to maintain their professional integrity and meet oversight requirements, we do not believe that limited narrow field of competition should result in any compromise in the quality of service or objectivity of that opinion.

5. What is the role of auditors and should it be changed?

The auditors’ role should continue to focus on providing an opinion on the financial statements and other matters as set out in the Companies Act 2006 (and, for Shell as a Foreign Private Issuer in the USA, an opinion with regard to internal control over financial reporting pursuant to the Sarbanes-Oxley Act). At present we see no obvious benefit to our shareholders and other stakeholders of widening this role.
6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

8. How much information should bank auditors share with the supervisory authorities and vice versa?
   Not forming part of this sector we are not in a position to comment on the role of auditors in the financial services sector.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?
   We believe that auditors already have the necessary incentives (and powers as captured in relevant codes and regulations) to remain objective in their dealings with clients.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?
    To avoid any potential risk of a perceived conflict of interest in forming an appropriate audit opinion, requirements are necessary to restrict auditors taking on consultancy work for their clients (we have mechanisms in place to monitor any incidental non audit services).
    Certain work may not technically be labelled as “audit” (such as interim reviews) but is complementary to the audit itself. These costs should be disclosed but under certain circumstances use of our auditors provides efficiency benefits and would not comprise their independence.

11. Should more competition be introduced into auditing? If so, how?
    Please refer to our responses to Questions 1 and 2 above. As regards the practicalities we do not see that there could be a market-based solution in the foreseeable future, and believe that any more invasive interventions such as forced de-mergers or explicit restrictions on firms to either audit or consultancy work would need careful consideration to ensure the interests of clients are not adversely affected.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?
    We do not believe any further regulation is needed with regard to internal audit. The role and the scope of activities of the internal auditors differ from those of the external auditors. However, it is important that there is interaction, particularly in the areas of risk and internal control. This promotes improved insights for both parties and, with appropriate co-ordination and testing, external auditors should be able to, in part, place reliance on the work of internal auditors thereby driving efficiencies in the process.

13. Should the role of audit committees be enhanced?
    Whilst any guidance should be reviewed from time to time, we believe that the role and responsibilities of the audit committee as set out in the FRC’s Corporate Governance Code (June 2010) and its Guidance on Audit Committees (October 2008, subject to consideration of any amendments resulting from the current consultation process) are appropriate and comprehensive.

14. Is the auditing profession well placed to promote improvement in corporate governance?
    We would expect that the auditing profession, along with other stakeholders, is well placed to continue to contribute to future consultations to ensure that best practice in corporate governance is maintained.

21 September 2010
Examination of Witnesses

Witnesses: MR ASHLEY ALMANZA, [Chairman, The Hundred Group of Finance Directors, and Chief Financial Officer, BG Group], MR ROBIN FREESTONE, [Member, Investor Relations and Markets Committee, The Hundred Group, and Chief Financial Officer, Pearson Group], GRAHAM ROBERTS ESQ, [Finance Director, British Land], and MR MARTIN TEN BRINK, [Executive Vice President Controller, Royal Dutch Shell].

Q291 The Chairman: Good afternoon, gentlemen. Apologies for starting a little late, but we had quite a number of internal matters to discuss today. Welcome to the Economic Affairs Committee. For the record, copies of Members’ interests on this matter are available on the register of interests and where Members have new interests to declare they will do so during the course of our hearing. Thank you all very much indeed for coming. We’d be grateful if you would speak loud and clear for the webcast and the shorthand writer, and when we get to questions, in order to save time, if you actually agree with the comment that has been made by the first speaker please don’t just repeat it. But if you have a different point of view or something else you want to say, by all means come in on any question. Would any of you like to make an opening statement or will we go straight to questions?

Mr Almanza: Straight to questions.

Q292 The Chairman: Straight to questions, good, thank you very much. Well, I’ll kick off with the first question, and that is that I recognise that today we’re talking mainly, but not entirely, to companies who have a major global reach. Therefore, as some of you have stressed in your evidence to us, it’s important to have auditing firms that have the same global reach. I think it’s also clear that in the written evidence you’ve given us you tend to feel that, from your point of view at least, there is competition. You are satisfied with the situation in relation to the Big 4, and you don’t share some of the misgivings that have been made to us by a number of other witnesses about the lack of competition and the difficulties of the next tier being able to expand their businesses and get more options and opportunities because of the restriction, as they feel it, of competition and choice. So we do recognise that you are by and large representing that particular sector. But could I just ask you two questions to begin? One is would you all share the same sort of comfortable view of the present situation if the Big 4 came down to Big 3? And the second is could you as experienced finance directors and others cast your views a little wider and answer the question: are you happy about the predominance of the Big 4 in the auditing world generally and for companies in the 250 and so on where a lot of the concerns have been expressed? Who would like to kick off?

Mr Almanza: Shall I go?

Mr Freestone: Yes, sure.

Mr Almanza: Big 4 to three firms I think would be regarded by most large companies in the UK, certainly by our company, as an unwelcome change.

While I would agree with your comment earlier that large corporates in the UK, by and large tend to find sufficient competition is provided by the Big 4, going to three I think would undermine that and would be unwelcome. As to whether we’re happy with the current state of affairs, I think that certainly we’re content in general terms with the service provided and the competition that we observe in the market today.

Q293 The Chairman: Any other views?

Graham Roberts: I would like to add to that in that context there’s a tremendous increase in the amount of transparency through the operations of the FRC and the AIU in terms of audit quality. There is a measure of audit quality out there and certainly I’ve not observed any weakening in that quality just as a result of a move down from six to four.

Q294 Lord Lawson of Blaby: May I move on to a slightly different area. IFRS in general and mark to market in particular? We have had, as you will know, some evidence suggesting that a number of aspects of IFRS are, in fact, inferior to UK GAAP and in serious ways. So far as mark to market accounting, I think that what has emerged is some evidence that while this may be a brilliant convention 90% or 95% of the time, at the peak of a bubble and also at the depth of a serious recession it produces unwelcome results in totally different ways. I can spell those out, but you will be well aware of them. So, do you have any observations about either IFRS or mark to market?

Mr Almanza: Yes. I think that all large companies in the UK have had to invest a lot of time, effort, money, so it’s been on the one hand a net cost to us but on the other hand we see IFRS is conveying significant benefits to our shareholders and to shareholders and the public in general. Because a global standard, we think, delivers a net good for companies, investors, society, so we’re strong supporters of IFRS in a general sense.

More specifically, mark to market has limitations. I think IFRS recognises today those limitations. On the point that you were making, Lord Lawson, about it measuring values at the top or the bottom of the market, I think what we would say, at least I would say, the objective of financial statements ought to be to measure objectively the value and if market value happens to be high or low that’s what it’s measuring. So the volatility that has been seen in reported results reflects underlying volatility. I think a valid question, though, for standard setters and policymakers to ask...
is: what are the limits of mark to market accounting and IFRS? Where assets and liabilities are not traded in a liquid market, you can get quite odd results by trying to mark to market, and I think that’s a legitimate question for standard setters and policymakers to keep in view. Certainly, it’s one that as a company and as a group of companies we do comment on when the ISB consults.

Q295 Lord Lawson of Blaby: So in your opinion, just to press it, there is a genuine problem there that needs to be resolved and has not yet been resolved and the example I think you’re absolutely right to point your finger at, where there is not a very large market, not a very wide market, but there is, as it were, a price. At the top with a financial bubble, as we saw before the banking crisis broke in a number of cases, that enabled huge paper profits which could never have been realised in the real world to be declared on the basis of which there were substantial distributions either in bonuses to the management or in dividends to shareholders. That was a real distribution of rather phoney, spurious, evanescent, ephemeral profits, which caused a considerable weakening, therefore, of the institutions concerned. And then again at the bottom end they had to relax it because it was a Doomsday machine where there was a market price that was so underwater that something had to be done about it. So these are serious defects and, as far as I can understand your general answer, you agree with that. I’d be grateful if you could let us know what you think the remedy should be.

Mr Almanza: Just to clarify, I’m saying that the primary underlying problem is that prices were inflated or depressed excessively. And I think that was widely apparent. You didn’t need to look at the market to market accounts of any of these institutions, companies, organisations to divine that there was an asset bubble. There was plenty of well-informed commentary around annual report and accounts suggesting that there was an asset bubble, for example, and I think there was plenty of commentary in the immediate aftermath to suggest that the market had overshot in the other direction. So I think that’s the primary problem.

I think the remedy is for standard setters and policymakers to recognise that mark to market accounting really works best in markets where assets and liabilities are traded in depth and with liquidity. So, active markets are clearly priced on a regular basis by many participants. Where you had what I think you referred to as spurious profits, the biggest problem would probably tend to be where you had very few participants in a market and there wasn’t an actively traded or quoted or observable market. Other than that, I think IFRS should report what it sees rather than try to correct what the market establishes as a price or a value.

Q296 Lord Lawson of Blaby: Yes, I go a long way with your analysis, although I would push it a bit further. But what I’m not clear is what your proposed remedy is.

Mr Freestone: Could I suggest one that might help, but I’m not sure it doesn’t have its own faults. I think the issue with fair value accounting, which is where mark to market has come from, is that it values things at a point in time. And the benefit of that is that there’s an objective value if there’s a decent market, as Ashley says. The downside, of course, is that that market may not always be rational and, therefore, sometimes those values may be either over-inflated or depressed. I think the concept of fair value has become a value at a point in time, largely at our balance sheet dates, and therefore if you’re looking at a fair value that isn’t at a point in time, that is some form of average, that might mean that values weren’t always taken at points that were either very high or very low. That’s quite a departure in terms of how values are set compared to how accounting standards are phrased today.

Q297 Lord Lawson of Blaby: Would you recommend the use of that?

Mr Freestone: There are certainly benefits to it. It brings back into debate all those questions about how that average is struck and many other things that would materialise from going that way, but it would move to a less point-in-time-orientated valuation. That would be the benefit.

Q298 Lord Best: It has been suggested that one of the reasons why there was a good deal of contentment with the audit arrangements that companies like yours have is that there’s a rather cosy relationship between the firms of auditors and your own companies and, indeed, that some senior staff move between the firms of auditors and your own.

Do you think that this is a misapprehension or are those personal relationships where people have moved one way or the other, really leading to a position in which the degree of contentment that you seem to have with your auditors is perhaps a little too cosy?

Mr Almanza: I think as a general matter the cosy relationship is not something I’ve observed. I think the cornerstone of a healthy relationship between auditors, companies and shareholders is the board and the audit committee. If you have a board that comprises primarily clearly independent directors and an audit committee that comprises solely independent directors, then that’s the principal axis through which the relationship between the auditor and the company should operate. Again, in my
experience it's pretty rare for senior members of an audit firm to leave that firm and become senior members of the executive or management team in the client company where they’re exercising judgments over financial reporting, financial control and so on. Many companies just prohibit it outright; you may not do that. You do get exceptional circumstances. There have been, of course, exceptional circumstances where that occurs, but I think the root of this is the audit committee. If you have an independent audit committee, an independent board, they “own the relationship” with the auditors and their interests are closely aligned with the auditors. They want an objective view as to whether or not management is preparing accounts that fairly reflect the business.

Q299 Lord Best: We know you don’t go out to tender very often and it’s very rare to change your auditors, but do you think that this concentration in the hands of the Big 4 leads to higher audit fees than would be the case if there was a more competitive environment out there?

Mr ten Brink: I’m not sure that the relationship between concentration and audit fees is all that obvious. I believe there are a number of important aspects to consider in what determines the cost of external audits. Equally important is the way that the company has set up its internal processes, systems, activities and, therefore: what is the audit effort required to actually come to an opinion? So what is the degree of commonality and standardisation in those processes? Is it one accounting system or is it multiple accounting systems that need to be considered? Typically, those aspects have a fundamental impact on the effort associated with the audit and, therefore, the cost.

Q300 Lord Tugendhat: Can I come back to the relationship with the auditors? It has been suggested to me by an executive at one of the banks that got into trouble that under the previous regime there was far too cosy a relationship between the relationship partner and the Chief Executive of the bank concerned and that the Chief Executive of the bank concerned rather overawed the relationship partner. Now, inevitably, the Chief Executive and the relationship partner are going to have a relationship that is closer than other executives, apart from yourselves perhaps, but in your long experience of your profession have you noticed a tendency on the part of some Chief Executives to have a rather domineering relationship with the person who is auditing them?

Mr Almanza: I haven’t and I think it would be a cause for concern if that was something that the board observed.

Q301 Lord Tugendhat: Certainly, in my experience, which happily is not the same as the one I’ve just reported, I have noticed that sometimes the Chief Executive is a rather stronger character than the person who is auditing the firm and that on second thoughts the auditor doesn’t always have quite the same opinion about an issue that was concerning him that his first thoughts were. He was no doubt convinced by the strength of the argument, but Chief Executives are strong-minded individuals. None of you have noticed this phenomenon?

Graham Roberts: If you take a long-term view there’s been a fundamental change in the relationship between auditors and companies caused by the rather poor standard of accounting we had at the back end of the 1980s and the crisis and the response to that. So when the Financial Reporting Council was created and the various bodies like the FRRP and audit committees began we’ve been on a trajectory of some time of professionalisation of those audit committees and the relationship now is much more driven around the audit committee and the audit committee chairman. And certainly in terms of decisions around auditors, that has much more moved towards the non-executive rather than management, and I think that is probably one of the reasons why. Leave aside one’s views on the banking side, we’ve had very few audit failures in the UK over the last 10 to 15 years in terms of scale.

Q302 Lord Tugendhat: So if a phenomenon of the sort that I was reporting on occurs, it is likely to be a reflection of the Chief Executive’s dominance overall, including of his non-executive directors, rather than a problem that is specific to Chief Executives and auditors?

Mr Freestone: I certainly would have thought so, and I would have thought in that scenario the audit partner should have sufficient backup in the form of technical departments and other people that he or she has to convince back at their audit firm such that that pure relationship between one individual in the company, whether it be the Chief Executive or the Chief Financial Officer, and the single auditor is not the be all and end all. It’s the relationship between several other parties within the audit firm and, indeed, the audit committee as a whole that would override that relationship in most normal circumstances.

Q303 Lord Moonie: Anybody changed their auditors recently?

Mr ten Brink: 2005.

Q304 Lord Moonie: In that case it’s actually appropriate for me to ask the next question. If and when you put an audit out to tender, do you invite...
The Chairman: Can I ask about tendering? In evidence it says "audit market" here. In the same letter, Mr Williams suggests that in some arenas there is a Big 6”. So Lord Tugendhat: So there was a particular factor that your business, but I was very surprised in the letter we got from Peter Williams of The Hundred Group in which he says, “We do not feel the audit market is unduly concentrated. Indeed, we see that in some arenas there is a Big 6 of accountancy firms providing increased competition”. Nobody else who has come before us has talked about a Big 6. Everybody seems to agree that there is a Big 4 and the reasons for it may well be reluctant to go beyond that unless they feel they really have to is that changing the audit engagement does bring increased risk and they will keep that in mind when they’re thinking about—

Q305 The Chairman: Can I ask about tendering? In terms of competition and choice and acknowledging that you take the view that you have to have one of the Big 4 for the reasons you’ve already described to us, why is it that so very few tenders are actually done and even rarer for an audit firm to be changed? And we’ve seen the figures on this.

Mr Almanza: I think one of the reasons is that 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. So, for example, some companies pre-qualify without going to tender. So I don’t know whether that’s in your statistics, but you go and engage with the competition and pre-qualify them. Your auditor will know; you’ll be very open with your auditor that’s what you’re doing. And that will certainly cause them to stay on their game and price competitively and, I think, deliver quality. I think that’s one of the reasons that you don’t get change very often. If I may, the other reason that audit committees may be reluctant to go beyond that unless they feel they really have to is that changing the audit engagement does bring increased risk and they will keep that in mind when they’re thinking about—

Q306 The Chairman: How many of you actually have done pre-tendering? Have you any idea, apart from yourselves which I’d be interested to know, of what the overall statistics are?

Mr Almanza: I can’t say I know the overall figure. We have done it.

Mr Freestone: We’ve done it, too.

Mr Almanza: I don’t know what the overall statistics are, but we could certainly get that information if you’re interested.

Q307 The Chairman: And you’ve changed?

Mr ten Brink: We changed in 2005 when we changed from a joint audit model to a single auditor.

The Chairman: So there was a particular factor there to—

Mr ten Brink: Indeed.

Q308 Lord Tugendhat: I know that so many companies reply as you did and I quite understand the nature of your reply about the international scope of your business, but I was very surprised in the letter we got from Peter Williams of The Hundred Group in which he says, “We do not feel the audit market is unduly concentrated. Indeed, we see that in some arenas there is a Big 6 of accountancy firms providing increased competition”. Nobody else who has come before us has talked about a Big 6. Everybody seems to agree that there is a Big 4 and the reasons for it may well be reluctant to go beyond that unless they feel they really have to is that changing the audit engagement does bring increased risk and they will keep that in mind when they’re thinking about—

Q309 Lord Tugendhat: That’s not quite the same as saying there is a Big 6. In which area of activity can one possibly say that there is a Big 6? FTSE 100 doesn’t have any non-Big 4; FTSE 250 hardly.

Mr Freestone: Not for auditing, no, but certainly for the other services that we—

Lord Tugendhat: But it says “audit market” here. This is a view put forward by Mr Peter Williams, “We do not feel that the audit market is unduly concentrated . . . in some arenas there is a Big 6”. So perhaps it just wasn’t very precisely drafted.

Mr Freestone: I think there were separate sentences there. I think when it comes to audit services per se four is probably sufficient. If we were to go through a full audit tender process, looking at four is probably enough.

Q310 Lord Hollick: In the same letter, Mr Williams says, “In particular, we note the high level of competition demonstrated during an audit tender process. In our experience, this process brings out a high degree of competition in terms of emphasis of approach and on audit fees paid”. So he’s clearly very approving of this process. But this seems to be a process that few companies undertake on a regular basis. Now, I think three of you have said you’ve recently had an audit. Is that part of a regular
process? When you do it, is it at the behest of the audit committee? What were the criteria, without going into any sort of confidentiality issues, that you had in mind when you looked at it and what swung it which way?  

Mr Almanza: I think it’s important to differentiate between a prequalification process and a full tender process, and I think again we may be guilty here of conflating the two and using slightly imprecise language. I think, as is the case here today, there are many more companies that would run a prequalification process than would go the next step to a full tender and a change of auditor. I think it can be initiated by the audit committee or management, but in any event it will always require, in my experience, the approval of the audit committee. My guess would be most likely it would originate from the audit committee but it wouldn’t be unreasonable, I think, for a finance director to say, “I think we ought to test the market”. And so long as the audit committee was comfortable with that and understood the reasons, because there can be many reasons for the finance director saying that, that would be fine. The criteria would commonly be capability in your industry sector. So there isn’t equal capability and capacity in each of the Big 4 in all industries. So you would look at industry capability, capacity, and their geographic footprint and capability around the world and how that matched with your own and indeed your plans to grow in the future. I think those are the important criteria.

Q311 Lord Hollick: Did your tender process lead to a change or lead to improved financial terms with your existing auditor?  
Mr Almanza: In our case, we didn’t make a change. As I alluded to earlier, we felt we’d done enough to satisfy ourselves that we were getting good quality and good value for money, but also doing this periodically is one way of keeping things honest, if you like. Forgive me, I forgot the second part of your question.

Q312 Lord Hollick: Did it lead to a reduction in the fees of your existing auditor?  
Mr Almanza: Hard to say, but I suspect it kept them pretty keen. 

Graham Roberts: I think there’s another feature, which is why maybe the turnover rate is relatively low, which is the companies are also quite often in constant change. There are changes of business structure, changes of management; you can have quite a high level of management swing. In the consideration for audit tenders you also need to bear in mind that if there’s a loss of knowledge or a change of structure of the business it may not be a good time for that sort of process if it leads to a change of auditor and a loss of knowledge.

Q313 Lord Lipsey: You are not bankers but your companies suffered as a result of the economic problems of the last few years. Now, when the Big 4 came before us, they tried very hard to convince us that audit was splendid in all essence, it’s just not their fault that anything went wrong, but it’s probably fair to say that the Committee wasn’t instantly convinced, which has caused the Committee to ask for additional evidence from them in an attempt to substantiate this case. They’ve got obviously their own cause to plead. Looking at it more objectively from your situation, do you really feel they did a good job in auditing the banks as the crisis broke?  
Mr Almanza: Well, in my case I can’t say I’m a great student of precisely what they did in executing their audit of banks. I would venture as far as to say, though, that there were many contributing factors and one would have to look at management of those banks, boards of those banks, investors, regulators and auditors to form a view of what contributed to the failure. I would also say that many of the warning signs were clearly there. Of course, it’s easy to say that in hindsight, but actually there were a lot of people— I wasn’t one of them—who were saying that in advance and you could see it in the annual report and accounts. So to the extent that matters were being reported clearly and risks identified and auditors were taking that into account, I would look beyond the role of auditors to the underlying problem, which is—

Q314 Lord Lawson of Blaby: If I may come in, I know that you’re not a banker and that none of the four of you are bankers, but you and your colleague on your right are here representing The Hundred Group, which does include banks.  
Mr Almanza: It does.

Q315 Lord Lawson of Blaby: I think that what Lord Lipsey said was not that auditors were uniquely culpable but maybe there was a failure of auditors among the other failures. So I think that is what needs to be addressed.  

The Chairman: Could I just follow that up by saying you said that in advance lots of us knew all the problems that were around among banks or words to that effect. The issue that we’ve had with the auditors is that they were certifying these banks as going concerns when there must have been a lot of concern as to whether they were going concerns.  
Mr Almanza: I agree, and I think that, to try and answer all three of those questions, that is a proper question to ask and to be examined, but it needs to be
done in a specific way rather than a general way. In other words, the Audit Inspection Unit or the appropriate body ought to be looking at the audit files and asking, “Well, what questions did you ask to satisfy yourself that this was a going concern and what evidence were you provided with? What view did you take, for example, on dependence on wholesale funding as opposed to term funding in arriving at a view on going concerns?” So, I think it’s a proper question. I’m afraid I don’t have the answer but I think it would be right for the AIU or some other body to pick up those audit files and ask those questions in a very specific way.

Q316 Lord Lipsey: There are specific issues, but there’s also a sort of general issue involved, which is that if we take the view that they failed to spot what was going on in the banks, the worry for you and, indeed, for your shareholders must be that they have failed to spot things that are going on in individual firms, perhaps for a quite different set of reasons than applied in the bank. You present a picture in your evidence, and I quite see why, of the good service you’re getting and how satisfied you are with all this. Surely there is somewhere in the back of your mind a lurking fear that these people aren’t the capable professionals that from day to day they may appear.

Mr Almanza: I’m doing all the talking. I may have to answer but—

Mr Freestone: I think that companies are very focused on risk. Certainly, we spend significant amounts of time assessing risk, applying “Turnbull” principles, looking at probabilities of risks arising and how we mitigate those risks. We try and encapsulate that in a relatively small, somewhat unread, section of the annual report called “risk and uncertainty”. I think when one of these issues arises you would look at that section and say, “Was that risk suitably flagged?” Now, it may be that that section is not as prominent as it should be. It may be that the probabilities of risk are not particularly well talked about there. It may be that mitigation of that risk and how management is managing that risk is not always talked about in the way it should be. But I do think it’s up to the management, actually, to define the risks and uncertainties of the business and manage those and the auditors to comment upon them.

Q317 Lord Hollick: But if I may, we heard last week from Mr Powell that it’s not the job of the auditor to look at the business model. So, that makes it rather difficult for them to comment sensibly on the risk management of the business if they don’t, in fact, have a view and don’t fully understand the business model.

Mr Freestone: Well, the risk section is within the directors’ report that the auditors comment upon in terms of it being consistent with the numbers in the accounts. So they do look at that. They may not explicitly make a comment on it, but they certainly are reading it and making sure that it’s consistent with the rest of the numbers in the accounts.

Q318 Lord Hollick: But do they not make a general statement about the going concern nature of the business? It struck many of us last week when we heard them say this that it was rather difficult to form a view about the going concern if, in fact, you didn’t look at the business model and how it related to the risk and the management of risk.

Mr Almanza: They are required to form a view on going concern as the basis of the preparation of the accounts in 99.9% of all cases.

Q319 Lord Lawson of Blaby: Going concern implies looking into the future, not just looking at the past.

Mr Almanza: Twelve months. It does, it implies looking ahead 12 months, and I think again what I’d say on this is that a common cause of failure in banking—and I said at the start I’m not a great student of this—was an assumption that banks would have access to capital in the wholesale markets, that credit would be available, and it turned out that the wholesale markets weren’t there when they were needed. That was an assumption being made by management teams, boards, investors in these companies. Some investors were going in the other direction, of course. Some investors were shorting these companies because they took a different view on that assumption about the availability of capital. And the auditors in coming to a view on going concern—and I make this as a general statement; you’d have to look at each specific case—must have in the case of going concern come to the view that sufficient financial resources, sufficient access to capital would be available for that organisation for the next 12 months. There’s no other way around that. You have to come to the view that that’s the case. I don’t know that it would ever be possible to redefine the terms of an audit and audit scope such that the auditor would be required to get that judgment right in all cases. This is in no way a special pleading for any special interest group, but many people got that judgment wrong: regulators, shareholders, management teams, boards made an assumption and that turned out to be flawed. I guess in the going concern report that may have been an assumption that was made. It needs to be checked but I think it’s not a bad question to ask.

The Chairman: Well, that is actually what we’re following up with the Big 4 because we were not very happy with the answers we were being given. Of
course, we have looked at some of the others, like regulators, in this Committee as well, but this is a focus on auditors.

Mr Almanza: Yes, I understand.

Q320 The Chairman: I wondered if any of the others of you had anything to say on this because it’s an important subject for us.

Graham Roberts: I would like to make an observation just specifically around bank auditing. I did audit banks in the early 1990s, and one thing that has puzzled me in this process is the apparent falling away of the dialogue between the audit firms and the regulator. I think it was an important thing because a going concern statement is a nuclear option for a business built on confidence and, therefore, certainly in those days back in the early 1990s it was a very powerful means of ensuring that the regulator was aware of the micro regulatory risks. The regulator is in a better position to see the whole market than any auditor can be, but for some reason I understand that fell into disuse, presumably after the FSA took over the—

Lord Lawson of Blaby: That appears to be the case.

Graham Roberts: And that I just don’t understand because as an auditor of a financial institution you need that dialogue.

Q321 Lord Hollick: Do you think the audit as presently constituted gives you good value for money? There’s been one suggestion I think from an American academic that, in fact, it’s an assurance policy and, therefore, why not make it an insurance policy and do away with the audit? Obviously, there are a number of different uses and purposes for the audit. Do you think that from a company point of view it’s value for money and do you think from your shareholder point of view it provides good value for money in giving them a really clear, objective view about the business and how it’s performing financially?

Mr Freestone: I think the fundamental requirement that I have in my job and as we have as a finance function within the company that I work for is to get the numbers right. That’s what we’re trying to do because the prospect of a qualified audit report or a restatement in a subsequent period of those numbers is daunting. One doesn’t want to get into that position. So what I rely upon the auditors for is to make sure that we get the numbers right, and that’s why we want high quality at a reasonable cost. Clearly, they’re doing other things because frankly they’re representing the interests, really, of financial stakeholders external to the management team and, therefore, they’re doing a lot of other work to make sure that they can give that assurance to other parties who are going to use the accounts as well. That bit is not really for me, that’s for the shareholder, the potential shareholder, the bankers, the other people who want to look at the accounts. So, the bit that they do, which is help me make sure the numbers are right in the first place, is certainly something that I rely upon. Could we get it cheaper? Possibly, but I think there’s also an issue about quality. We want to make absolutely certain we’re getting the best advice to achieve that objective.

Mr Almanza: I think the other thing we get is our auditors—and I think many companies would find themselves in the same position—happen to audit other companies in our industry and so they do provide us from time to time with non-competitive but nevertheless valuable insights. “Well, this is how other companies do it”, process improvements, that sort of thing. Our audit committee also asks in the absence of management for the auditors to benchmark management’s financial judgments, estimates, and significant accounting policies those against others in the same industry. So, “Where would you rank this management team on a scale of one to 10? Conservative? Aggressive?”, that sort of thing. And I think that that adds a lot of value to the audit committee and provides a lot of perspective, context, even assurance for the non-executive directors, which you wouldn’t get from an insurance policy but you can get from auditors.

Q322 Lord Shipley: As a new member of the Committee, I declare my interest as a member of the audit committee of One North East, the RDA for the north-east? The auditors are KPMG and the National Audit Office. I think Mr Almanza talked about commentary in annual reports about an asset bubble arising and later you made a reference to the fact that the environment was getting more difficult generally and you could see it in the annual report. I just wondered if you could say a little bit more about whether you would welcome the extension of the scope of a mandatory audit into providing assurance on narrative assertions, including descriptions of the business model, in the annual report. In other words, should it be extended into the narrative that has been produced in the annual report?

Mr Almanza: My own view is that would be very difficult to achieve. I think that it is along the lines that Robin said, it’s the role of management and the board to ensure that the business model, the risks and the mitigation measures taken to manage those risks—and there’s always an amount of residual risk that shareholders take in exchange for the return—are best done by management and ultimately the board. I think it’s quite difficult for an audit firm which, today at any rate, the profession focuses very much on ensuring that the financial statements provide a true and fair view of the underlying
business, rather than providing or passing a judgment on the business model per se. They are required to ensure that the directors’ report and the narrative in the directors’ report is not inconsistent with the rest of the financial information that’s being presented. I personally think it would be difficult and I’m not confident we’d get an effective product in the end. I think the auditors, whatever product they produced, would have to be so heavily qualified I query whether investors would get real value.

Q323 Lord Shipley: Can I press you then? I’m not clear who it is that you think is responsible for disclosing potential problems. So, there are various people who can, but it seems as though you’re saying that actually it is those for whom the audit is being done.

Mr Almanza: The disclosure obligation rests with management and the board of directors. They should be properly describing the business model, the risks that they’re taking and how those risks are being managed.

Q324 Lord Tugendhat: We’ve heard a lot about audit committees naturally enough in this discussion, but I’m sure you’re aware that when she appeared before us Baroness Hogg made a suggestion about risk committees. She was suggesting that risk committees be required to seek independent assurance and that was also a suggestion in the Walker Review, which I recognise, of course, was devoted to banks. Then when they came before us on 23 November, the Big 4 supported the suggestion, though they also made a pitch for the external auditor to be permitted to give this independent advice. So, I have two questions. First of all, do you think that there should be new audit provisions requiring board risk committees to seek independent assurance? And secondly, depending on your first answer, do you think it would be helpful if that independent advice came from somebody from outside the magic circle of the Big 4?

Graham Roberts: Certainly, I think the risk committee or the audit committee—and in some businesses it may be more appropriate for the audit committee to encapsulate the risk committee, it depends on the nature of that business—are tasked and take on the role of ensuring that the disclosures, et cetera, on business model and risk are fair in the annual report and in so doing should seek the necessary assurance that they consider is appropriate. I’m not convinced that all of that needs to be independent. Some of it may be, it depends on the nature of it, and some of it could be done by an internal audit function operating towards the Chairs. In my experience, the audit committees have a good feel for what they should seek assurance on. Some of that may be from the external auditor, but I don’t think that actually mandating it is necessarily a step that is required.

Q325 The Chairman: May I ask you in what order would you rank these parties in terms of their relative influence and, indeed, what should be their relative influence on the choice of auditor: shareholders, the board, the audit committee and management?

Mr Almanza: You might get four different answers here, I don’t know.

The Chairman: That would be very interesting.

Mr Almanza: I would say the audit committee, the board, shareholders, management. That would be mine.

Q326 The Chairman: The management should be bottom in terms of the influence?

Mr Almanza: Yes, and let me explain why I say that, because ultimately this is put to the shareholders every year so if they have an objection they can intervene in a very clear and direct way. I think it’s more difficult for management to do that. I recognise that management and the finance director will have the most ongoing contact with the auditors and from an appearance point of view it’s possible one could think that management has a lot of influence. But I’ll go back to my earlier comment—if you’ve got a properly constituted board and audit committee of truly independent directors, that won’t be the case in my view.

Q327 The Chairman: Well, I’d be interested to hear what the other three think because I presume you’ve talked about this beforehand and you might have a different view. Would all of you put management bottom of the list in terms of their influence on the choice of auditor?

Mr ten Brink: Yes, I would say that all four of them have an important role to play and their own responsibility to exercise in that selection process in determining who the auditor is going to be. So I’m not sure whether I would necessarily talk about relative influence or a relative order. I think it’s important to recognise the individual role of each of those four players in the process, so to speak.

Graham Roberts: Yes, and I would put the audit committee/board at the top of that. Certainly, with the change to a majority of independent non-executives, I think that has shifted the balance of those judgments from where it might have been 20 years ago and the pre-eminence for the shareholders who vote. And clearly, in my view, if there’s a vote or a large abstention around an auditor at an AGM then that is something that should prompt a dialogue.
Q328 The Chairman: But on the shareholder position, I can’t recall any situation, any AGM, where the recommendation of the board as to the auditor has been challenged in any way. It seems to me it’s the item on the AGM that just goes through on the nod every time.

Mr Almanza: Yes, maybe we’re answering this question in too strict a fashion, in other words looking at who has the ability to influence the auditor if they choose to exercise that influence. In practice, if you were going out to tender, would management have more influence? Possibly yes, but I would agree strongly with Graham’s comments that the audit committee ought to be in the driving seat and in my experience are in the driving seat.

Q329 The Chairman: But given that there is very rarely a tender and hardly ever a change of auditor, what would you think of arrangements whereby the external auditor was appointed independently of the board of management, for example by a shareholders’ panel or independent regulator?

Mr Freestone: Well, I think it has some benefits and some risks. I think one of the things that I’ve found over many years of being audited by different firms is that the most important factor in the quality of that audit is knowledge of the business by the auditor. The greatest fear I have is that they miss something because they didn’t actually understand the business. My worry about repeated changes of auditor is the risk that comes with that. Clearly, the perception of independence increases but actually, from my perception, the risk increases because we have then a brand new audit team who don’t actually understand much about the business for the first, maybe even the second year. So I think it has some appeals but it also has some risks to it.

Q330 The Chairman: Any other views?

Mr Almanza: Yes.

The Chairman: I was told there might be four different views.

Mr Almanza: Yes. On this question, I don’t think it’s an attractive idea. I think that a cornerstone of UK corporate governance is the role of the board and I think, at the risk of repeating myself, an independent board and independent audit committee is the route to go. I think if we were to go down the road of regulators appointing auditors, for one thing that would require us to build regulatory capacity, substantial capacity, to deal with different industries and I think that would add a lot of cost. I share Robin’s concerns. I’m not sure we’d get a better outcome.

Graham Roberts: I agree with that. I think also the audit committees could probably do more in articulating their activities in this particular field and being available for discussion with the shareholders, which I think is a preferable route to a shareholder panel.

Mr ten Brink: I do support the earlier comments made. I would also say that the importance of compliance is primarily the responsibility of senior management and the board. It is part of the licence to operate, so the interests of the board and senior management in preserving that licence to operate I think is undisputed; thereby giving them the responsibility to determine who the auditor would be I think entirely logical.

Q331 Lord Lawson of Blaby: I would like to pick up on a remark that Mr Roberts made a little bit earlier when he said, and please correct me if I’ve got it wrong, that the requirement for there to be a private dialogue between bank auditors and the supervisors or regulators, which I put in the 1987 Banking Act—and it was a requirement, it wasn’t just permission—ceased with the transfer of responsibility for the supervision and regulation of banks in 1997 from the Bank of England to the FSA. And I wondered whether at the time anybody said, “Hey, wait a minute” or was it just an oversight and nobody noticed it was happening or nobody cared, they couldn’t care less? Did anybody say, “Hey, wait a minute, this is a rather useful dialogue”? Did the supervisor say it? Did the FSA say that? Did the auditing firms say, “Well, thank God we don’t now have to talk to the supervisor or regulator” or did any of the auditing firms think this was a bit odd, this suddenly being dropped? Or did nobody notice what was going on?

Graham Roberts: I think that is the question I would have liked an answer to myself. I don’t know the answer to that. Clearly, I was not engaged in that activity at that time, but I think it’s actually the seeds of the gap that opened up. It’s just a personal view from a distance.

Q332 Lord Lawson of Blaby: Do any of you have anything to add to that answer?

Mr Almanza: No, I don’t.

Mr ten Brink: Not really.

Lord Lawson of Blaby: Thank you. Well, we’ll have to pursue it further.

Q333 Lord Best: Yes, I think we’ve done quite a bit on the role of the audit committee, your views on that, and we’ve done quite a bit on the cost of the audit. But perhaps I could move to a question about the desirability or otherwise of the same firm of auditors providing non-audit services to you, as you see after your main audit. Is that another characteristic of cosiness or is this a helpful and useful thing to have
the same firm doing consultancy work for you on other matters?
Mr ten Brink: We apply very strict rules to the provision of non-audit services by the external auditor. In such incidental cases clearly it is key that there isn’t a conflict of interest, which is why we apply separate approvals, why there is appropriate disclosure to the audit committee of such incidental use, but it can be of value where it concerns an acquisition or a divestment and where matters of valuation are involved. The auditors may have access to the information required to provide that specific service. But it’s incidental and it’s not material in terms of the overall cost of the audit. So, we do apply very strict rules in that respect.

Q334 Lord Best: Does everybody else apply strict rules?
Mr Almanza: We do. Our audit committee oversees those rules, sets the budget annually and outlaws completely or prohibits completely certain work. So, yes, management is bound by rules set by the audit committee and I expect they’re pretty similar to Martin’s rules.
Mr Freestone: We have the same.
Graham Roberts: So do we.

Q335 The Chairman: Does that mean that you think we in the UK could go as far as the Sarbanes-Oxley Act, under which I understand most audit work by auditors is outlawed for companies with primary or secondary listings in the United States?
Mr Almanza: We’re no longer dual registered so I’m not current with ACC requirements, but certainly we were listed in New York post Sarbanes and not all audit work was outlawed then. I’m not sure it’s the case now.
The Chairman: Not all, but I understand most is.
Mr Almanza: Yes.
Mr Freestone: Significant elements. We are governed by Sarbanes-Oxley. We have a US listing. The rules that we just talked about actually take that into account.

Q336 The Chairman: I assumed it had done, actually. Would you think there would be an advantage in extending that here?
Mr Freestone: I think the Accounting Practices Board is looking at this at the moment to establish whether the line of what can and can’t be done by audit firms is in the right place. I think I’d wait to see the outcome of that study.

Q337 Lord Shipley: Can I just clarify? I didn’t fully understand whether each of those answers applied globally or whether they were a UK answer. Do you apply the same rules in all countries automatically?
Mr Almanza: Yes.

Q338 Lord Shipley: There’s no doubt about that and there’s no first tier and second tier or anything like that?
Mr Almanza: That’s correct.

Q339 The Chairman: So that means that if those of you who are in that situation have to abide by the Sarbanes-Oxley Act, that’s something you apply globally?
Mr ten Brink: Globally applicable, indeed.

Q340 Lord Lipsey: There is a balance to be struck here because many companies see advantage in their auditors conducting consultancy work for pretty obvious reasons. They know the business already and, therefore, you’re not having to spend a lot of money, time and effort bringing them up to square one. Do you think, in fact, the rules might have gone too far and be a bit too tight?
Mr Freestone: No, I think there’s a real issue with audit firms conducting consultancy that then results in some change to financial process or financial systems and then auditing those. So I think actually that would not be sensible.
Mr Almanza: I don’t think it’s gone too far. Mr ten Brink: I agree.

Q341 Lord Moonie: The last question that we have on this sheet suggests asking you what you think would most assist in widening choice, but from your answers tonight you don’t really seem to think there’s all that much necessity in widening choice. So I was just wondering if there was anything at all you would particularly like to change in this issue—
Mr ten Brink: Well, maybe the obvious point to make is that as an international company the degree to which we have consistency and alignment between the regulatory frameworks obviously does help to create more of a level playing field. Will that bridge the gap between the Big 4 and the next tier? I think the reality is that it will require very significant investment of a tier two audit firm to actually position itself as one of the tier one firms. So, that reality is out there and undisputed.

Q342 The Chairman: Do you think there’s no way that a second tier firm could become a big fifth?
Mr Almanza: I don’t agree with that. I think they can, and my answer to that and to Lord Moonie’s question would be while we don’t generally see a problem with four, we certainly wouldn’t like to see it go to three and we’d welcome a fifth, and I think most
FDs would say that. But I think this is a question of investment by the second tier firms. There is, as far as I can see, nothing preventing them from merging or investing more in creating a global network. After all, the Big 4 arose out of consolidation and it’s not clear to me what’s preventing second tier firms from pursuing that strategy if that’s what they want to do.

Q343 The Chairman: But you’ve said twice, Mr Almanza, that your fear would be of a Big 3 and that you would not welcome that at all. If there became a risk of a Big 3 or if it happened, what do we do?
Mr Almanza: That’s a very good question. I’m afraid I’m not sure I have the answer. I think something we have discussed with the FRC before is that the regulator needs a contingency plan, if we lost another firm, for an orderly transition of those audit accounts to a new firm. And that seems to me to be a fairly low cost, sensible idea that the regulator has a contingency plan to assist the transition of those audit clients to new auditors, although in many cases I suspect companies would be acting promptly out of self-interest. But beyond that I’m afraid I don’t have a specific suggestion.

Q344 The Chairman: Anyone else?
Graham Roberts: The only difficulty with that is that it needs to be on a global regulation position because that’s where the difficulty arises. If a firm is not there in the US how do you get a US subsidiary audited? So it’s actually I think a combination of global regulators.

Q345 Lord Hollick: As members of The Hundred Group, you’re in a unique position to know what the real concerns are today of the top 100 company finance directors in this country. What are the one or two things that are right at the top of your agenda about the audit process?
Mr Almanza: Do you want to answer this or should I?
Mr Freestone: You have first go.
Mr Almanza: It sort of picks up a theme from the previous two answers. Something that concerns us deeply is the idea that we’ll end up with multiple regulatory regimes, one in Europe, one in the UK, and for those that are dual registered, another in the US. We are following closely and with some concern the EU Green Paper on auditors. There are aspects of that that I think overlap with what we’ve discussed today. What would we welcome? We’d certainly welcome improvements, but I think we would say more regulation is not necessarily better regulation. So harmonisation of regulation between Europe and the UK would be high on our agenda insofar as the role of auditors is concerned.

Q346 Lord Lawson of Blaby: But on that front, what’s your biggest specific concern about the EU Green Paper?
Mr Almanza: I think I’m concerned about the notion that regulators will appoint auditors rather than audit committees. I’m concerned about mandatory joint audits. I think that, as I said earlier, there’s no reason to prevent second tier firms from consolidating if that’s a strategy they wish to pursue. I think that there is a risk there that we create regulatory capital for second tier firms. So, for one, I don’t support that. Those would be two factors I would highlight. Robin?
Mr Freestone: Well, I think on the joint auditors, the worry then, of course, is that that means that in looking for a firm to provide consulting services you’ve got a choice of two if you want a firm to do that internationally for you. So you’ve then effectively locked out two firms if you have joint auditors, which is unhelpful in the context of what we’ve just talked about. So I think that is a worry.

Q347 Lord Tugendhat: May I ask a different question? I address it to Mr ten Brink, if I may. The banking issues are all fresh in our mind because the crisis occurred recently. Rather longer ago Shell had a problem over its reserves, as I recall, and the details of that are much less clear in my mind. But basically, as I recall, the problem was over the assessment of your reserves and the reporting of them, and a senior Managing Director and your predecessor or whatever, maybe predecessor but one, I don’t know, lost her job as a result. Now, could you tell us in that particular issue when the figures, to quote somebody a moment ago, were spectacularly wrong, what was the role of the auditors? Did they spot a problem? Did they warn of a problem? Was there any fallout on the role of the auditors? Did they spot a problem? Did they warn of a problem? Was there any fallout on the auditor’s reputation as well as on the top management at the time, or was this rather like the banks, an event where a bombshell occurred and it emerged that the auditors had been blindsided by it?
Mr ten Brink: Maybe two points to make. The first point is that the disclosure of proved reserves is in actual fact not in scope of the audit assignment. So the auditors did not have a formal role to play in that particular case. I guess I would point to the fact that the company self-declared the misreporting of proved reserves, this was not by an external event that it got recognised. It was internally that the management and the board actually took its responsibility to provide openness about the situation and then institute an independent investigation to determine the causes and the extent of the issue. It’s a rather different context, I believe, in terms of circumstances and what has occurred.
Q348 Lord Tugendhat: I know there have been all kinds of changes in the company, partly no doubt as a result of that and partly because you’ve changed your structure and so forth, but do the auditors have a role now in relation to the assessment and reporting of reserves?

Mr ten Brink: They do not have a formal role in that process, so that’s subject to limited audit requirements. There is an independent review through a reserves committee, which is constituted in the company, which reports ultimately to the audit committee. So that provides an independent assurance in terms of the correctness and completeness of the numbers that we disclose.

Q349 Lord Tugendhat: And who does that?

Mr ten Brink: That’s a group of fairly specialist people with particular expertise around making these kinds of assessments, both from a technical and a commercial perspective.

Q350 Lord Lawson of Blaby: Sorry, are they employees of the company?

Mr ten Brink: They are employees of the company.

Lord Lawson of Blaby: Right, so they’re not independent?

Mr ten Brink: They provide an independent line of assurance to the audit committee.

Q351 Lord Tugendhat: I see. Do you see any similarity at all with the problems that you ran into over the reserves? What’s in my mind is that here we had the banks, I’m thinking particularly of Northern Rock, perhaps, where it had a very particular business model that everybody praised at the time, I quite agree, the shareholders and everybody else. And it collapses and the auditors hadn’t given a breath of warning, nor did others, I quite agree. But I was wondering whether you saw any similarity between this enormously embarrassing incident in your corporate history and the problems that have afflicted the banking industry.

Mr ten Brink: Indeed, a serious problem for the company, one that in the context of the profitability had somewhat limited impact on the financial results that we reported, so I would find it difficult to draw the parallel with a bank that ultimately collapsed in this particular example that you quote.

The Chairman: Gentlemen, we’ve covered a wide range this afternoon and it’s clear that there are in this some big and difficult issues with which we’re grappling. If in the light of this exchange there are any other points that you’d like to put to us in writing, please do. But meanwhile, we thank you very much for your contribution this afternoon.¹

¹ Questions 352, 353, 354 and 355 unallocated.
Memorandum by the Institute of Internal Auditors (ADT 40)

**SUMMARY OF KEY POINTS**

1. The role and value of internal audit should be better recognised within the UK Code of Corporate Governance, and guidance issued under it by the Financial Reporting Council (FRC), with regard to publicly listed private sector organisations. This would bring the private sector into line with best practice in the public sector.

2. At the same time, we would like to see a clearer understanding of the differences between external audit and internal audit and an appreciation of the different contributions they can make.

3. Audit committees have a vital role to play in supporting internal audit quality. The FRC’s Code of Corporate Governance and the supporting Guidance for Audit Committees should require audit committees to satisfy themselves in relation to the competency, confidentiality, independence, objectivity, security of resources of internal audit and of the effectiveness of the relationship between internal audit and the audit committee.

4. Regulators in general should give greater recognition to the assurance that they can take from the work of a professional internal audit function.

5. The breadth and scope of internal audit’s role means that it has a significant role to play in supporting the organisation to improve corporate governance.

6. Accounting firms should not provide internal audit services to their external audit clients.

**THE INSTITUTE OF INTERNAL AUDITORS**

7. Established in the UK and Ireland since 1948, the Institute of Internal Auditors—UK and Ireland has over 8,000 members and, from 1 October 2010, becomes the Chartered Institute of Internal Auditors (IIA). It is the only professional body dedicated exclusively to training, supporting and representing internal auditors in the UK and Ireland. We are part of a global network of 170,000 members in 160 countries.

8. Members of the IIA work in all sectors of the economy: private business (including most FTSE 100 organisations), government departments, utilities, voluntary sector organisations, local authorities, and public service organisations such as the National Health Service. All members globally work to the same International Standards and Code of Ethics, which are part of a globally agreed International Professional Practices Framework and have been recognised in the Financial Reporting Council’s Guidance for Audit Committees and adopted in UK central government’s Government Internal Audit Standards and in the internal audit standards for the NHS.

9. The IIA offers a postgraduate level professional qualification in two stages, leading initially to the PIIA (practitioner) designation and subsequently to the designation “CMIIA” (Chartered Internal Auditor), with an ongoing requirement for professional development and adherence to professional standards. The qualification assesses a combination of knowledge, understanding and professional competence.

**WHAT IS INTERNAL AUDIT?**

10. All organisations face risks in everything they do. It is the role of senior management and the board to put in place frameworks and processes to manage all types of risks and to monitor how successful they are at managing them. Internal audit provides assurance to the board on the effectiveness of these frameworks and processes.
11. To perform their role effectively, internal auditors must build strong relationships with line managers, audit committee chairs, chief executives and chairmen. These relationships enable the internal auditor to champion effective risk management, challenge those responsible for it on its success and use their knowledge of the business and the management of risk to act as a catalyst for improvement in an organisation’s risk management practices.

12. Internal audit is a function that belongs to the organisation and sits within the governance structure; but it must be independent of the areas it evaluates and internal auditors must be free from undue influence from management, or indeed, anyone else, so that their judgments can be as objective as possible. To help safeguard their objectivity and independence, the head of internal audit should report directly to the audit committee.

13. Internal audit is essential to the long term success of an organisation. This is because, alongside non-executive directors, executive management and external audit, internal audit is one of the four cornerstones of good corporate governance. Without it, the board would lack information and insight into how well the people within the organisation are managing their risks.

Three lines of defence

14. The three lines of defence model has been increasingly applied to corporate governance, and particularly risk management, over recent years. The IIA finds it useful to help demonstrate the different roles in governance and the interplay between them.

15. The IIA believes that risk management is an essential part of management. The first line of defence is formed by line managers who own the risks that they take every day.

16. In larger organisations, there are specialist “risk management functions” which support the line managers with this work. They form the second line of defence. They facilitate risk management activities, advise line managers and help ensure consistency of definitions and measurement of risk.

17. Internal audit provides the third line of defence. It is part of the governance process but sits outside of the risk management process. Internal audit regularly evaluates the effectiveness of each element of the risk management process and of the process overall, ie the performance of the first and second lines of defence. Internal audit may (and indeed should) use the outputs of risk management activity in forming its conclusions.

INTERNAL AUDIT COMPARED TO EXTERNAL AUDIT

18. The IIA recognises that the historical connections between providers of external and internal audit services mean that many stakeholders may not be as familiar with the differences between external and internal audit as we are. The table below provides an outline of these differences. More detailed explanations of these differences are given in Appendix 1.

Table
ILLUSTRATING DIFFERENCES BETWEEN INTERNAL AND EXTERNAL AUDIT

<table>
<thead>
<tr>
<th>Item</th>
<th>External audit</th>
<th>Internal audit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recipient of reports</td>
<td>Shareholders or Members</td>
<td>Board members and senior managers</td>
</tr>
<tr>
<td>Objective(s)</td>
<td>Add credibility and reliability to reports from the organisation to its shareholders by giving an opinion on them</td>
<td>Provide the assurance that members of the board and senior management use to fulfil their duties</td>
</tr>
<tr>
<td>Coverage</td>
<td>Financial reports and related disclosures, financial reporting risks and their management</td>
<td>All categories of risks, their management including the flow of information around the company, and governance</td>
</tr>
<tr>
<td>Timing and frequency</td>
<td>Project(s) tied into financial reporting cycle, focused on objective of audit opinion</td>
<td>Ongoing and pervasive</td>
</tr>
<tr>
<td>Focus</td>
<td>Mainly historical</td>
<td>Ideally forward-looking</td>
</tr>
</tbody>
</table>

1 NB risk management starts with objectives/purpose, then includes identification, evaluation and assessment of the risk; selection and implementation of the appropriate responses; and monitoring to ensure that the responses are working as required.

2 See footnote 1.
Question 12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

Role of internal auditors

19. We have outlined above the role of the internal auditing profession. The IIA does not believe that role needs enhancing. However, we do believe that the corporate governance code for listed companies needs to recognise the modern role of internal auditing.

20. Currently, the Code of Corporate Governance of the Financial Reporting Council recognises the need for internal audit but treats it very differently from every other element that contributes to good governance, in that it requires companies only to consider the need for internal audit. We believe that the Code should be amended to include a clear provision that the company should have a professional internal audit function. This is particularly important for internal audit since it is not a statutory requirement. As with all other provisions, the company will be able to explain why it does not comply if it does not believe it needs internal audit (ie comply or explain).

21. Since modern internal auditing’s scope is very broad and is intimately related to the information that the board needs, we propose that this provision be included within the Section B.5. of the Code, relating to the Information needs of the board.

22. In contrast, the requirements in the public sector are much clearer. The Code of Good Practice for Corporate Governance in central government departments and similar guidance for local authorities are clear that “the board should ensure that effective arrangements are in place to provide assurance on risk management, governance and internal control. In this respect, the board should be independently advised by: . . . an internal audit service operating in accordance with Government Internal Audit Standards”.

Interaction with external auditors

23. The IIA’s International Standards impose on the head of internal audit a professional obligation to coordinate the internal audit activity with other assurance providers. We recognise that the work of the different assurance providers, including external audit and internal audit, may sometimes be looking at the same things in the same areas. Where that is the case, then a close working relationship, sharing plans and reports, can ensure that the organisation receives more effective and efficient coverage of all its risks.

24. However, it is important that the head of internal audit and the external audit partner work together in an environment where they both understand each other’s objectives and scope and respect their different professional standards.

25. In particular, it is essential that everyone involved, including external audit, internal audit, audit committees and regulators, recognises that, even when internal audit is working in the same areas as external audit, they are very likely to be addressing different sets of questions. These may not be appropriate to the needs of external audit and external audit will report that it is not able to rely on internal audit work to reach their conclusion on the truth and fairness of the financial statements. This does not mean that the internal audit work is of poor quality or that there is unnecessary duplication. The audit committee may find that it benefits from receiving the different insights from the two groups of auditors.

26. There are two other areas of contemporary debate: firstly, the extent to which an accounting firm might provide its external audit client with internal auditors and, secondly, the extent to which an external auditor might use internal auditors to gather evidence to support the external audit opinion.

Responses to Questions Relating Particularly to Internal Auditing

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27. The IIA believes that internal audit and external audit are two of the cornerstones of healthy governance. If two of those cornerstones are provided by the same entity, it is likely that the entire corporate governance structure will be weakened. Therefore, we recommend strongly that an accounting firm does not provide internal audit services to its external audit clients.

28. The IIA believes that where the external auditor undertakes internal audit work there are—or there could appear to be—potential threats to the quality of external audit work from self-interest, self-reliance and taking a management role. In addition, the IIA believes that relying on the external auditor to provide internal audit services may pose threats to the independence, objectivity, competency and resourcing of internal audit services.

29. In the case of external auditors using internal auditors to gather evidence for their opinion, the IIA sees similar issues—it weakens the overall quality of governance. In addition, it may reduce the quality of internal auditing in the organisation since the opportunity cost of internal auditing completing external audit’s work is less internal auditing resource to deploy on all the other risks facing the organisation. It provides a management problem for the organisation too. The internal auditors concerned may wish to obtain written confirmation from the organisation that their employer is happy to waive any terms related to confidentiality, etc, so that they can report findings to the external auditor.

Question 13. Should the role of audit committees be enhanced?

30. Audit committees already have a pivotal role in overseeing the audit arrangements of the organisation.

31. The IIA believes that the Code of Corporate Governance and the supporting Guidance for Audit Committees, provided by the FRC, concentrate too much on the financial statements and the external auditors. We would like to see some clarification and rationalisation which ensures that the audit committee satisfies itself in relation to competency, confidentiality, independence, objectivity, security of resources of internal audit and of the effectiveness of the relationship between internal audit and the audit committee. We would like to see audit committee members:

(a) Understand the different objectives and scopes of external audit and internal audit.
(b) Support the external auditor in providing an effective service to the shareholders.
(c) Consider whether the non-audit services the external auditor provides undermine—or may be seen to undermine—the quality of the external audit.
(d) Recognise the importance of the audit committee’s role in providing the environment in which a healthy internal audit activity can flourish—the audit committee is key to self-regulation.
(e) Ensure that the activities of these two important services are coordinated and do not duplicate unnecessarily. However, the Institute advises audit committee members to bear in mind the value of both covering the operational risks of each business area and collecting evidence to support assertions in the financial statements—this may necessitate some overlap to provide effective checks and balances and healthy debate.
(f) Insist on the services of a competent, qualified and experienced head of internal audit to oversee all internal audit activity, including that carried out by any external service provider, whether a firm or individual contractors.
(g) Take care to provide effective support to the head of internal audit: build a relationship that allows the head of internal audit to challenge and to raise issues directly with the audit committee, unmediated by management.
(h) Take steps to ensure the competency of every person undertaking internal audit work.
(i) Ensure that anyone undertaking internal audit work is required—either by employment contract or by contract for services—to respect the international ethical and practising standards of the internal audit profession, as set out by the international Institute of Internal Auditors Inc and the IIA in the UK and Ireland.
(j) In particular, satisfy itself that all internal auditors:
   (i) respect the confidentiality of information about or from the company; and
   (ii) feel able to remain unbiased whether they are employees of that or another organisation.
Question 14. Is the auditing profession well placed to promote improvement in corporate governance?

32. External audit has a key role to play in corporate governance. It gives a view on the reliability of the statements that are the tool to provide transparency over financial results, allowing the directors of a company to report to the owners. It wields a fairly blunt instrument: it can give a clean opinion or it can provide a less than clean opinion, all flavours of which can be disastrous to most companies. There is perhaps a limited role that the company’s external auditor can play in improving these aspects of corporate governance.

33. Internal audit operates within the governance structure. Its role is both to provide assurance on the effectiveness of governance processes, including the management of risk, and to help the organisation to improve. When it is effective, it may not be very visible since it works to facilitate and assist the managers in making changes and improvements that they want to make. However, this way of facilitating change can be very effective.

Question 10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

34. Yes. We endorse the view of the external audit standards, which are clear that non-audit work poses potential threats to external audit quality. They identify six types of threats: self-interest, self-review, management, advocacy, familiarity or trust and intimidation.\(^4\)

35. The external audit ethical standards provide extensive procedures that external auditors must follow to prevent such threats from affecting the external auditor’s independence. The extensive inspection regime seeks to ensure that the standards are followed and, thus, mitigate the threats.

36. The only way to avoid threats arising would be to prevent audit firms from performing any other work. This would require a substantial reengineering of the industry and would have implications for the quality of the people involved and the work that they do and the price of audits.

37. For internal audit, the question is slightly different. Helping the organisation to improve is central to the internal audit role. However, the International Standards make it clear that internal auditors must not take management’s responsibility when they do “consulting” work and that they may not provide assurance on those areas of the business where they have undertaken design work—thus avoiding the management and self-review threats above. In general, for internal auditors, “consulting” means facilitating the efforts of managers to make the changes they want to make.

RESPONSES TO QUESTIONS RELATING TO EXTERNAL AUDIT THAT HAVE IMPLICATIONS FOR INTERNAL AUDIT

Question 1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

38. There is a great deal of evidence available on this topic since it has been the subject of academic research and of the 2006 study\(^5\) commissioned by the government. Our comments are limited to the relevance and implications for internal auditing.

39. Internal auditing is essentially different from external audit. The market for internal audit services in the private sector is smaller than that for external audit services in that it is not mandated in most of the sector. In addition, in-house teams still meet much of the demand for internal auditing, particularly at the larger end of the FTSE index, where concentration for external audit services is more of a concern. This reduces still further the market for internal audit services supplied by third-party contractors.

40. The demand for internal audit services from third-party contractors comes from two sources. Firstly, in-house heads of internal audit do often supplement employed resources with extra resources either to fulfil a spike in demand or to meet a need for specialist skills, eg in computer auditing, a practice often described as co-sourcing. Secondly, some organisations out-source their whole internal audit department.

41. The supply of internal auditing services is met not only by the big four global firms but also by small specialist consultancies, independent contractors, the mid-tier and smaller accounting firms and two large international consultancies, Jefferson Wells and Protiviti, which are not accounting firms.

\(^4\) Para 32 in Ethical Standard 1 (revised April 2008), issued by the Auditing Practices Board. See Appendix 2 for definitions of the threats.

\(^5\) Report entitled Competition and choice in the UK audit market prepared by Oxera for Department of Trade and Industry and Financial Reporting Council, April 2006.
42. We have recently commented to the Auditing Practices Board on their call for evidence with regard to the rules that guide external audit firms in providing non-audit services to their external audit clients. As outlined above in the answer to Question 1, we strongly believe that it is healthier for corporate governance if the statutory auditor of an organisation does NOT provide internal audit services to that organisation. We would like to see the rules strengthened in this area to prevent that aspect of concentration.

**Question 2. Does a lack of competition mean clients are charged excessive fees?**

**Question 3. Does a narrow field of competition affect objectivity of advice provided?**

**Question 4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?**

43. The research referred to above did find some relationship between the increase in audit fees over 25 years or so and the increasing concentration of the market for external auditors. However, they also point out that there are other drivers including the increasing complexity of external audit and the desire of audit committee chairs for quality.

44. We support the need for a quality external audit product. At present, the “client” is often in practice the executive management of the organisation who perhaps benefits least from the external audit. We support any practical development that gives a bigger say to the shareholders, and other owners, in appointing and retaining an external auditor.

**Question 5. What is the role of auditors and should it be changed?**

45. Above we have outlined the role of external auditors and the role of internal auditors. The IIA does not see the need to change these roles but would like to see better understanding of the similarities and differences. This needs regulators such as the Financial Services Authority (FSA) and FRC and bodies such as the CBI and the Institute of Directors to recognise and promote the role and value of internal auditing.

**Question 6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition a contributory factor?**

46. The debate about scepticism raises interesting questions for both internal and external auditors. The evidence we have gathered so far does not support a lack of scepticism from internal auditors in the banks in the run up to the 2008 financial crisis. However, the question remains: how can internal audit help to prevent a future crisis? The IIA is shortly to undertake a review that will seek to provide answers to that question. It is unlikely that the results of this work will be available in time for the committee’s report.

47. It is possible that it was not scepticism that was missing but the capacity to think differently from everyone else in society—not just in the companies being audited. Even if the external auditors had had that capacity, how capable would the other players in the market have been to hear what they said—not just executive management but also non-executive directors, investors, shareholders, regulators, media and even policy makers?

48. This has implications also for internal auditors. Although they are independent of the parts of the organisation on which they give assurance, they are still part of the organisation as a whole. They need to make efforts to cultivate a different perspective from the rest of the organisation. The IIA provides educational and networking opportunities, allowing internal auditors to mix with colleagues from different sectors and industries. This helps them to develop new perspectives and supports them in presenting the challenges to management that may result from such scepticism.

**Question 7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?**

**Question 8. How much information should bank auditors share with the supervisory authorities and vice versa?**

49. In responding to the FSA last year on the conclusions of the “Turner Review”, the IIA stated that the FSA ought to be able to rely more on the work of internal auditors. A very large proportion of the risks in which the FSA is interested are also of interest to their supervised firms. Therefore, they should be the risks that are within the scope of internal audit in those firms. There is scope for the FSA, or any new regulator, to obtain assurance from the existing work of these internal auditors.
50. However, we also pointed out that this must be done sensitively. As long as internal audit is a function that is operationally independent, it delivers real value to management because it enhances the organisation’s ability to achieve its business goals. We have discussed above one aspect of internal audit’s independence: being separate from the functions it evaluates. However; interaction with the regulator could pose a different threat to independence: internal audit being perceived as an extension of the regulator, rather than focussing on the needs of the business.

51. Therefore, any move to provide more information to the regulators than is already done must safeguard independence in order to protect the overall quality of the work on which the regulator is relying. One way to achieve this would be to encourage the management of financial services organisations to refer, in their reports to the regulator, to the evidence they have to support their assertions. This would include the results of internal audit work performed by competent, qualified internal auditors working to internationally recognised professional standards.

**Question 9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?**

52. For internal auditors, the best incentive to provide such advice is the response of those receiving it. High quality internal auditing does not exist in a vacuum: it needs openness and receptiveness in the management team. One mark of effective heads of internal audit is that they have raised with senior managers issues and facts that were unwelcome. Audit committees can help here by insisting that performance assessments of heads of internal audit are realistic, ie that they recognise that such uncomfortable conversations are a sign of good performance. The IIA also seeks to help by preparing internal auditors to work in this environment and by providing them with networking opportunities to help them deal with the resultant stresses and strains.

**Question 11. Should more competition be introduced into auditing? If so, how?**

53. See response to question 12 above re: internal auditing.

24 September 2010

**APPENDIX 1**

**KEY DIFFERENCES BETWEEN INTERNAL AND EXTERNAL AUDIT**

**Main “Customers” of the Assurance**

1. External auditors provide assurance to the shareholders or members of company, ie outside the company’s governance boundary. It is vital to the quality of their work that they focus on this customer group.

2. Internal auditors, in contrast, provide assurance within the governance boundary, to the audit committee, the board in general and to senior management.

**Purpose of the Assurance**

3. The external audit opinion, and the work that the external auditor performs in order to provide it, exist to add credibility and reliability to reports from the company to its shareholders.

4. Internal auditors provide members of the board and senior management with assurance that they can use to fulfil their own duties to the company and its shareholders.

**Coverage or Nature of Work**

5. External audit provides an opinion on financial statements and the related disclosures, on other forms of reporting from the company to shareholders as well as on financial reporting risks and their management.

6. Internal auditors cover all categories of risks and their management, starting from their identification, taking in various responses to risks, including traditional internal controls, and including the flow of information around the company about risk. Internal auditors also cover governance processes.
Timing and Frequency of Audit Work

7. Ideally, internal auditing is a permanent and ongoing presence in a company. Much of its work will be in the form of engagements scheduled in advance. However, internal audit may also react to changes in circumstances and undertake unscheduled and, possibly, surprise pieces of work.

8. External audit work is tied into the company’s cycle for financial reporting and designed to support the external auditor’s opinion on the annual report and related items.

Focus of Opinion

9. The external audit focus is predominantly on validating that the financial statements are a true and fair representation of past performance.

10. For internal audit, the focus ideally is on providing assurance that the governance and risk management processes are effective in managing risks that might happen. Therefore, the focus is also forward-looking.

Responsibility for Improvement

11. External auditors have no explicit responsibility to improve their clients’ governance or risk management processes. They have a duty to report problems that they come across as part of their work. In addition, the added-value service proposition of audit firms as businesses means that they want to assist their clients where they can.

12. In contrast, improvement is fundamental to the role of internal auditing. Working within the organisation on an ongoing basis allows internal auditors to advise, coach and facilitate managers’ efforts to improve processes. At the same time, internal auditors have a professional duty to avoid usurping the responsibility of those managers to manage.

Status and Authority

13. As a regulated profession, external audit’s status and authority is provided by statute and supported by the framework of regulation provided by the FRC working with the appropriate professional bodies.

14. Internal auditing has a set of professional standards, the International Professional Practices Framework, including a Code of Ethics and the International Standards for the Professional Practice of Internal Auditing (International Standards). These require the head of internal audit to establish an internal audit charter that sets out the authority of the function and to present this to the audit committee and senior management. Internal auditors rely on the support of the audit committee to maintain their status and authority.

15. The UK Code of Corporate Governance provided by the FRC recognises that the audit committee is responsible for overseeing the effectiveness of internal audit. The Guidance for Audit Committees, also provided by the FRC, provides additional tasks and recognises the International Standards as a source of more detailed guidance.

Independence

16. A reflex reaction is often that external audit is more independent than internal audit. To counter that, there is also a view that no-one who engages with an organisation or person is entirely independent of them.

17. For internal auditors, independence is about avoiding responsibilities for functions on which they provide assurance and having a reporting line to the audit committee that provides some degree of guarantee of their independence from the areas they evaluate. It is also necessary to be sure that internal auditors are independent of any other group, such as other assurance providers or regulators, in order to ensure that the assurance they can give is also independent.

18. For the external auditor, the profession’s ethical standards and other regulations and rules seek to protect independence. There is an extensive regulatory regime in place, administered by the accounting bodies and the FRC, that enforces these standards. In addition, the UK Code of Corporate Governance expects the company’s audit committee to review and monitor the independence and objectivity of the external auditor.

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APPENDIX 2

THREATS TO EXTERNAL AUDIT QUALITY—
AS SUMMARISED IN ANSWER TO QUESTION 10 ABOVE

A self-interest threat—when the external auditor has financial or other interests which might cause it to be reluctant to take actions that would be adverse to the interests of the audit firm.

A self-review threat—when in the course of the audit, the external auditor may need to re-evaluate the work performed in the non-audit service.

A management threat—when partners and employees of the audit firm from take decisions on behalf of the management of the audited entity and the audit firm may become closely aligned with the views and interests of management.

An advocacy threat—when the audit firm undertakes work that involves acting as an advocate for an audited entity, supporting a position taken by management in an adversarial context and adopting a position closely aligned to that of management.

A familiarity (or trust) threat—when the (external) auditor is predisposed to accept or is insufficiently questioning of the audited entity’s point of view (for example, where close personal relationships are developed with the audited entity’s personnel through long association with the audited entity).

An intimidation threat—when the (external) auditor’s conduct is influenced by fear or threats (for example, where the auditor encounters an aggressive and dominating individual).

Examination of Witnesses

Witnesses: Lord Sharman OBE, Dr Ian Peters, [Chief Executive, Chartered Institute of Internal Auditors], and Dr Sarah Blackburn, [Past President and Member of the Governing Council of the Chartered Institute of Internal Auditors].

Q356 The Chairman: Good afternoon, and welcome to our colleague Lord Sharman. Our principal objective is to talk about the role of internal audit but Lord Sharman, no doubt, will respond to the matter more widely on any of the points that come out of the questions. For the benefit of two of you at least, could I ask you to speak up—and not too fast—for the assistance of the Hansard reporters, and so on, and for the webcast? When we come to the questions: if you have nothing to add to the first response but agree with what has been said, we are quite happy for you to not come in because there are three of you. Would anyone like to make an opening statement, or will we go straight to questions?

Dr Ian Peters: I am happy to go straight to questions.

Q357 The Chairman: I will kick off and then questions will come from my left. The Financial Reporting Council said that the role and responsibilities of audit committees should include, “to monitor the integrity of the financial statements of the company and any formal announcements relating to the company’s financial performance, reviewing significant financial reporting judgements contained in them”. Given the financial crises and the corporate scandals that we’ve seen, but particularly the financial crises, which have been of considerable interest to this Committee, has there not been a failure of both auditors and internal audits during the period leading up to these crises?

Dr Ian Peters: Perhaps I should kick off in response to that. Internal audit provides assurance to the board—and to the audit committee in particular—on the identification of, management of and mitigation of risk. Of course that covers a whole range of risks, the whole range of risks that any organisation faces. So I think we have to put this in the context that we’re covering a whole range of sectors and of course, not surprisingly, we would take the view that internal audit does a very effective job in most instances. However, in the case of the financial crisis and in the case of the banks and the financial institutions, it is clear that internal audit was part of the structure that went wrong. I think there are many lessons that we need to learn from that and that we are still learning. But I think particularly important is the fact that internal audit and audit committees were very much focused on process and on internal controls within the organisation, and were not looking beyond that; were not looking at the wider picture as much as clearly with the benefit of hindsight, they should have been doing. That would suggest that, going forward, internal audit needs to play a much broader role and a much more significant role, in looking at the governance of the organisation, looking at the behaviour in governance, the behaviour of management and the board, the skills, the abilities, the capabilities of the board and the non-executives in particular, to ensure that they are able to play their role effectively in identifying and ensuring that the organisation is mitigating risk.
The Chairman: Would you like to add to that?  
Dr Sarah Blackburn: I should like to add one thing to that. Having both been chair of an audit committee and an internal auditor, I think the two roles are symbiotic. We need both acting together. We need the strength of an audit committee that, from its non-executive base, is able to challenge, feels empowered to look into everything that needs looking into and does not shy away from particular areas, which I think might have been one of the problems in the financial crisis. Internal auditors provide a lot of information and a lot of detail to the audit committee, and they can provide more if they are asked for more.

I still think that internal auditors should act intelligently and should raise issues themselves, but if they are not backed up by their audit committee chair then they can have great difficulty in being heard.

Q358 The Chairman: Looking purely at internal auditors and not at the audit committee more widely for a moment, I think Dr Peters said that one of the lessons is that internal audit needs to look wider. In your written evidence to us, particularly in relation to this question, you said that internal audit needs to make efforts “to cultivate a different perspective from the rest of the organisation”. How does it do that, given that my impression—certainly from being a non-executive in companies—is that internal auditors have a rather narrower focus? They don’t have that wider focus that I think you are suggesting. Does this not mean new skills and experience in recruiting internal auditors?  
Dr Sarah Blackburn: It certainly means that you need to recruit internal auditors who have the intellectual ability, the education, the qualifications and the experience of business. They need to understand the business, not just in terms of its operational nuts and bolts but understand where it’s going and where it should be going, to understand the strategic mind of the organisation. Only by having that level of understanding can you challenge and ask questions that are catalytic, in order for the management and the board to think clearly, “What is going on here, and are we going in the direction we want to go, and are the things working properly in the way we intended?” So I think that is a challenge.

As in any occupation, not every internal auditor is a shining example. I think the best internal auditors I would liken to the social anthropologist who lives among the tribal peoples of the Amazon, say, and learns what is going on there, perhaps participates in some of the rituals but is able to stand back with a degree of objectivity to write the report about what is going on, in order to share the enlightenment.

Q359 The Chairman: Is there a problem in that, effectively, internal auditors are part of the management, are paid by the company and, therefore, may sometimes find it difficult to express a contrary view to the view of the management?  
Lord Sharman: Can I just make an observation on that? I should like to make an observation on the first one. I think it’s a mistake to look at all internal auditors as being the same. There are very different approaches, particularly by industry and also within companies with industry. In some cases, internal audit will focus very heavily on process rather than the financial aspects of the operation. There may be very good reasons for doing that but I think it is just as well to bear that in mind.

I don’t think — and it is stupid to think it could — that an internal audit group could ever be independent. People talk about independence. They can’t be independent. They’re part of the organisation. But what they can be is truly objective. The way in which I think you have to go about doing that is, while it’s necessary in terms of the pay and rations, that there be some link into the organisation — and I believe it should always be the most senior manager in the organisation — then the audit committee should be very actively involved: firstly, in the determination of the work programme of internal audit; secondly, in the determination of the objectives of the head of internal audit; thirdly, in the determination of the head of the internal audit’s performance against those objectives; and fourthly, if nothing else, in the amount of variable pay that a head of internal audit might get, and that variable pay should be arrived at on a different basis from other members of the management team. In particular, it should not include any objectives that are related to the financial performance of the company.

Q360 The Chairman: Do you think what you have described happens often, particularly in financial institutions?  
Lord Sharman: No. I think it’s an aspiration for some, but it’s an aspiration that I don’t think you would find widely spread at the moment.

Dr Ian Peters: If I may say, I think Lord Sharman is absolutely right there, and that is why the role of the audit committee and the internal audit are inextricably linked. The audit committee, and the chair of the audit committee, must understand and grasp the nature of that role, recognise the critical importance that he as an individual, or she as an individual, has in ensuring that you get the best from internal audit, that you maintain its objectivity if you like—if we don’t call it “independence”—and that relationship is key. If a chair of the audit committee and the audit committee itself does not grasp that and take that into account, then it is very difficult for internal audit to play an effective role in providing assurance and in providing the information and input that is required.
One point on independence by the way: I think we could debate that all day, but I’m not quite sure why external audit is any more independent, in the sense that it’s paid for by the company concerned and you change your external auditor. If you don’t like them, you can get rid of them and change them for another one. So we could have the same debate about external audit as internal audit. The issue is what safeguards are in place to ensure its objectivity.

Q361 The Chairman: We will be coming onto external auditors in that context. My impression is that what Lord Sharman was saying, and what he himself said was carried out by a minority of companies, is not the general way in which internal audit has been treated and regarded in many companies until now. Is that your experience?

Dr Ian Peters: Well, no, I don’t think that’s entirely my experience. I think that probably all organisations could do better, because we are all human. However, I think that some organisations have got a lot further on the path than others and, again, this kind of guidance comes from the top. It’s to do with the direction from the chair, from the board members, and particularly the non-executive members, because they are the independent ones, and they are the ones who should set the tone of what it is that they want. I sometimes say to people, “You get the internal audit you deserve”.

Q362 Lord Smith of Clifton: Since the oversight of risk management is one of their main tasks, should audit committees have been more effective at heading off the impact of the financial crisis on their companies?

Dr Ian Peters: I think the answer to that is “yes”, put simply. It comes back to this point as to whether the audit committee adequately understood and delivered its responsibilities, its role, in ensuring that the risks were being managed effectively, being aware of the range and scope of risk, in ensuring that the governance of the organisation was effective and that appropriate behaviours were adopted. So I think we would have to say that, yes, audit committees bear a significant degree of responsibility, but not on their own.

I think one thing Lord Sharman said a moment ago is very important. We shouldn’t put everybody together in this. I think it is quite important to separate the situation in the banks in particular—the banks and the financial services sector, but particularly the banks—from the rest of the corporate community, and not tar everybody with the same brush. Certainly, within the banks, the focus—and I think partly a reflection of the sophistication of the banks and the banks’ products—means that inevitably the focus is often on the detail, on the process, on the controls, perhaps more than taking a more stand-back view of the organisation and its risks as a whole.

Q363 Lord Smith of Clifton: Would you go along then, with Sir David Walker’s recommendations that banks and insurance companies should have separate risk committees?

Lord Sharman: Could I respond to that, because I am the chairman of an insurance company. I recognised, and I think many others did—perhaps in my case five years ago—that what we were asking audit committees to do, in terms of the span of their responsibilities, the time input required, the sheer volume of material that they were looking at, was not a viable, ongoing proposition. We separated the risk function, or the governance of risk, from the other aspects of the audit committee, because we wanted to ensure that risk would get at least as good a scrutiny as the other things. The problem with having risk in the audit committee—in my view anyway—is that there is a whole pile of things that the audit committee is mandated to do: it has to approve the financial statements; it has to approve any announcements about takeovers. It has a whole pile of things that it must do. So, when it comes to its deliberations those obviously come first. I think Walker is absolutely right on this and I would go beyond banks and other financial institutions—I think they’re called BOFIs—and say that, in my view, in any organisation where there is a complex risk scenario you should have a separate risk committee.

Dr Sarah Blackburn: If I might add to that from my perspective in the National Health Service, because clinical risk is so complex and is so much governed by the expertise of the clinical professions, indeed, you do find this separation out of clinical risk. However, one of the things that we have found in the National Health Service is that, unless these are brought back together—the operational risk, the administrative risk, the strategic risk together with the clinical risk, the complicated technical part—that it doesn’t all hang together properly, so the board needs to assert its responsibility over all types of risk. It’s very important in having a risk committee that risks aren’t slid off that risk committee and that the board as a whole retains its corporate collegiate responsibility.

Q364 Lord Shipley: Can I ask you about whether you think there is a partial assurance vacuum at the moment? Recent corporate troubles and the financial crisis would tend to suggest that there has been. Can you say something about how you think boards’ assurance needs might be better met in the future?

Dr Ian Peters: I think this again is a reflection of the fact that assurance was being provided in the areas of process, of internal control, but not in the broader areas of governance, of board behaviour, of management capability. What we need to do is look
to those areas as well if we're going to have a total assurance, as far as one can have total assurance. You don't have full assurance of course. It can only ever be as far as you can offer an opinion, but nevertheless I would come back to that same point in a sense. It's another dimension of it.

Q365 Lord Shipley: But looking at it from the perspective of the individual board member who has responsibilities, how might an individual be helped in terms of getting external advice, for example, about policies being pursued that they might have a concern about?

Lord Sharman: Can I make an observation on that, again, from personal experience? I have found—and again, as I said, I operate in a regulated industry—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—somebody completely independent, who acts as an advisor to those committees and can therefore also act as an advisor to the board—is particularly helpful. In our case, being a complex industry, it needs to be somebody with a very deep understanding of the industry in which we work.

Q366 Lord Lawson of Blaby: Are there any cases of that or is this an entirely new idea of yours?

Lord Sharman: No, I put it in place, Lord Lawson, 18 months ago.

Q367 Lord Lawson of Blaby: How general is it?

Lord Sharman: I suspect it’s not very common.

Q368 Lord Forsyth of Drumlean: Isn't one of the worries that you can destroy the unity of the board by having competing sources of advice?

Lord Sharman: I don’t see them as competing. I see them as complementary.

Lord Forsyth of Drumlean: They might be competing.

Lord Sharman: In that case, then, I think the board should be deeply concerned about what makes it competing and should pay great attention to it, because I think there you would have the nub of something the board should properly be focusing on. Particularly in the area of risk or anything like that, board members do need help. We have to do a lot of training these days. We do probably more training than I did when I was a practising accountant. But we have regular training sessions and things like that, and you have to provide the support for people who are sitting on boards to have the best possible basis for making a decision.

Q369 Lord Smith of Clifton: Why wouldn’t this luminary actually be one of your non-executives?

Lord Sharman: Because you have a relatively limited pool to fish in. In any particular industry, once you start to eliminate people who are effectively conflicted because they are involved with competing organisations, it can be very difficult to get the expertise as a non-executive board member.

Dr Ian Peters: We would also take the view that the internal auditor is a provider of information and, not advice, but input to the non-executives themselves. I think we almost touched on it earlier on in the discussion: how do we know that the internal audit function itself has sufficient expertise to perform its role effectively? When we’re looking at the more complex areas in banking, for example, we don’t know that necessarily. One of the key things we need to look at is: how can we strengthen the internal audit function within the banks and the financial sector in a way that enables the function to provide adequate assurance to the board. That means looking, yes, at pay and remuneration. It also means looking at where the pool of expertise is from which we can draw and feed into internal audit.

As an institute, of course, we would like to think that all internal auditors were qualified with the institute’s qualifications and that made them perfect internal auditors. In practice, the world isn’t quite like that. We need to bring in external expertise, because to audit effectively, yes, you need good audit skills, but you also need to understand what you are auditing. So, of course, taking the risk management area in banks it wouldn’t be inappropriate, necessarily, to draw on risk management and bring people from that area into internal audit for a period and then send them back again. The guest internal auditor or coming into internal audit by rotation is an approach that one might adopt to make sure that you have an appropriate mix of skills. It gets quite sophisticated and that’s something that, certainly in the financial services sector, we need to look very closely at.

Q370 The Chairman: Could I take a particular example to see if I can draw you out on what you were saying earlier? Dr Peters said that perhaps there was too much focus on process in internal audit in the banks leading up to the crisis. Would you expect in the better world internal auditors to be challenging, in the case of one bank in particular for example, that it was focusing on and investing too much in subprime mortgages from the United States and drawing attention to the risks that there were in relation to subprime mortgages? Or would that be coming from the external consultant?

Dr Ian Peters: The simple answer is “yes”.

Dr Sarah Blackburn: Yes, well, when we look back with hindsight we can all see things that people should have asked questions about, and why would you lend money to somebody who didn’t look like they could pay you back? That is such a basic
question. I don’t think you need an economics degree or great experience in the City to ask that question. Most people off the street would not lend money to somebody they didn’t think could pay them back. So I think it does come back to this question of: even with external experts, how do we get a different point of view? How do we cultivate the Cassandras of this world—the people who will say things that are unacceptable, because they are worth saying so that people have another think and work out whether they are missing a risk here?

Q371 Lord Forsyth of Drumlean: Isn’t the answer to your question, in the case of why you would lend to people who weren’t in a position to pay it back, because the Government had passed a law requiring you to do so? I’m just thinking—Lord Sharman’s point—you could have a non-executive who had a particular view on a board and, if he could go and get external advice and challenge the executive policy—say the executives want to do a big merger or they want to take some strategic position—you could have a Cassandra. Cassandra happened to be right, but not all Cassandras are right.1 I am just thinking what the practicalities are of how you would run a board where people can go off and get competing advice. We all know that in investment banking you can get advice to do whatever you want. Is this a practical way to try to maintain a structure within a unitary board? I can see the superficial attraction but, in practice, are you—as a chief executive rather than a chairman—going to welcome this kind of innovation in corporate governance?

Lord Sharman: One of the great challenges of chairmanship these days is balancing the need for what I would describe as constructive challenge of the executive members of the board with being able to maintain the responsibilities of a unitary board. Technically, it’s much easier with a two-tier board, because you have supervisors and you have managers. From my experience it still doesn’t mean to say there is a great deal of challenge from supervisory boards, but I do think there is that. Technically, I’d be very surprised if any of the FTSE 100 in their appointment letters to non-executives do not provide for the non-executive to get independent advice if he wants to do it. Then coming back to: does it happen that frequently? It probably doesn’t happen as frequently as it should do. On the issue of the banks that got themselves into trouble through not lending money but buying subprime instruments which I suspect no one understood at times, I suspect—and this is just suspicion—that the change in the risk profile of certain institutions was not understood as a result of this. It is that area where I think audit committees should be focusing in the future—on things like activities that change the risk profile of an entity. That is quite difficult to define, because I suspect again that in many cases, bits of the banks would be operating within delegated authority, because delegated authority was defined in a monetary amount—i.e. “you can run a book of this size”—but probably wasn’t defined in terms of, “you can run a book of this size, but you mustn’t change the risk profile of the bank”. That is a struggle that certainly I’m struggling with at the moment: how do I move from just defining delegated authority in monetary amounts to delegated authority in monetary amounts and within defined risk parameters, or whatever? I think that’s partly what we have to get right if we’re going to prevent these things happening in the future.

Q372 Lord Forsyth of Drumlean: Do you think that the annual reports, rather than having a report to the board about the audit committee, should include a separate report from the audit committee, which deals with issues like how they chose their auditors and how they ensured their independence, and so on? Lord Sharman: There are examples, quite a few examples, where you have reports like this. They are not as voluminous as the remuneration committee report, I have to say, but there are examples of audit committee reports in the FTSE 100 where it is a report from the audit committee to the shareholders, effectively. I should like to see that more widespread and I should like to see more engagement through the AGM with shareholders and the chairman of the audit committee. My experience on a Dutch board, where this has been the case for some time, is that you do get questions from the floor directed to the chairman of the audit committee about the way in which they’ve gone about discharging their duties. Dr Ian Peters: I think our view would be not quite that. It is perfectly appropriate and not in any way unhelpful for the audit committee to produce a report, which the board then determines to be included in the annual report. But essentially I think, rather as we took the view with the proposal from Walker about risk committees, it’s essential that the board doesn’t pass on its responsibility to individual committees within the board. So I think we would take the view that the annual report and accounts is the board’s report and accounts and must be approved by the board, and the board must be accountable for the content. That includes the report about the role and activities of the audit committee. Now, if the board should choose to invite the audit committee to produce that report and simply signs it off, that is absolutely fine, but our view is that it is the board’s responsibility.

1 Note by witness: As in reply to Q363, responsibility for risk remains with the Board—they must decide—a “Cassandra” merely gives a contrary piece of information.
Q373 Lord Forsyth of Drumlean: Would that include the specifics that I mentioned; that is, it actually addressed specific matters such as how the audit committee monitored the independence of the external auditor and how it determined the choice of external auditor?
Dr Ian Peters: Absolutely, it should include that, yes.

Q374 The Chairman: Would you also include in that how often the audit committee went out to tender—in terms of competition, choice, independence and so on—for the external auditor and how often it changed its auditor?
Dr Ian Peters: It would be entirely appropriate, yes.

Q375 The Chairman: We do know that they have to change their audit partner. Is it every five years of seven years?
Lord Sharman: Every five years.

Q376 The Chairman: Every five years. The evidence is that very few of the FTSE companies change their auditors and very few go out to an external tender.
Lord Sharman: Well, there is a problem with something that I know you’re discussing—but I’m particularly not keen to comment too much in view of my former life—but there is a problem with choice.

Q377 Lord Forsyth of Drumlean: Yes, but at the moment you have more chance of seeing Halley’s Comet than seeing a change of auditor in a FTSE 100 company.
Lord Sharman: I can’t remember how frequently Halley’s Comet arrives, but I’m not prepared to challenge that.

Q378 Lord Lawson of Blaby: Please don’t be shy. We all know of your distinguished former career, but that does not prevent you from giving us good advice now, so if you would answer the Chairman’s question in an uninhibited way.
Lord Sharman: I believe, as I said, Lord Lawson, that the audit committee should justify once every five years or so the relationship with its auditor. It should do a thorough evaluation of it, and it should come to a decision as to whether it believes it should tender or not, and then justify that decision to its shareholders.

Q379 Lord Best: We’ve heard that the UK Corporate Governance Code is not mandatory and companies don’t have to have an audit committee. Are we right in thinking that the FRC’s guidance on audit committees doesn’t count for very much?
Lord Sharman: I think that would be a harsh judgement. Since the Smith Guidance—which I think has now been turned into the FRC Guidance—which was in 2003, the function of audit committees has developed significantly. Not all of the change can be attributed to that guidance, but it has been helpful and I think it has set a benchmark against which audit committees should judge themselves. So I wouldn’t dismiss it. I think it’s helpful that it’s updated from time to time essentially to codify best practice. I think there is no doubt that the level of acceptable practice has been raised in the past seven years. I think if you go back seven years, audit committees were much less effective than they are today.

Dr Sarah Blackburn: I must concur with that. My experience is that they have become more professional since the time of the Smith Guidance. Of course everybody is still working towards that. Like boards, audit committees should evaluate themselves in a similar way, not just looking at the processes and going through some sort of tick list—have they done this; do they have one of those?—but looking at how they operate and whether they operate effectively. What has changed in the organisation as a result of the things that they have looked at? There are a number of parties you could call upon in order to help you and be involved in that self-evaluation, possibly even going to an external evaluation. Certainly, I have run those for audit committees and I think they are tremendously valuable in making sure that you focus on the service that you provide to your colleagues on the board, because of the extra scrutiny with which you look at areas of risk and the financial reporting.

Q380 Lord Best: Are proposed revisions on non-audit services likely to be accepted, listened to or acted upon?
Lord Sharman: I think so. I came from an audit committee relatively recently where there was an extensive discussion about the level to which we were prepared to contract the auditor for non-audit services. You have to be a bit careful about definitions here because, essentially, the way the thing is defined today, there are three categories of services: audit, which is the statutory audit; then there are audit-related services, which are the things you need to do because you are the auditor. They might be regulatory reports and things like that. Then there is non-audit, and in particular things like tax advice and that sort of thing. I think it is eminently reasonable to expect that audit committees will take
Lord Sharman OBE, Dr Ian Peters and Dr Sarah Blackburn: One of the areas I think needs to be defined as a non-audit service is internal audit. Internal audit should not come from the external auditors of the company, but there may be circumstances in which there are things that fall into near audit services or where pragmatically there is a need for them to work closely together. Those sorts of things need to be overseen and co-ordinated by the audit committee to make sure that there is not a blurring up of the two assurance lines, because they are very different and have different purposes.

In terms of thinking about what is in the non-audit services category, that’s where internal audit should be. It’s not part of the external audit and any extension of external audit activity should not be such as to encompass things that are done by internal audit, and not least from the audit committee’s perspective: it’s useful to have more than one source of assurance and more than one point of view.

Lord Sharman: Yes, I would agree with that. I would put an absolute outright ban on anything that represented outsourcing of any kind. If there was a proposal that we will outsource our computer audit activity from the internal audit to the external audit, I think that would be totally unacceptable, because that’s taking away a part of the assurance that you should rely on. I have a great deal of difficulty with much else as well. I don’t believe there’s a very strong case for external auditors providing internal audit services. I think I’d agree with the assertion there that you do need two. The more levels of assurance you can get, the better you’re going to be.

Q381 Lord Lawson of Blaby: I should like to focus on the problem, which most of the discussion has been about, of the auditing of the banks and “what went wrong?” Of course, a lot of things went wrong and the question of the audit, both external and internal audit, is only a part of it, and not a major part in my judgement. Nevertheless, what we are focusing on is what can be done there.

First of all, if I may say from my personal experience of rather a long time ago, I do think it is unrealistic to place great weight on the sagacity or understanding of the non-executive directors. Ms Blackburn said what you should look at is what changes have taken place. I remember—this is between 15 and 20 years ago, when I was a non-executive director and a member of the audit committee of one of the biggest banks in this country—what I was conscious of changing was the extraordinary growth in derivatives in the derivatives business. I was a bit worried because this was such huge growth and, therefore, it seemed to me this was an area we should look at. The question was: how risky was this? I didn’t understand the complexities of the derivatives business, and I don’t think my fellow non-executive directors did.

My concern was that it didn’t seem to me that the management did. When I challenged the management and said, “Look, this is growing very fast. Are we comfortable we’re not taking on too much risk?” they said, “Oh yes, we have a new thing called VAR, Value at Risk, and there is a very good mathematical model. We know all about it”. That was how it was approached in those days. I don’t think they understood it. They didn’t understand the mathematical model. How could they? There were people in the business who claimed to understand it but certainly the non-executives couldn’t. They couldn’t challenge that. So we do need good professional steer, good professional advice, both external auditors and internal auditors.

So with that background, what is your assessment with the benefit of hindsight—I’m not blaming anyone, but with the benefit of hindsight—of what went wrong? Was it that the auditors of all kinds didn’t recognise that there was something that might be dangerous taking place; or was it that maybe they did have this instinct but there was no mechanism by which they could turn that into action; or was there a mechanism? Was there—as Lord Sharman said—the dialogue with the chief executive and the chief executive took no notice of it? In that case what do you do, if the chief executive says, “No, it is fine, I’ve looked into this very thoroughly and it’s fine”? So which of those three is it? I’d like your answer to that. Then, finally, because this is what we are about, if you can identify what the problem is, what is your solution? What can be done that would reduce the chances of having a similar failure? I say that without wishing to be too melodramatic. I say that in the sense that Dr Peters very honestly admitted that there had been a degree of failure. What should we put in place, which will minimise—it won’t eliminate it, but will greatly minimise—the chances of that happening again? The great thing about hindsight is that, although you can’t turn the clock back, you can learn something from it. So what have you learnt in practical terms?

Dr Ian Peters: That is a big question, Lord Lawson. As I am sure you will understand, there isn’t a simple answer, though I’ll try to be brief. First of all, I think we are still learning. That’s the important point. Two years ago, before I joined the institute, the institute did do some research early on—a survey of heads of audit of the financial services, banks in particular—and got some initial input. At that time, it was very difficult to get anything that gave us much of a handle on what had happened. It was too raw. People were unable to speak out, I guess, in many instances. More recently, we started doing some more work in this area to try to look back with the benefit of hindsight, the dust having settled a little. Anything I
say now, I have to put the caveat on it that I don’t think we are at the position yet where we have a clear view. It’s an emerging view.

The feedback that I get is that—you listed three alternatives—it was essentially more that it wasn’t just internal audit. It was everybody, from regulators, through to auditors internal and external, through to management, who were not looking in the right place; not so much not wishing to look in the right place but not recognising that they needed to look there, it not occurring to them that there was a potential problem.

Q382 Lord Lawson of Blaby: If I may interrupt you at that point, because it is interesting you mentioned the regulators. Do you think you could have tipped off the regulators in some cases and that you failed to do so?

Dr Ian Peters: I don’t think that was the situation, no, as far as I’m aware. I’m cautious here, because there may have been some in some banks who may have been in that position: I’m not aware of any at the moment. The people I’ve spoken to—the input that I’ve had—would rather suggest that what internal audit was doing was down in the long grass. It was dealing with the detail, with the controls, with the processes. It wasn’t looking up over the top and looking at what was out there, what was on the horizon. It now seems very odd, but in practice nobody was looking at the horizon at those potential risks. I don’t know, maybe I’m stating the obvious. There have been a lot of reviews done of this, as we know; a lot has now been written.

I don’t think internal audit was in any more of a helpful place than anybody else was at that point. So, the question then arises: why wasn’t it? Why was it not looking in the right place? Why was it not focused in the right area? Again, I think it’s because you have to look at the context within which internal audit is operating. The board was not looking for assurance in those areas from internal audit. The audit committee was not looking for assurance in those areas from internal audit. Even the regulators were not raising these issues. So I think you have to then ask: how on earth was internal audit expected to spot that; everybody else had not seen this and they could see it? Unfortunately, everybody was blinded because we were all caught up. They were all caught up at the time in the hubris of it, in the fantastic situation that we were in, in the potential to make more money by engaging in deals in new financial products, and so on. Nobody could see that that was going wrong.

My fear is that sounds like the obvious, but in practice sometimes it is the obvious. I think, as you rightly say, we now have to learn from that and say, “How can we put the right structures in place, the right arrangements, the right framework, so that next time we’re looking in the right place?” In my view, that has to be looking at the relationship between the board, the audit committee, the internal auditor, the external auditor, and the regulator. Some of the feedback I have had from the banks on the regulators now is that, they’re so fearful of it all going horribly wrong again, they’re dealing with all the detail again, and that, whereas maybe the auditors and the audit committees should be spending 90% of their time on 10% of the problems, the regulators are looking for them to spend all their time on all of the problems. There needs to be more focus on the issues that matter most.

Again, back to a point you made a moment ago, if I may, I think that is about expertise and knowledge and understanding. You’re right that the non-executives generally will not understand the detail; neither will the internal auditors, as professional internal auditors, so they need to find another source of that expertise to be able to inform their own activities.

The Chairman: Could I just follow up, and one other colleague wanted to get in, in response to the question of Lord Lawson.

Lord Lawson of Blaby: Do any others want to add anything to that?

Q383 The Chairman: I am going to ask in a minute. But to follow up on one point, that is: we have had discussions with other witnesses about whether the internal and external auditors should engage in more, sometimes confidential, dialogue with the regulators. One can see some of the pitfalls in this as well as some of the benefits. I wonder if you have any views on that subject.

Dr Sarah Blackburn: I wouldn’t want to talk for the external auditors. For the internal auditors, I think we are in the position of a service to the board, a service to management, and an intrinsic part of our value is that we are internal, that we are embedded in the organisation. I wonder whether we would be as effective, whether anybody would ever tell us anything. It’s rather along the lines of: would you tell your GP anything that had been going on in your life that affected your health if you knew that, once a year, he was going to post it up on the internet so the whole world could see? I think we have to be very careful. The benefits of an internal audit service are that they give the company an opportunity to look at itself and to put things right before other people need to know about them. Therefore, I think I would be rather disinclined for internal auditors to be always popping outside to tell the regulator something.

Lord Lawson of Blaby: Just to clarify, what the Chairman was talking about was not posting anything on the internet, but having a highly confidential discussion.

The Chairman: Absolutely.
Lord Sharman: Could I just say that, whatever everybody might wish, I think it’s going to be inevitable that regulators will want to have a dialogue with external auditors and internal.

The Chairman: And internal?

Lord Sharman: Yes, and to some degree it already takes place. To some degree in financial institutions, the regulator has access to internal audit reports. It can request access to internal reports. It can request internal audit to do specific work for it, if it wants to. I think that’s the de facto situation. The next step with more intensive regulation—I prefer to call it “intensive”; the regulator prefers to call it “intrusive”, so we’re having a little debate over syntax there—which we’re going to have is that it is inevitable that the regulator, if he’s going to do his job, will want to have as much access to as much information as he can. So from that point of view, I don’t think it’s avoidable and I don’t think it’s entirely a bad thing.

May I return to Lord Lawson’s question because I have some points I’d like to make on that? You were asking about the lessons we can learn, because you’re absolutely right that it’s no good sitting here saying there was no one to blame. I think three things I would focus on in terms of causes of this crisis, but an overriding point I would make is the speed at which it happened. The crisis happened very quickly. No one foresaw it, and when you look at the trigger of commercial paper markets just shutting down, one of the interesting things that I think you would find is that if you went to anybody’s stress-testing prior to that period they would have stress-tested their financial models against changes in interest rates, and things like that. I bet not many of them would have stress-tested against the availability of finance for the AAA-rated organisations. So that’s just an overriding thing.

I think three things happened that were inadequately appreciated. I think there was a significant change, and it was very much—as you were saying, Lord Lawson—about the move to derivatives, but I think as that move developed there was a significant change in the risk profile of many of the financial institutions that failed. You can look at the building societies that failed; a significant change in the nature of their derivatives, the CDOs and other stuff that they were investing in. I do not believe—and it is just my opinion—that anyone within the top echelons of those organisations appreciated the change in risk profile. I certainly don’t believe the boards fully appreciated what was happening, and I suspect the audit committees didn’t either. The question then arises: should the external auditors and the internal auditors have appreciated that? Given that no one else did, I think that is a harsh judgement.

Again, the second thing that happened was that some of the organisations that failed had a flawed business model. It was flawed, and surprisingly I can recollect being told that one business model that failed was the new face of banking, but it didn’t fit with the basic education I’d had. Again, I find it difficult to believe that, certainly, the regulator did not understand that that was a flawed business model. But clearly the board didn’t or they would have done something about it.

The final thing is that I think there is evidence of a number of poor judgements made by boards. There were several transactions that—again, with the benefit of hindsight—turned out to be poor in judgement and execution.

What do we learn from it? What I would say is this: that audit in the past—and I say “in the past”—has always been a process that looks backwards. I think we have to find a way of getting assurance that looks forward. The only aspect of an audit that looks forward at the moment is the assessment of an entity as a going concern, and that is just something where you sit there, “Do we have finance and everything in?” But I think audit, and particularly external audit, is directed to the opinion on a set of financial statements that have passed. I think it would be more helpful—and my colleagues are not going to bless me for this—and much more useful to corporate Britain, and society at large, if we could find a way of giving some assurance over forward-looking trajectories.

Dr Ian Peters: Of course, that is exactly what internal audits should be about. External audit is about a snapshot and, therefore, effectively a look backwards. Internal audit—when it’s done properly, when it’s truly risk based—should be about looking forward and anticipating risk. That of course is effectively what didn’t happen in banking and financial services as it should have done. That is the model that we promote throughout the profession. I am sure there are plenty of examples of that, although of course they’re generally not public.

Dr Sarah Blackburn: Of course, the other thing is that, when things are working well, those will not be the things that come to people’s attention; it is only the obvious problems that we know about.

Q384 The Chairman: But to pick up the points that Lord Sharman made, reading a lot of the books and other serious studies of this period, as I have been doing, I entirely agree that most people didn’t see the risks of CDOs. It’s astonishing to see how they were built up in the States as well as the subprime mortgages. No one challenged it. So it’s quite difficult to see how internal auditors would be able to get underneath the surface and challenge those, when very intelligent directors of banks didn’t do so either.

Dr Ian Peters: I agree.
Q385 Lord Forsyth of Drumlean: Perhaps I have a slightly cynical view of this. But wasn’t what was happening that the money supply was being expanded very rapidly; there was cheap credit about; the banks were making shed loads of money from this cheap credit; people created derivatives, which enabled people to get around some of the regulatory constraints, and it would have been a very brave auditor who put up his hand and said, “Excuse me, Sir Fred, can you stop doing this?” at a time when lots of money was being made. Indeed, if you look at some of the banks that showed restraint—such as Lloyds before it did its disastrous deal with HBOS—they were pilloried in the city and their share price was squeezed as a result because they were not expanding their balance sheets. So isn’t the analogy a bit like a stampede where everybody is going along? Lord Sharman, you said that nobody realised the risks. I can remember the chat about credit derivatives, and there were people expressing anxiety. But the truth was: if you were a rating agency, or if you were audit, or even if you were a regulator, or even if you were the bank, to put up your hand and say “Stop” to the stampede would have had terrific financial consequences for the Government, and isn’t that what happened? In seeking a solution that relates to the conduct of auditors, are we not missing the systemic problem that arose because of the nature of the bubble that was created by this expansion of the money supply?

Dr Ian Peters: I think that is absolutely right. That is why I said earlier it’s about the relationship between the different parties; it’s not one particular party. It is checks and balances, it seems to me.

Q386 Lord Forsyth of Drumlean: But that relationship is about making money and getting fees.

Dr Ian Peters: Yes, but it does not have to be just about that.

Lord Lawson of Blaby: Not in the case of the regulators.

Lord Forsyth of Drumlean: No, not in the case of the regulators. Well, yes, in the case of the Government it was about getting tax revenues.

Dr Ian Peters: Indeed, of course, the bubble did burst and those organisations then failed, or very nearly failed; in private sector terms did fail. So I don’t think it has to be just about that, and it is important that boards and management are reminded that there is a bigger picture. Take BP, for example; we all know what happened there. What is interesting is that the new Chief Executive of BP has introduced a new bonus arrangement for senior management in the organisation that puts the management of risk at the top of the criteria on which bonuses are based, rather than just how much money they make for the organisation. So it is about structures; it’s about incentives; it’s about remuneration; it’s about how we incentivise people to achieve the appropriate goals and objectives. Yes, somebody needs to decide what those goals and objectives are and, ultimately, of course that has to be the shareholders. So we all bear a responsibility in order to question the decisions that the management and the board are making.

Q387 Lord Forsyth of Drumlean: To take my stampede analogy, do you think the auditors are going to be in a position to stand aside and say, “Hang on a second, chaps, we need to go this way”? Dr Ian Peters: No, not if everybody is stampeding. But if the structures enable questions to be made in different parts of the organisation, then one would expect the internal auditors to be one of those groups putting forward the questions and creating the challenges. It’s about the checks and balances. You’re absolutely right, if you go back to what happened then, no, nobody could have expected the internal auditors to put their hands up in that situation. But I think, going forward, if we put the right checks and balances in place; it’s all about minimising risk, at the end of the day. We will never avoid it completely. We will never prevent another crisis.

Q388 Lord Forsyth of Drumlean: One of the ways that I think you could stand up to the stampede is to have that channel to the regulator, saying, “Look here, we’re auditing these banks because we’re worried about the extent to which the balance sheets are being extended”, or whatever. That raises the issues you were concerned about, client.

Lord Sharman: I would just add there, Lord Forsyth, that this comes into this issue. I don’t know whether you call it the conflict or the interrelationship between accounts, accounting and prudence. I take the view that prudence is the job of the regulator. Accounts and accounting are the job of showing something that is true and fair, and the two may not necessarily be the same.

Q389 Lord Shipley: I would like to be a bit clearer about how we move from a situation, in which internal auditors are sceptical, to one in which they can challenge. You say in your evidence, in paragraph 48, “The evidence we have gathered so far does not support a lack of scepticism from internal auditors in the banks in the run-up to the 2008 financial crisis”. So we accept there is a problem and we have just been discussing the reasons for the problem. What I’m not clear about is what your solution to that is that would enable internal auditors, a large number of whom were apparently sceptical prior to the crash, to move from that position of scepticism to one of challenge with a meaningful outcome.
Dr Sarah Blackburn: I certainly think there is potential in the combined code to strengthen the position of internal audit, and to refer to it not among a host of provisions but perhaps raise it to a principle level, in order that internal audit be seen as one of the essential elements in corporate governance. There is always a virtuous circle that we need to create in which there are more credible internal auditors who support more credible, independent non-executive directors. If non-execs have learned anything from the past few years, it is how precarious things can be, and how much a non-ex can lose if they get to market. Is there a need to reform the regulatory environment in which internal audit operates. So, in our view, the corporate governance code is not strong enough, in terms of setting out—both in principle and in practice—where internal audit should sit and the relationship that it should have. It is not one of the key principles in the code, in terms of comply or explain, and that is where we believe it should sit. It is there but it’s at a lower level in the area of accountability. We believe it should have a more prominent position and certainly, in terms of the guidance and support, there is no doubt in the mind of the institute that it is essential that internal audit should report to the chair of the audit committee and with a dotted line, by all means, to internal management. It needs a relationship with internal management—it is internal—and pay and rations, if you like, in terms of where the money comes from, but the remuneration levels and the hiring and firing of the head of internal audit should sit with the audit committee and the chair of the audit committee, as indeed should a view on the resources, on the budget available to the internal audit function.

Lord Smith of Clifton: If you are going to approach the regulator, whether you’re internal audit, external audit or a non-executive director, how do you go about this? Do you say to the chief executive or the chairman of the board, “I am going to report you. I am going to be a virtual snake”, or are you a whistleblower? What are the protocols you follow before you tip off the regulator that something is amiss?

Dr Ian Peters: I am happy to respond, but—

Lord Sharman: It is difficult to envisage those circumstances, because I would hope the person would certainly have had a long conversation and a series of discussions with me as the chairman. In extremis, I think they just go. I would work on the basis that there had been conversations and normally the threat of going would get pretty significant attention. If somebody said to me, “Look, I’m unhappy with this, I don’t think you’re responding; I don’t think the management is responding. I’ll give you enough time to do it, but if I come back and nothing happens I’m going to go and see the FSA”, you can reckon there would be a trail of people coming in and out of my office fairly swiftly.

Dr Ian Peters: Certainly one would expect the head of internal audit to have the conversation with the audit committee chair and to then, if necessary, have the conversation with the chairman of the board. If it came to talking to the regulator—by which time, incidentally, the head of audit might well have resigned as part of this process—but certainly the relationship with the regulator, particularly in financial services with the FSA, is ongoing anyway. The FSA appoints its staff to work with specific companies and organisations. They know each other on first name terms, so it certainly wouldn’t be difficult.

Lord Sharman: Just to add to that, in a financial institution these days the chairman will sit down with the regulator at least twice a year on a one-to-one basis. The senior independent will do the same; the chairman of the audit committee will do the same; the chairman of the risk committee will do the same, and to some degree in future I expect the chairman of the remuneration committee will also do that. At the non-executive level there is very much an ongoing dialogue. The opportunity is there. But, as I say, if it was a really serious issue then I would expect it to have been aired with me and if we differed, then fine.
The Chairman: We must move on. I think we’re going to have the possibility of a vote, in which case, since we have a number of other topics we want to cover, you will have to forgive us while we go away for about 10 minutes and then come back again.

Q392 Lord Lipsey: Just to go back one. As I understand it, internal audit is not compulsory at the moment for companies. Should it be?

Dr Ian Peters: We would tend to go with the principle-based approach of comply or explain. I think the view of the corporate world in the UK is that that works well, it’s not a system that is broke, and it doesn’t need to be fixed as such, though we may well want to look at particular aspects of it, as indeed the FRC has been doing. But I don’t think we would look for internal audit to become compulsory. Going back to my point earlier, it’s about the positioning of internal audit, in terms of the combined code, or the corporate governance code as it now is, that should be more prominent and should be a key principle. We should try that first, certainly, before we go down the route of further regulation. I’m not somebody who generally favours regulating unless one absolutely has to. I have another role, which is a member of the Regulatory Policy Committee for the Government, and I would always rather find an alternative to regulation than to regulate, if possible.

Q393 Lord Lipsey: But you don’t know that you should have had internal audit until the thing goes wrong, and then it’s too late to do anything about it. It might be regarded as more sensible for everybody to have the internal audit to begin with and see whether that doesn’t solve some of the problems before they happen.

Lord Sharman: My own view, for what it’s worth, is that I would not sit on a board that did not have a proper internal audit function. I wouldn’t be happy with the amount of assurance—

Lord Lipsey: That is why you’re so sought after as a non-executive.

Lord Sharman: No, I’m too old. According to the code, I am beyond useful endeavour.

Dr Sarah Blackburn: In terms of taking on a role in an organisation where I had no faith in the internal audit provision, that would be something I would not want to do. But I think we should look closely at some of the other sectors in this country where internal audit is mandatory, and notice that sometimes making something compulsory encourages people just to tick the box, and to have something cheap and nasty, or cheap and cheerful, is not productive. Sometimes I get a bit controversial with internal auditors by saying that I think it would be better for some organisations not to have a poor-quality internal audit function at all. What one needs is to have one that is worth having, that is effective. So if you have a mandatory system where people just go for the cheapest, I don’t think that is helpful. I may add, I think my opinion of external auditing is that that, too, may be too cheap, although perhaps companies wouldn’t thank me for saying it. If you do buy the external assurance on behalf of the shareholders on the basis of, “How quickly and cheaply can we get this done?” that doesn’t strike me as a very good basis for providing assurance to those shareholders.

Q394 The Chairman: I must say that I am slightly surprised at the institute’s position on this. Given all the discussion we’ve had earlier about the importance of internal audits in relation to avoiding future financial crises, and so on, to say that major companies don’t have to have an internal audit seems to me to be an unusual position. Even if you argue that some of them are cheap that is a question for the board and management to ensure that that doesn’t happen, but to simply not have an internal audit function at all seems to me to be slightly odd.

Dr Ian Peters: May I be absolutely clear? We’re not saying they shouldn’t have it. The question is: should it be mandatory; as in, should it be a regulatory requirement? I would question whether that is necessary. I think only this week Grant Thornton published a piece of work on the FTSE 350 that says it’s somewhat over 90%—I cannot remember the precise statistic, but it’s certainly in excess of 90%—do have an internal audit function and do have an audit committee, and I wouldn’t mind betting if you looked at the ones that didn’t, in many ways it’s not appropriate because they’re an investment trust or some sort of holding company, or whatever. So it’s not that people are saying, “No, we don’t want this” or “No, we shouldn’t have it”. The danger is, we bring in a piece of regulation—with respect, your Lordships well know that Governments have a tendency to do this—“Oh, it’s okay, we’ve regulated, or “No, we shouldn’t have it”. The danger is, we bring in a piece of regulation—with respect, your Lordships well know that Governments have a tendency to do this—“Oh, it’s okay, we’ve regulated, we’ve legislated; it’s not a problem now, and the problem has gone away”. Well, of course it hasn’t because by regulating all we do—as Sarah Blackburn said—is tick boxes, but it doesn’t say anything about the quality of the internal audit, about the effectiveness of it and the way it relates to the other aspects of governance in the organisation. So I think it’s too easy and simple to go for a regulatory solution.

The Chairman: I entirely recognise the point about being effective. We’re about to have a Division, so we’ll return, if we may—

(The Committee adjourns)

Q395 The Chairman: Some of our colleagues are unable to come back and I hope we won’t be too long now, but I would just like to ask a question that Lord Lawson was going to ask, which he told me about. Prior to the shift in responsibilities for much of the
bank regulation supervision to the FSA under the previous Government, he understood that it was pretty normal for external auditors to have conversations with the regulator, that is the bank of England in that case, but that this practice was discontinued when the FSA took over the responsibilities. Any comment?

**Lord Sharman:** I think that is the case. If I go back to the days when I was involved in auditing banks, there was quite regular dialogue between auditors and the Bank of England. I think it was part of the new—what was then described as—light-touch regulation.

**Q396 The Chairman:** So some of the possible problems that we discussed earlier in this session, about these conversations between the regulators and the auditors—or did you have any evidence during that period?

**Lord Sharman:** I can’t comment. I don’t know, but I don’t believe they did.

**Dr Ian Peters:** I don’t think I can comment on what external audit did. I have no particular knowledge or expertise in that, but I think it is important to distinguish between internal and external audit when it comes to the implications of a conversation with the regulator, because clearly the internal auditor—as we’ve discussed—has to have that relationship with management within the organisation. I think it has to be a final course of action, rather than a regular occurrence, otherwise it has the potential to undermine the relationship with management.

**Q397 The Chairman:** I think both of you made that point earlier in fact. Thank you. Turning to a totally new point, and this is an issue that we have been discussing quite a bit in the committee, particularly from some of the evidence we have had. In your experience, have IFRS hampered the exercise of prudence in financial reporting, and have ISAs made the audit more a matter of following a complex but routine box-ticking process, with lessened judgement on whether the financial statements are true and fair?

**Lord Sharman:** Can I go first on that one? I think there are a great number of aspects of IFRS that can be improved. But I do feel too much has been made of this point. As I said before, I think it’s worth noting that while prudence has a place in financial reporting so do other characteristics; for example, the information presented should be up-to-date, it should be relevant. Prudence is clearly very important in financial services regulation. If society wants—and it clearly does now want—financial services companies to be run on a more prudent basis, then I think the way to achieve that should be through prudential rules, through capital and liquidity requirements imposed by the regulator. I don’t think it should be through the back door of accounting. As I said, accounts aim to show the affairs of a company on a true and fair basis, but it’s

for boards, shareholders and regulators to decide whether that reality is sufficiently prudent because there are other aspects of prudence, and again, it’s more about looking forward than looking backward in my judgement.

**Dr Sarah Blackburn:** Just one thing I would like to add on that, and I’m not going to talk about the IFRS because that is not my area of expertise. But I think, as a general principle, it’s not a good idea to encourage people to design systems with the main criteria that they are easy to audit. It is very important that we put the best systems that we can in place and if that makes them difficult to audit, then we have to find ways of auditing them. We must not reduce things to box ticking.

**Lord Sharman:** Can I go back to the ISAs as well now, because I forgot to comment on that? I have a rather sceptical view about how much better auditing gets because you have more boxes to tick. I have always believed that the big judgements are what auditing is about, and you very rarely get there by ticking the boxes. My judgement is that, certainly if you look to the United States, which has always been much more rules-based than the UK, I do not think we have any evidence at all that more and more rules improve the quality of auditing.

**Q398 The Chairman:** Going back to IFRS, can I just ask Lord Sharman to comment on remarks made in a speech by the new Governor of the Irish Central Bank recently. I don’t know if you’re aware of them.

**Lord Sharman:** No, perhaps you would quote them for me.

**The Chairman:** I will just quote them for you, and this is a quote, “I have already railed elsewhere against the backward-looking loan-loss provisioning practices encouraged by IFRS and still all-too-pervasive in the reporting by most of the Irish banks. I find it unsatisfactory that expected losses in many parts of the portfolio are clearly higher than the provisions already taken, because I fear that this evident and in some cases explicit discrepancy may awaken doubts in the minds of investors as to the relevance of other aspects of the reported accounts”.

**Lord Sharman:** I agree with him. I think that was what I was getting at when I was saying that one of the lessons we need to learn from the crisis is that we need to provide assurance over the future rather than the past. If you look at a snapshot in time, and say, “At that point in time the right amount of provision was x”, but six months to a year down the road you may need something different or bigger, that is what I’m talking about when I talk about looking forward. I think that is the problem with historical accounts, it is the problem with too many rules. You can’t anticipate in historical accounts, within very sharp limits, what is going to happen in the future.
Q399 Lord Forsyth of Drumlean: Has IFRS made it worse.
Lord Sharman: Yes.
Lord Forsyth of Drumlean: I think that is the point.
Lord Sharman: Yes, that is absolutely the point.

Q400 Lord Best: Can we ask Lord Sharman—as the expert in the round—your views on the concentration of audit in the hands of the Big Four? We have heard everybody else speak about this but, discard your background and the perspective of today, what would be your one thing if you believed it would be better and more competitive if there was a Big Five or a Big Six? What do you think would make that difference?
Lord Sharman: I am tempted to give you the Irish answer and say, “I wouldn’t start from here”. Because clearly anybody who chairs a major company, or sits as chairman of an audit committee of a 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. As you use the other audit firms for other services—as quite often you do—you find they’re not independent, and therefore you couldn’t appoint them, and so on. I think it’s a matter of great sadness to me that at the time of the Andersens failure, and, allied to the PricewaterhouseCoopers’ merger, you had this great concentration because what effectively happened was Andersens was absorbed into the other Big Four. I would have liked to have seen Andersens absorbed into one of the second-tier firms or perhaps just the audit practice of it, which would have maintained it at five. Today I think we have to encourage the second-tier firms to invest more in the sorts of things they need and, in particular, international networks. Where you get the problem with the Big Four is that if you have a widely spread international business, you want to use a single firm of auditors and, quite frankly, the Big Four have much better networks, or in some cases they’re integrated much more than they were, even when I was there. So, I think there is a problem there. I don’t have a quick solution for you.

Q401 The Chairman: I think we have found so far that there is pretty widespread agreement that there is a big problem there. I think the Big Four would say there is a big problem if you get down to the Big Three.
Lord Sharman: I’m not sure that makes too much difference.
The Chairman: But that is what they have said. I think our difficulty is to settle on a set of recommendations that will improve the situation.
Lord Sharman: Yes, if you look at the European Commission Green Paper, I think some of the notions embodied in that would make things worse, not better. We need to be very careful about the notion of joint audits, which I think are a waste of space. I think they would be forever blaming each other. I think somehow we need to get the second tier up to speed.
Lord Smith of Clifton: They were very reluctant. They said they wanted more access to the FTSE 250 but not much more. They were partners in the cartel as junior partners, so the coalition Government all over again.

Q402 The Chairman: I think the way to conclude this, Lord Sharman, is to say that—I do not want to prolong the session today—if we were to furnish you with the sort of recommendations that we’ve had to improve the situation, and to have your views on any that you think would be worth following up, we would be very grateful.
Lord Sharman: I would be very happy to do that.
The Chairman: I conclude by saying that we’ve spent rather a long time today, not least because of the Division, but certainly even without it. I think that is a measure of the interest that you have created with us, so thank you very much indeed for your attendance.

Supplementary memorandum by The Lord Sharman (ADT 41)

POSSIBLE MEASURES THAT MIGHT ASSIST IN WIDENING CHOICE IN THE AUDIT MARKET—PUT FORWARD BY WITNESSES TO THE INQUIRY

MEASURES AIMED DIRECTLY AT FORCING MORE COMPETITION

1. Reforms to achieve fair and regular public tendering (perhaps once every five years) with independent oversight to provide opportunities for firms to increase their market share. Mazars in their written Evidence suggest the tendering might be 2-stage providing for the submission of a short document at the first stage by a number of firms from which a shortlist would be selected for the final presentation. Kingston Smith in their written Evidence suggest that at least one non-Big 4 firm should be included in the tendering process.

I think that this has merit, as I said in my evidence I would require Audit Committees to carry out a formal evaluation of their audit relationship every five years, and if it was decided not to tender, then to explain the reasons therefore in the Audit Committee report.
2. Mandatory rotation of audit firms as in Italy (but, if specified inappropriately, mandatory rotation of all audits might compound the problem of market concentration if it led to 'Big 4' firms supplanting 'Mid-Tier' firms—not a problem if mandatory rotation limited to FTSE 350).

I don’t think that there is any evidence that this has improved matters in Italy. In the case of Singapore where it was introduced it has been reversed.

3. Greater rotation of auditors (FSA)
No comment.

4. Transformation of the Audit Commission into a large audit firm.
This has some attractions, particularly if its focus was on the public/private interface. The C&AG has since The 2006 Companies Act had the power to audit limited companies, so far I don’t see much evidence of the moving outside the public sector, although I have always believed that there is a strong case for them auditing certain public interest enterprises eg The Big Four, who are audited by 2nd Tier firms.

5. Removal of the mandatory requirement for an audit, leaving it to market forces. It has been argued that government intervention has stifled competition in the audit market and is responsible for the market concentration. If this is so, then this Inquiry needs to be cautious about recommending measures which would entail further government intervention.
I don’t agree with this assertion, I can see no basis for it.

MEASURES AIMED AT DECREASING THE MARKET SHARE OF NON-‘BIG 4’ FIRMS

6. Greater use of shared audits by leading listed companies.
I can’t see shared (as opposed to joint) audits working-the extra cost involved in the principal auditor reviewing and validating the work of the second auditor would make it economically unattractive.

7. Mandatory requirement for joint audits (as distinct from shared audits) of large companies or just of large financial entities. Possibly mandatory joint audits with one of the two firms required to be a ‘non Big 4 + 2’ ‘Mid-Tier’ firm (Mazars evidence). With a joint (as distinct from ‘shared’) audit, both audit firms provide the overall audit report and opinion, and the audit work would be required to be shared equitably in order to encourage the ‘Mid-Tier’ firms to grow. Joint audits make it less likely that the auditors develop a too-trusting ‘cosy’ relationship with the client. Mandatory joint audits would create ‘regulatory capital’ for non-‘Big 4’ firms (Oral evidence on 07Dec10).
Although I am not greatly in favour of joint audits, I think that they are expensive and inefficient, they have worked in the past and in other parts of the world. If they worked so as to open up the big four international networks to second tier firms this would be worth pursuing.

8. A regulatory code of conduct promoting the use of non-‘Big 4’ firms: this might be as auditors of subsidiaries within large, public groups.
I don’t for the reasons set out in 6 above think that this is viable.

9. Board’s risk committee of large companies should be advised by someone who isn’t the firm’s auditor (another source of advice which would not require the same sort of global network and could therefore be provided by a non-Big 4 firm. A bit like a joint audit. (Baroness Hogg, 9th November).
I support this for both the risk and the audit committees. The adviser does not necessarily need to be an audit firm.

MEASURES AIMED AT REDUCING ‘BIG 4’ DOMINANCE

10. Placing limits on the market share of firms measured by the number of appointments held, say, over a five year period, monitored by representatives from regulators and investors (Grant Thornton’s suggestion in their written Evidence to this Inquiry)
This seems to me to be a classic competition solution (limit market share) I can’t see why it would not work.

11. Elimination of covenants restricting choice of auditor, which even sometimes stipulate which of the ‘Big 4’ should be used.
I’m not aware of this as a major issue, but I agree the proposal is sensible.

12. The audit committee’s report to explain why they considered the need to appoint a ‘Big 4’ firm.
This is a sensible proposal (see 1 above)

13. According to Standard Life’s March 2009 response to the EC’s consultation on ‘control structures in audit firms and their consequence on the audit market’, Standard Life considers another catalyst to accelerate access to international audit markets would be for boards and/or their audit committees [to] disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and the key conclusions arising therefrom.
Again sensible (see 1 above)

14. Strengthen audit committees and require them to report/justify publicly their work and rationale re. audit and non-tendering decisions.
Agreed (see 1 above)

15. Break up of one or more of the Big 4.
If this were to be considered (again a classic competition measure) it needs to be looked at by reference to audit market share and not the total size of the firms measured by say revenues. It could be achieved in the context of 10 above by requiring divestment of audits to 2nd tier firms.

MEASURES AIMED AT STRENGTHENING NON-‘BIG 4’ FIRMS

16. Relaxing the limit to the amount of outside capital of an audit firm (currently set at less than 50% by the EC). Ownership rules of auditing firms need to be changed (FRC—9 November).
I think that this would be helpful.

17. Increased investment by, or mergers of, non-‘Big 4’ firms in order to create one or more larger ones (Mr. Ashley Almanza, Hundred Group and BG in oral evidence on 07Dec10).
I think 16 would be necessary which I think is desirable.

18. ‘Second-tier’ firms must be encouraged to invest more (to enhance their international networks, etc) (Lord Sharman’s oral evidence—14th December).
I think 16 would be necessary which I think is desirable.

19. Defection of a large number of specialist bank auditors from a ‘Big 4’ firm to a ‘mid-tier’ firm.
I would leave this to the market, if 16/17/18 were to be achieved then the environment for this to happen would have been created. This should include specialist auditors in any field.

20. A workable mechanism for the limitation of auditor liability, so that the risks of auditing large entities do not outweigh the benefits. Possibly a cap on auditor liability (as in Austria, Germany, Greece) and also the introduction of proportionate liability.
This is highly desirable, and is already viable as a result of The 2006 Companies Act. I am not in favour of a cap as opposed to proportionate liability, nor I suspect would Institutional Investors be either.

MEASURES AIMED AT BREAKING THE CLOSE RELATIONSHIP BETWEEN MANAGEMENT AND AUDITORS

21. Alternative appointment processes for auditors, eg involving shareholder panels, or appointment by regulator.
These could be viable, but I believe that any move to disenfranchise the shareholders in the process is wrong.
22. The audit committee to appoint the auditors, as in the US under Sarbanes-Oxley and report in some detail their decision (E&Y witness).
This works but UK law requires appointment by the shareholders in general meeting, this can be achieved by the audit committee recommending to the AGM the appointment and explaining the reasons therefor.

23. Introduce a financial statements insurance approach as an optional alternative to the present audit. An interesting concept which would need to be explored with say Lloyds of London to see if the market would be willing to underwrite such risks.

MEASURES AIMED AT REGULATORS AND STANDARDS SETTERS

24. Reduce complexity of financial reporting and auditing standards to better enable smaller audit firms to cope with the audits of large companies.
Given where we are I don’t see this as viable.

25. Narrow the scope of the annual audit, so that companies can get other advice from other firms, so allowing mid-tier firms to compete better.
I think that this would be a retrograde step, we need broader assurance including looking forward not more narrow assurance.

26. Consistency of the regulatory framework globally would help, but may be insufficient (Shell: oral evidence, 7 December 2010).
This is desirable but won’t be the solution.

27. Make sure that regulators of cross-border activities do not act as an effective barrier to using non-‘Big 4’ audit firms.
This is a valid aim.

28. The regulator should be less burdensome of the profession (Q50 of transcript of 19 October 2010 session—answer by Mr. Hodgkinson of ICAEW: ‘Oblige regulators to consider how regulation affects availability of choice. Make it a criterion for regulatory action because it is clearly of public interest.’)
I don’t agree. By contrast with other regulators, the FRC has not in my opinion been overly burdensome.

29. The regulator needs a contingency plan for orderly transition of audit clients if a Big 4 firm fails (Mr. Ashley Almanza, Hundred Group and BG in oral evidence on 07Dec10).
I agree.

30. Develop living wills for the largest audit firms to mitigate the risk of any exiting the audit market (Deloitte witness).
Again I agree

MEASURES AIMED AT INVESTORS

31. Find a way of ensuring that the largest institutional investors act together to influence large companies to consider ‘Mid-Tier’ audit firms, as ‘they usually get the changes they are looking for’
This would be desirable, they have and continue to be very effective on remuneration issues. Perhaps shareholder committees is one way forward.

32. The FRC should convene a group of large institutional investors to come up with audit market intervention initiatives.

It will be interesting to see what they come up with.

GENERAL

33. Ignore the present system and build an alternative in parallel, alongside the present system.

Great in theory, but where do you start and what sort of a system would you seek to build?

34. First, work to reduce market concentration in FTSE 250 audits so as to build a sustainable platform for the ‘Mid-Tier’ firms to be able later to compete effectively for FTSE 100 audits.

This would be good in process terms but the 2nd tier need to understand that The FTSE 100 is the aim.
**Memorandum by the Association of British Insurers (ADT 42)**

**Introduction**
1. The Association of British Insurers, on behalf of its 300 members is the voice of the UK’s insurance, investment and long-term savings industry. It is an important contributor to the UK economy and manages investments of £1.5 trillion, over 20% of the UK’s total net worth. As institutional shareholders in UK-listed companies they have a strong interest in the existence of a competitive market in auditing services and the delivery of a quality audit product. We welcome the interest of the House of Lords Select Committee on Economic Affairs in this subject and are pleased to respond to this invitation to submit evidence.

**General Comments**
2. We remain seriously concerned both about the risks posed by a market structure of only four auditors and the “too big to fail” argument that is consequently advanced which we consider damaging to the behaviour, conduct and faith in the auditors. A public policy objective of securing the survival of existing firms would be unlikely to work given that audit firm failure is most likely to come from catastrophic damage or regulatory prohibition rather than a pure business or financial failure.

3. There is no simple solution to increasing choice and the subject must be seen in both domestic and international contexts. Significant change would be likely to result from any follow-through by the European Commission on the work undertaken on liberalisation of ownership arrangements. We see this as important not so much in that it would facilitate new entrants as that it would allow a “failed” firm to be recapitalised. A takeover in such circumstances by another Big 4 firm would lead to further market concentration and we doubt that any Tier A firm would have the necessary skills and firepower to absorb a failed Big 4 firm. It would be helpful if the Select Committee were to send a signal that this work should be taken forward.

4. Other improvements in the working of the market for audit services should continue to be sought. Further encouragement of those firms next in size to the Big 4, the Tier A firms, to increase their share of FTSE Mid-250 audits and, in due course of FTSE 100 engagements should be given though progress on this front has been slow.

5. Reliance in the current environment on market forces to achieve greater competition and reduced reliance on the largest audit firms for the audit of large and complex companies is unlikely to be effective without regulatory pressure and we think regulators both at national and international level should signal that this is a priority. In the UK context we suggest that the recommendations of the FRC’s Market Participants Croup should be given further attention and progress sought on these.

6. We give our answers to the specific questions posed by the Committee. We would particularly highlight the concerns already picked up the FSA and FRC as regards exercise of professional scepticism by auditors and our concern that auditors’ ability to exercise this has been undermined by the perception or the reality that the time-honoured principle of prudence has been lost from the accounting and auditing framework. We also would stress that dialogue between auditors and regulators in the case of banks and financial institutions needs to be encouraged, but on the right terms.
QUESTIONS FOR CONSULTATION

1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?

The development of a global Big Four in accounting and auditing has occurred in part by accident, through the demise post-Enron of Arthur Andersen, but mainly as a result of previous mergers of major players the last of which led to the creation of PricewaterhouseCoopers. A top tier of four such global networks may perhaps be considered as consistent with the needs of the market and we would not regard, say, the creation of a fifth global audit network as the remedy for lack of competition. We see no good reason, though, why the total market for audit amongst market-traded/listed companies needs to be as concentrated as it is within this top tier of four firms.

2. Does a lack of competition mean clients are charged excessive fees?

Our primary concern as to the market for audit has not been that excessive fees have been charged but, rather, the risk that the securing of audit engagements is viewed by accounting firms as a means of accessing other business opportunities with client companies. The concern is therefore that the cost of audit could be kept low at the expense of quality and conflicts of interest. These concerns have been lessened somewhat in recent years, through effectiveness of regulation and within the corporate governance framework to give audit committees improved oversight.

3. Does a narrow field of competition affect objectivity of advice provided?

We have no evidence that a narrow field of competition affects objectivity of auditor or other assurance or advice services.

4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

Nor do we think, conversely, that limited availability of alternative audit firms allows greater scope for auditors to provide unwelcome advice.

5. What is the role of auditors and should it be changed?

We consider the all-encompassing role of the auditor to be to reach a judgment that the accounts of the audited entity give a true and fair view in accordance with the requirements embodied in the Companies Act 2006. In carrying out this task, which will likely require substantial engagement with both company management and non-executive directors through the audit committee the auditor will have performed an important role within the governance framework, providing shareholders with the assurance that the financial information provided by the company will allow them to exercise their ownership responsibilities effectively.

6. Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?

The Financial Services Authority and the Financial Reporting Council have made clear in their discussion paper that they do not believe auditors were sufficiently sceptical in challenging assumptions and assertions of bank management of banks and that assets may therefore have been overvalued in the run-up to the banking crisis. Subsequently the Auditing Practices Board has published a discussion paper on scepticism to which we intend to respond in due course.

Our initial view is that greater auditor scepticism was indeed needed but that professional culpability of auditors in this regard should be tempered by the recognition that their ability to apply scepticism has been undermined by changes in the accounting framework which has relegated the principle of prudence. That change at the same time as a move towards much greater use of fair values rather than transaction-based accounting has been particularly detrimental in ensuring reliable accounting numbers in overall terms.

The ability of auditors to question the prudence of management not only acts as a counterweight to optimism bias and less innocent attempts in isolated circumstances by management to convey a rosy view to shareholders. It also provides a means by which a greater measure of consistency can be achieved between companies where honest management judgment may vary in the estimation of what would be appropriate accounting numbers. We are not aware that lack of competition between audit firms has accentuated any lack of scepticism on the part of auditors.
7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

The visible output from the audit is the audit opinion and this provides limited information to shareholders as to matters that have been weighed in reaching the audit judgment. If the opportunity were available to auditors to convey greater information in this regard it is possible that shareholders would have been alerted at an earlier stage to the risks and uncertainties that were building up as regards bank assets and liabilities during the run-up to the banking crisis. Considerable thought has been devoted in recent years by the Audit Quality Forum, the Auditing Practices Board and others to how auditor reporting can be improved without any clear action having been initiated to ensuring either that auditors or audit committees can provide improved qualitative information to shareholders.

Auditors are already under various obligations to communicate with regulators of banking entities that they audit. It is clear, though, that this dialogue has been insufficient in recent years the FSA not having kept open the channels of communication that had been in place prior to its becoming the regulator. This aspect is now being addressed by the FSA and FRC in their current discussion paper, and also at EU level through the recent consultation on the proposals in their green paper.

8. How much information should bank auditors share with the supervisory authorities and vice versa?

It is important that engagement between auditor and regulator takes place on a basis of mutual respect of the proper role of each party and that this communication is two-way and improves the quality of both regulatory supervision and of audit. This is in the ultimate interest of all parties. Channels of communication between auditors and regulator need to exist in respect of both individual audit engagements with banking institutions and at the generic level. This dialogue should not, however, lead to auditors being co-opted into regulators' work, or risk their independent statutory judgment and function as required in statute.

9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?

We have no special observations on how incentives on auditors to provide objective advice to clients could be strengthened.

10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?

Conflicts of interest between audit and consultancy roles are capable of mitigation in various ways including through ethical standards and their enforcement and through vigilance of audit committees. The Auditing Practices Board has recently consulted on the safeguards required where non-audit services are supplied by the auditor and has proposed improved disclosure that we hope will help shareholders satisfy themselves that these risks are minimised and that audit committees’ oversight in this regard is effective.

11. Should more competition be introduced into auditing? If so, how?

More competition in auditing is needed. We have supported the efforts and deliberations of the FRC’s Market Participants Group to achieve this. Further significant changes may, however, be difficult to achieve without more radical change regarding ownership rules. Any such changes would require the initiative to be taken at EU level to modify Directive requirements. Although tentative conclusions were reached in research undertaken on behalf of the European Commission that a more competitive environment could be secured by such changes, which would be expected to reduce the cost of capital of auditing firms as well as permit new entrants and easier recapitalisation of any existing firms that encountered difficulties, there appears to have been no material progress on this project of late. We encourage the Committee to impress upon the authorities in the UK and Europe the need to make progress given the risk of another crisis or other event affecting the viability of one of the Big 4 firms narrows the market yet further.

12. Should the role of internal auditors be enhanced and how should they interact with external auditors?

The role of internal auditors, who are accountable to management and board, is distinct from that of the external auditors but there needs to be a healthy level of interaction between them.

13. Should the role of audit committees be enhanced?

The role of audit committees has been substantially enhanced in recent years, in formal terms through the changes codified under the Smith Guidance in the post-Enron period. If there is further change required this needs to focus particularly on communication between audit committee and shareholders, the enhancement of which would allow better shareholder understanding and engagement as appropriate.
14. Is the auditing profession well placed to promote improvement in corporate governance?

Auditors play a key role within the governance framework of the company although it is not their role to take the lead in promoting improved governance. They can be a force for good in ensuring effective governance and, in entering into an audit engagement, they should satisfy themselves that the governance environment is appropriate. Where, in exceptional circumstances, they are unable to secure improvements if these are necessary to the carrying out of their duties they should be prepared to resign the engagement and request that shareholders be informed as to the reasons.

24 September 2010

Examination of Witnesses

Witnesses: Mr David Pitt-Watson, [Hermes], Mr Paul Lee, [Hermes], Mr Iain Richards, [Aviva Investors], Mr Guy Jubb, [Standard Life Investments], and Mr Robert Talbut, [Chief Investment Officer, RLAM, and Member of the ABI Investment Committee].

Q403 The Chairman: Gentlemen, good afternoon and thank you very much for coming to this Select Committee meeting of the Economic Affairs Committee. As you know, we are coming rather towards the end of our inquiry and I think we are particularly interested in having your views on the subject of our inquiry this afternoon because we haven’t really looked at this to date. I just have to say at the start that copies are available of Members of the Committee’s entries in the Register of Interests and also those that they have declared as relevant to the inquiry. I should be grateful if you would speak loud and clear for the benefit of the webcast and the shorthand writer. Since there are five of you, if one of you responds first to the question and you all agree, you don’t necessarily have to say that; just nod or keep quiet. But we’re happy to hear from all of you. I should like to begin with the first two questions that are fairly general and I think will probably be setting the tone for some of the subsequent, more detailed questions that you will be getting. The first question is: is the standard audit report useful to investors? Mr Richards: Perhaps if I start on that one. The audit is valued. The audit report adds little value of itself and it tends to be fairly anodyne. The times that it tells us anything, it signals anything, it’s often far too late in the day and very often when an issue does arise you have a history of clean audit opinions behind it. It is binary, yes or no. There are some other elements of the audit that get reported on, some on an exceptional basis, and I think there is considerable scope to enhance audit reports and make them far more useful to shareholders.

Q404 The Chairman: Well, we will be following that up, how you can enhance the audit reports, but is that a general view? When you say the audit is valuable, you mean the underlying work done to produce the standard boilerplate stuff in the annual reports? Mr Richards: The general concept of an audit. There obviously have been concerns about some individual audits and concerns about the nature of audits under the standards, but the fact that we have an audit is valued by investors.

Mr Pitt-Watson Chair, may I expand on that? I think audit and accountancy are absolutely fundamental to the integrity of our capital markets and the good governance of our companies. In the UK—and this is different from other countries—the role of the auditor is to provide the information necessary to allow shareholders to play their role as owners of the company. The existence of the audit in itself, like the existence of lots of information, does not require that it’s given to the shareholder and then the shareholder acts. The very fact that this is going to become a document that is given to shareholders changes the behaviour of companies and, in that sense also it, is fundamental to the good governance of companies in this country.

Q405 The Chairman: As you know, this was a quote from a Hermes publication and it seemed to raise the question that one was really doubting the standard audit report but it wasn’t querying the underlying work that’s gone into it. Mr Lee: That’s absolutely right. Mr Jubb: One of the challenges for investors is that 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. This is where the audit committee clearly plays a very important role on behalf of the board and on behalf of shareholders, but it is the audit report that is the aspect that investors ultimately see. As my colleagues have referenced, the reliability that we have to place upon audited financial information is the lifeblood of capital markets. If we didn’t have an audit that would clearly be a matter of great concern. Mr Talbut: If I may just add on that one. The point is that the more information that is going to be available to shareholders the better position that shareholders are in to be able to discuss that information with members of the audit committee or elsewhere within the company and, therefore, discharge their duties as institutional shareholders of the company. I think, in particular, that the type of information that would be extremely useful to understand within a better quality audit report would
be issues where there have been questions of judgement, perhaps, or nuance within the report and accounts, or where the particular issues were where there might have been more contention between the company and its auditors. Because those are types of things that it would be much easier for shareholders then to be able to have further questioning on and, as I say, properly discharge their duties.

**Q406 The Chairman:** Well, I think that’s of interest to this Committee as well because we would be interested to know your views as to what kind of information and where the relationships aren’t quite right at the present time. We will be following that up. Does anyone else want to add anything on the actual report?

**Mr Jubb:** You asked about the usefulness of the report. Let me just take it one layer down into the content of the report. One of the criticisms that I think most investors and certainly we have of the audit reports is that they are very, very standardised in their content. They are often—I have used the expression elsewhere—riddled with “get out of jail free” clauses in terms of what is in there. The aspects that colleagues were referring to, such as matters of emphasis just to help guide the investor and reader, would make the audit report a good read rather than otherwise.

**Q407 The Chairman:** As you know, we have been partly looking at the question of audit market concentration in the Big 4 and I think it would be fair to say that we are getting quite a lot of concern from a number of our witnesses on those grounds and particularly, of course, if the Big 4 came down to the Big 3. I’d just like to know from the investors’ point of view whether this audit market concentration—we note also that there are very rarely changes of auditors among the FTSE 350 and especially the FTSE 100, so there is a longstanding relationship there—causes unease among investors.

**Mr Lee:** Shall I take that first? Absolutely it does. I think the major concern is the lack of competition, but particularly the lack of competition on audit quality. I think it was very clear from the evidence that you received from the Hundred Group that the only competition that they experience is on price and certainly that is all that we are aware of occurring in the market. Part of the problem is the invisibility of audit quality. We’ve all referred to problems with the audit report not providing useful information. That’s just an example of the lack of information there is about audit quality. In the absence of that information it’s no wonder that there’s no competition on that topic.

**Mr Jubb:** Could I add a slightly different shade to that, because from our standpoint, while we believe strongly that the concentration of audit markets is fundamentally unhealthy and represents a systemic risk that has the potential to undermine confidence, it is not so much the competition issue but it is the lack of choice that is the area of particular concern to us. We made representations to the European Commission and others in 2009 asking them to address this particular issue with a sense of alacrity. But we have come to this position where 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. We have waited a decade, give or take, for market forces to make a change and the strength of the oligopoly is not making any progress.

**Q408 The Chairman:** Quite a bit of the evidence we have had suggests that in the global market in which so many companies, particularly in the FTSE 100, now operate, you do need to have that global reach from the auditors. That’s a very expensive thing to provide. A great deal of expertise is required worldwide and this very much restricts the scope of any others entering the market. Have you any comments on that?

**Mr Talbut:** A particular point that I would emphasise on that one is that while we may well accept that with some of the very largest, the most international, companies, that is a reasonable argument, we don’t believe that that, therefore, applies right the way down the size scale. The degree of concentration within, for instance, the 250 companies within the UK is broadly similar to the degree of mix within the 100 companies. Now, I think that there are many, many companies within the 250 where those arguments of extreme complexity and extreme internationalism of the business just does not apply at all. But it doesn’t appear that the market is operating, even within those sub-100 companies, to introduce a greater degree of competition and choice. I would echo the point that has already been made; we don’t believe that reliance upon market forces will bring about any fundamental change in this marketplace whatsoever. There have been plenty of opportunities over the last 10 years or so for there to be and the Market Participants Group came up with a set of other possible recommendations that should be implemented. I would still observe that there is relatively little movement taking place in terms of the degree of concentration. That is why I would certainly support the idea of, within the 250 companies at least, a forced degree of intervention in the marketplace to lessen the grip of the Big 4 within the marketplace, to be overseen by the FRC, so that there is a reasonable opportunity of starting to create
another organisation that can take on a number of audits. Given the fluidity between the 250 and possibly moving up to the 100, that would, over time, I think, bring about a better opportunity of improving competition and choice in the larger companies as well as the 250 companies.

Mr Lee: Robert is absolutely right that the argument about internationalism doesn’t apply to many companies in the 250. There are certainly a number of companies in the FTSE 100 to which that argument does not apply. Admittedly, many are very multinational but not all are and it would be entirely possible for certain of them to be audited by a decidedly smaller, less international firm.

Mr Jubb: To develop the theme further, we have suggested to the European Commission that it should send a clear signal to the Big 4 networks to give the Big 4 networks time within which to organise their affairs in a way that will enable the global service to be provided but, at the same time, will enable greater choice without prejudice to audit quality; but within that message make clear that it is prepared to intervene in order to take action in the event that the Big 4 and other firms do not take action consistent with that objective.

Q409 The Chairman: I think it’s clear that a lot of the recommendations, many of them quite small, that have been made in the last 10 years have not produced much result. Is that what’s driving you to looking for more of a regulatory or even legislative solution?

Mr Jubb: Yes.

Mr Talbut: We have been talking about this issue for years and years and there is no movement whatsoever. There is no change in the concentration and there appear to be far too many vested interests in preserving the status quo.

Q410 Lord Lawson of Blaby: Have you put your specific proposals in writing?

Mr Richards: Yes, and I’ve handed them to the clerk ahead of the meeting. If I may, I fully agree that an ultimatum has to be given to the Big 4 that the market needs to change with a specific deadline and some measures agreed in terms of the targets for change, but that of itself won’t be effective. Within the markets, there are some very entrenched perceptions in audit committees that the Big 4 is what you need to go for. That is reinforced by the fact that investors and the markets prefer the Big 4. In the absence of any real insight into the audit, big is safe. So the market punishes people who don’t go for the Big 4. The bankers take exactly the same approach. You may have seen there’s been a debate around some of the clauses in debt instruments requiring the use of Big 4 firms. So there is a very persistent attitude throughout the market and through the players in this dynamic, all of whom tend to focus too much on the Big 4. So just tasking the Big 4 without changing other things isn’t adequate. There needs to be a wider range of change. Audit committees need to be forced to be much more transparent and thoughtful in what they’re doing, and the audit committee report does need to be beefed up. Equally, the position of investors and shareholders needs to be addressed and one of the ways of doing that might be to ask the FRC to review the stewardship code to incorporate this whole area of auditing and accounting more specifically within it. But unless there’s a package of reforms, any one reform is unlikely, of itself, to be effective.

The Chairman: I’m afraid the Committee haven’t seen the written evidence that you’ve given. Certainly, if we have any further questions on it, we would like to come back to you.

Q411 Lord Moonie: You say that it’s not price that you’re concerned about but quality. Surely, if appropriate external standards are set and rigorously applied, the number of firms available to you is largely irrelevant because the appropriate standards are being applied anyway. What counts is that you have an audit committee that does its job.

Mr Richards: If I may come back on that, I think there are two things. Between the Big 4 dominance of the markets and standards that have become much more process-orientated, the audit has become commoditised. So competition does not appear to be around audit quality. That seems to be confirmed by the ongoing findings of the Audit Inspection Unit that has repeatedly raised concerns about the appraisal of audit partners or Big 4 firm partners, which gives inadequate emphasis to audit quality compared to other things. I believe, in its most recent report in relation to PwC, it noted that the proportion of KPIs for partners relating to business growth had been increased from 25% to 40%, while those relating to quality had been reduced from 25% to 20%, and there are a number of other indicators that illustrate the emphasis away from audit quality.

Q412 Lord Hollick: Mr Richards, you mentioned that investors—not your exact words—take comfort from the fact that one of the Big 4 is auditing a firm. Is there any evidence in the experience of the four firms you represent that companies are punished in any way for not having one of the Big 4 or that you avoid making investment in them because they don’t have one of the Big 4 audit firms?

Mr Richards: Perhaps I may give an example of the opposite. It was a case where we didn’t own any of the shares, Sanctuary. The auditor was a tier A firm that was seeking to blow the whistle on bad practice,
accounting problems and internal control failures within the company. It was sacked by the directors, who brought in a Big 4 firm. The shareholders said nothing. There was no issue made of it. There is anecdotal evidence that people in discussions persuade companies perhaps to go the other way and also in the market reaction, which is something that the academics have looked at. There is evidence of it. Mr Lee: There certainly is a perception that investors favour the Big 4 and one thing that we and five other institutions, including Iain’s, did five years ago was write to all the FTSE 250 companies and say essentially, “It is not necessary, in our view, for you to be audited by one of the Big 4. Please take a look at the tier A firms”. In the five years since, the one thing that has happened is that the market has moved entirely in the other direction. So not only did we get a very limited response to our letters; the reaction over time was entirely contrary to our aspirations. Mr Talbut: When surveys have been undertaken of the attitude of institutional investors towards the Big 4 and other, say, tier A organisations, it is true to say that there is a perceived issue with respect to the very largest companies going for an organisation that is not one of the Big 4. It’s not a majority at the moment but there is an increasing proportion of shareholders who would say they would be quite comfortable if a tier A firm were to be doing the audit of certain, say, mid-sized type of companies. But that information does not seem to being acted upon by audit committees or the board as a whole. Mr Jubb: It is relevant to share with you that very little engagement takes place between audit committees and institutional investors about choice of auditors and audit matters. Last month the Institute of Chartered Accountants of Scotland published a document called The Future of Assurance. Declaring an interest, I was Deputy Chairman of the Working Group that developed the document. In line with the point made by my colleague, it has recommended that there should be included in the UK Stewardship Code for Institutional Investors a principle whereby institutional investors, for their part, will engage with companies and thereby audit committees about the quality of corporate reporting. But, equally, there is a suggestion in that report that every five years the audit committee should undertake a detailed evaluation of the service provided by its auditors and engage with its principal investors to discuss the findings of that so there is a forum for the dialogue to take place about the suitability of auditors and indeed the very quality of the service that is provided. That, sadly, is not currently taking place.

Mr Jubb: The evidence is perhaps embedded in your opening remarks in terms of the common sense of the issues concerning what happens when you have the Big 4 and it then goes down to the Big 3 and the Big 3 then become the Big 2. There are inherent issues in terms of the issue of liability—which I know is a very important part of the equation and is part of the solution that needs to be considered. In particular there are issues as to the attitude of regulators and others in terms of taking action which could bring down one of the Big 4, or indeed one of the Big 6 even, in a manner that would precipitate the consequences that judgement suggests is not going to be healthy for the capital markets and could undermine confidence in them. Mr Richards: If I could add to that; the other aspect that is significant for investors is the commoditisation of the audit versus the reliance that we place on the audit to provide not just the internal discipline but the external signalling when it is appropriate. If you look back over the crisis and you look at the lack of signalling given by auditors and what happened to the banks, there has been a problem. Mr Lee: I will take that slightly further. I think possibly we are seeing some complacency among the Big 4 firms. Iain has already referred to the work of the Audit Inspection Unit. A lot of what it discovered was the Big 4 pushing at the edges of the ethical standards, for example; trying to see what additional non-audit services they could squeeze in under the radar. These sorts of activities, I think, are a sign that the Big 4 are confident in their market position and don’t feel the need to maintain standards quite at the height that we would wish them to.

The Chairman: We would like to come back to the point about the banks specifically on its own because, as you may have noticed, we have been having a lot of evidence on that.

Q414 Lord Smith of Clifton: Gentlemen, following on from the last set of questions, what would you say should be the minimum number of active audit firms needed to constitute a genuine competitive market for the audits of the FTSE 350 companies? Mr Richards: It would be very easy to sit here and say that we would love to have the Big 8, the way we did back in 1987. The reality is that it is not particularly feasible. If you look at the largest firms, you would have to merge the next six audit firms in size just to equal the smallest of the Big 4. If you did that, you would then also risk leaving an even bigger gap between the then Big 5 and the rest. You may potentially raise issues, particularly if they are going to throw that resource at trying to capture large company audits, in reducing the choice for smaller firms. In terms of trying to tackle this issue, I would
hope to see a range of packages that would see another Big 5 firm evolve and, if we are lucky, potentially a Big 6. But I think you have to be progressive about that to avoid unintended consequences for the medium and smaller size companies. Mr Jubb: Having been in complete agreement perhaps thus far, perhaps I may inject a bit of differential opinion. I am not quite so reticent about suggesting that one can have a larger number of major networks beyond five or six. I do recollect and I did operate in the days of the Big 8 Plus 2. It is useful to remember incidentally there were Plus 2 in those days as well. In terms of the approach that I was articulating earlier whereby the major networks should organise their affairs and be given time to do that—and that will obviously involve discussion, in part, with their clients—I believe it is in their gift to organise their affairs in a way that could have a larger number than just the five or six global networks. I am not of a view that one should stipulate what the number should be but I am entirely clear that eight was a comfortable number. When we had eight I felt that we had choice.

Q415 Lord Lawson of Blaby: The normal thing to do when you have lack of competition and a fear, which you have voiced, of excessive concentration is not to promote mergers among smaller companies but to split up—bust, trust-bust—the large ones. I am surprised, given the views you have generally expressed, that you have not commented on this. The other thing that is related to that is that obviously this is an international business. The United States is particularly important. The United States has a great history of being interested in trust-busting of one kind or another. Is there any movement, as far as you are aware, in the United States of concern about the concentration and a feeling that some kind of trust-busting might be in the interests of the economy? Mr Richards: An in-depth study was done by the Government Accountability Office in the US—I cannot remember off the top of my head whether it was in 2000 or 2002—that identified all of the types of issues that are being debated today but it did not come up with any specific recommendations in the terms of the cost-benefit analysis. It didn’t see the case as being made and, in the absence of a sufficient problem with anti-competitive practices, didn’t feel that intervention was warranted; though it noted that it was a situation that needed to be kept under review. I am not aware, other than a subsequent review by the American Anti-Trust Institute, that there has been any other detailed examination in the US that has been published.

Mr Talbut: If I could come back directly on your point. My comment earlier on was very much along the lines that the organisations should be compelled to give up market share. That is not necessarily about splitting one of the Big 4 up but I think if you were to move down that road you could create a fifth or a sixth organisation over a reasonable period of time and that would have the effect that most of institutional investors would like to see.

Mr Lee: I am not sure whether, in the context of a dynamic such as we are talking about, you wouldn’t see partners shifting from one of the existing Big 4 to the fifth or the sixth and leading to that effect without the need for trust-busting in any form. Mr Jubb: The views on trust-busting were also inherent in my earlier remarks but it is perhaps the threat of trust-busting, along the lines I have previously suggested, which may help to deliver the solution in a way that causes the larger networks to move forward. In terms of the global and US aspects, we believe that this approach should be championed at the G8 or G20 levels in order to provide some leadership and indeed the requisite commitment. We would observe that a network is only as strong as its weakest link. Even if the UK, of itself, were to take a bold step in this regard, that could provide some form of catalyst for change that would otherwise have wider, global repercussions.

Q416 Lord Lawson of Blaby: You have not answered one of my questions. Do your opposite numbers in the United States share the concern that you have voiced today? Mr Jubb: We and a number of my colleagues here do engage in informal discussions with other investing institutions in the United States. Also I Co-chair the Global Auditor Investor Dialogue which brings together a number of major global investors in the United States and in Europe with senior representatives of the Big 6 auditing networks to converse informally on policy and practical issues. Two years ago a working group that was derived from the Dialogue developed some Disclosure Guidelines, which I shall gladly submit as evidence. They were designed to assist directors and audit committees regarding what should be disclosed on audit matters. Among other things, it dealt with the issues associated with the rotation and selection of auditors.

The Chairman: It would be very helpful if you could let us have that.

Mr Jubb: I would be very pleased to do that.

Mr Richards: If I could just add to that; the large focus in terms of action in the US in relation to auditors tends to be after the horse has bolted, in that they then sue them. That tends to be the focus in the way market investors decide their reaction to and interest in the audits. In terms of the engagement with auditors, I believe that the situation and access to the whole debate is much harder over there than it is here.
Here we can, at least at times, get access to audit committee chairmen. It is not as easy in the United States.

Q417 The Chairman: In terms of the Big 5, I think one suggestion that has been put to us is that the Audit Commission might become one of the Big 5. Have you any comment on that?

Mr Richards: I am not aware enough of the Audit Commission and its work to have a well-founded view about that.

The Chairman: Fair enough.

Q418 Lord Shipley: Can I move us on to your views on the mandatory rotation of the audit firms—maybe five, maybe seven years or whatever—and whether you think that might improve independence and quality? Might it also encourage firms that are non-Big 4 to become more active in the large company audit market?

Mr Richards: I look around. “No”, I think, is a fairly common answer you will get from shareholders. We believe that it risks being detrimental to audit quality. If I can characterise this rather crudely; if you appoint a new auditor in a reasonable-sized company they have a period of learning. If that were to be, say, a year and a half before they were completely up to speed and then they would have a period in which they provided, if I can call it that, a full-service audit. Then they would have a period at the end where their commercial interest would be to rotate their best people on to new clients; so you would have, if you like, a wind-down period. What you might risk ending up seeing is three years of lower quality audits for every four years of full-service audits. The other point I would make is that if you require mandatory rotation there is no reason why, if I were a company, I might not say, “This time I’ll have PwC and next time I’ll have KPMG and the time after that I’ll have PwC”, and so it goes on. So just mandating rotation would need to be thought through very carefully in terms of the potential impact to the quality of audit but, equally, just having rotation might not change anything. Indeed, if you took it down beyond the mid-250 it might give the Big 4 a greater opportunity to expand their current market dominance. So there is a whole series of issues that give people concern about the proposal. Where we looked at the issue, the next step we took was to consider whether there should be mandatory tendering of the audit. But, again, many of the issues were very similar and it wasn’t clear to us that we could make a strong case for it.

Mr Lee: We would actually disagree with the perspective that changing an auditor reduces quality. The main evidence that it might do so seems to come from a study by FEE, which is the profession’s own lobbying organisation in Europe. The evidence that we have from the Audit Inspection Unit in the UK is that audit quality improves in the first couple of years of an audit because the audit firms put in a lot more work to make it work. That is why we would be quite strongly supportive of mandatory tendering. We would not be supportive of mandatory rotation. We think the discipline of going out to the market on a regular basis ought to be enough to drive people to look at audit quality, as well as looking at price.

Mr Talbut: Something else I would like to add in on that one is to refer to the fact that what we are looking for here is not only greater competition but we are also looking for greater choice. I think that simply looking for mandating rotation does not seem to me to be attacking the idea of how we introduce greater choice to the marketplace. By choice, what I am referring to is trying to break away from the homogeneity of audits that we have at the moment so that, prospectively, we have organisations trying to compete for the audit on slightly different criteria. Coming right back to some of our initial responses to you, there does not appear at the moment to be the incentive or opportunity for organisations to come up with innovative approaches for how they wish to compete. We, as shareholders, have little or no information on the basis on which an audit is awarded. At the moment the prime criterion appears to be cost rather than incorporating a lot of other criteria that we as shareholders and other outside parties might like to see incorporated into that decision-making process.

Mr Richards: If I can add to that, I think it is not just cost. The term that is generally bandied around is the value-added services that can be derived from the audit firm. These are the non-audit services. One of the key interests from our point of view is putting audit committees much more on the spot; to make them much more accountable and transparent in the reporting they have to make in the audit committee report to explain what they have done in reviewing the audit relationship the non-audit services; in reviewing audit quality; whether it should be put out to tender. A whole range of information around that provides shareholders with a much more qualitative insight into what is really going on and the fact that this is being addressed in a substantive and prudent way.

Q419 The Chairman: Would it not be likely that if you did that you would get the same response from the companies as you gave us in your first response? They would demonstrate all the reasons why you wouldn’t want to have a change of audit in the same way as you said that mandatory rotation would not necessarily lead to a better result?
Mr Richards: We recognise that there is always a risk of boilerplates. That is what we have had to date, despite some very good efforts to try and instil a bit more life into audit committee reporting. Unfortunately there is always the influence of the lawyers in the process and that does seem to get in the way. I think the more we create a framework that calls for it and articulates it effectively, the greater the opportunity for us to engage and pin people to the table about some issues that are important in this area.

The Chairman: I am bound to say I was a bit surprised at your first answer because it seemed to me to give a total justification for the situation we have at the moment.

Q420 Lord Shipley: Can we just be clear whether everybody agrees with the position that has been set out: there is mandatory rotation and there is mandatory tendering. Earlier on this afternoon there was mention—I cannot recall the precise wording—of the Big 4 getting too comfortable, or something like that. I am not clear how you think that issue should be addressed. Would mandatory tendering provide that extra spur to making the Big 4 improve quality and independence and so on?

Mr Talbut: From my perspective I don’t think mandatory tendering would have any impact in diluting the power of the Big 4. I think you would simply find that the audit would just simply go around those organisations that are homogenous in terms of the service they provide. We need to think about other solutions if we are going to try and dilute the power of the Big 4. Our position was that we were comfortable with the idea that the audit partner has to be rotated because he has the prime responsibility for the quality of the audit within the organisation. We are somewhat ambivalent about whether rotation would have any meaningful impact.

Q421 The Chairman: Mr Richards, you referred to the fact that it was a benefit to the Big 4 in terms of their audit that they could provide non-audit services as well. I know there are certain qualifications around that but, nevertheless, most of them do in some form or another. Looking for something that would help to break up the monopoly, would you make that mandatorily impossible?

Mr Richards: I wouldn’t make it impossible but I think that there needs to be a much more rigorous look at the area. The UK, in my view, has a relatively permissive regime. Just by way of example, if you compare it to the French system or the US system, you see the average ratio of non-audit fees to audit fees in the FTSE 100—this would be 2009—was a little over 40%. In France it would have been about 5%. In the US it was just over 26%. In the UK the largest ratio of non-audit fee to the audit fee was 380%. In France it was 44%. So there is a very significant economic interest in higher-margin, non-audit services. The Big 4 have very clearly stated their intention to maximise that. This rolls back into our concern about the commoditisation of the audit; the comments that have been made about loss-leading and issues that exist around the use of shortcuts and managing timesheets, discounts and so on.

Q422 The Chairman: I don’t know what the statutory position is in France and the USA. Perhaps you could enlighten us as to why they have a different situation.

Mr Richards: In the US Sarbanes–Oxley was very strict in prohibiting a whole range of non-audit services that had been major revenue generators for the accounting firms. In France the model is slightly different. You can provide only very specifically audit-related services unless there is some compelling reason. I can’t remember the precise wording of the structure but, again, it is quite prohibitive about non-audit services; whereas the UK system encompasses all sorts of areas in terms of corporate finance; IT and HR; internal audit, where they say, “You can’t do that little bit of it but you can do all sorts of other parts of it”. The whole area just seems obfuscated. From our point of view the one that has been of particular concern has been tax advice. Obviously as shareholders, when it comes home to roost, we are the ones left picking up the tab. Where you see FTSE 100 companies facing actions for recovery of sometimes, billions in unpaid tax that has been unpaid due to whizzy tax schemes, we would like to think that the one person in there being sure that prudence is being applied is the auditor. Obviously if they have been providing tax advice, tax management and planning advice, there is a conflict.

Mr Lee: I am sure the Committee would not expect me to agree wholeheartedly with what Iain has just said, not least because I have been a member of the Auditing Practices Board throughout the period that we’ve just been considering the issue of non-audit services. What has come out of that process is a much greater understanding of what is audit, what are audit-related services—I suspect that when we look at reporting out of the US and out of France and other markets we see the audit bundled together with these audit-related issues—and a much clearer breakdown of what the genuinely non-audit services are. The conclusion that we reached on the board was that many of the non-audit services were appropriate to continue to be provided by the auditors. We tidied up a number of areas and removed certain aspects. But the big change that has come out of that review of the regulations is a move to generate much more disclosure on the nature of non-audit services.
provided by the auditors and that greater disclosure, going forwards, will be very useful to us as shareholders in calling the audit committees to account. I would agree with Iain that the one area where there remains a question mark—that is a personal question mark in my own mind—is on the issue of tax. Certainly looking at the statistics that we have, that is the one very sizeable remaining area of non-audit services. That will, in time, be looked at again.

Q423 Lord Hollick: Several of you suggested that the company’s annual report should include a more informative and direct report from the audit committee, which could cover the reasons for choosing an auditor and the reasons for going to a tender. It could also possibly lift the veil a little on the discussion between the auditors and the audit committee and shed some light in your cave on what were the particular issues of concern. What would you like to see in this audit report, if indeed you think there should be one?

Mr Richards: I think you have hit the nail on the head with what you say because you have raised a point about the key issues discussed between the audit committee and the auditors that I would highlight from the list of recommendations that the Scottish Institute has set out in its report that my colleague Guy Jubb referred to, which is quite fulsome in articulating what people would like and I think is extremely welcome. One point that I would highlight from it is the one you make: that it needs to include perhaps a summary of the key issues discussed between the audit committee and the auditor.1

Q424 Lord Hollick: Would that not spook investors?

Mr Richards: This is a very interesting point. It’s one that is thrown out repeatedly. It is one that we have had thrown in our face in questioning going concern statements over the past few years. When the going concern statement was first introduced it was the common assertion, “This will force companies into liquidation; you will ruin them”. The ACCA did a study of it in the years that followed and found that exactly the opposite happened. It allowed issues and problems to be addressed earlier and, whether it was by way of an emergency rights issue or a restructuring of the company, the survival rate increased. Regrettably, we slowly drifted back into, “Let’s keep a lid on everything; sweep it under the carpet and hopefully everything will be okay”, and the going concern statement, in my view, has been slightly debased.

Mr Talbut: I don’t think it would spook investors. It would help redress the balance somewhat in that the report and accounts are starting to become marketing documents on behalf of management rather than necessarily providing the type of objective and, dare I say, prudent view as to how that company has been managed over the previous period and what they believe the outlook to be.

Mr Jubb: Shareholders would rather know the truth and, in terms of how it is communicated to the market, if there is a particular aspect that has the potential to spook the market and spook investors—this can be very critical in financial services companies and the confidence that pertains in those sectors—then a great deal of care and thought has to go in as to how the communication of these issues to the market and to shareholders is handled.

Q425 Lord Lipsey: As parliamentarians we are held to account by a website called theyworkforyou, which analyses our voting records and so on and holds us to account. In theory you would think the auditors should have a site called theyworkforyou where you as shareholders—the people who, after all, are supposed to be getting benefit from this operation—find out what they are up to. Instead of which what we find is very short audit reports and a group of people who seem to be in an extremely intimate relationship with the finance directors, directors, the audit committee chairman and so on of the firms they are auditing. Isn’t there something wrong here?

Mr Lee: There is indeed something wrong. Possibly the most useful thing that I have done as a member of the Auditing Practices Board is to change the word “client” in the ethical standards, which was the term that was used for the company being audited, to the “audited entity”. But that use of the term “client” for the company being audited is what every single auditor does and that is just the term for it; whereas, in fact, shareholders are the underlying client and yet we have no relationship and no real opportunity, as yet, to have that relationship. There is an opportunity to change that. With audit firm governance shifting, we may now have some non-executive directors on the audit firms with whom to have a dialogue. We are certainly eager to have that. The firms are moving slowly in that direction.

Mr Richards: If I can come back. It’s true that there is a focus towards the shareholder and the audit but I think we need to be realistic about what’s implied by what Paul says. It is a duty owed to the body of shareholders as this ephemeral concept. It is not a duty owed to individual shareholders. So there is no real direct duty of care to an individual shareholder. It is to this nebulous concept of the shareholder body

1 Note by Witness: I incorrectly suggested that this was not included in the ICAS recommendations. It is: “In relation to the external audit process the audit committee report should include: Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.”
as a whole and that creates a bit of a fudge in terms of our ability to engage them. The more specific issue that comes up as investors is that many of the types of conversations we might want would give us access to privileged inside information and clearly that would create issues for us that we would need to be very careful about.

Mr Pitt-Watson: Yes, I think you are getting to the heart of some of the difficulties here because fundamental to this is that the auditors are working for the shareholders to help in the good governance of British companies. Actually the auditors are appointed by the audit committee and with very close relations to the finance director. Your question was: why don’t the shareholders create something called theyworkforyou? Well, we don’t have that for auditors. We don’t even have that for directors, which you might think was even more important. In part that is because most of what shareholders are doing has to do with the buying and selling of shares rather than the owning of companies. The five people that you see here today are a very substantial proportion of the resource of the investment industry that takes any interest at all in auditing and accounting standards. That may not be the way that we want the world. But it means that the audit is even more important, because there aren’t going to be the thousands of people who work in the fund management industry calling companies to account every time they hear a piece of news that is problematic. We absolutely depend on the auditor who does have substantial resource looking into the company and making sure that it is presenting a full and fair picture so that people behave in the right way without the shareholders having to intervene, rather than because that report shows something that’s problematic. But your question is as much a question about the problems of the fund management industry as it is about the audit industry, I think.

Q426 Lord Lipsey: I was going to say if you think of the sort of thing that might happen—if shareholders determined that they were going to change the nature of the relationship—one thing would be, as I understand it, that the appointment of the auditors has to be confirmed at the annual general meeting. If there were more revolts against that then you would find quite different sets of practices developing among the auditors and the companies that employ them.

Mr Talbut: I suppose the point about that is that we don’t have the information on which to make a decision about whether we should reappoint them to be auditors. It could be seen as just a purely arbitrary or spiteful decision. “We’ve just chosen you as a test case. We’re going to boot you out”. Whereas I’d like to be in a position to have the information, to have the dialogue and then make a decision as to whether I would wish to have that auditor continuing to audit that particular company and producing the audit report.

Q427 Lord Lipsey: You might have to be rather robust in the examinations if there’s something arbitrary about it and just give it a go on a few occasions, particularly where there is some obvious piece of evidence that the work hasn’t been done right.

Mr Richards: The problem is that although we do; the difficulty is not enough of us do and we vote against a notable number of audit appointments during the year. It can be for a variety of reasons relating to the audits and to the accounts. But I think companies know that we are in such a small minority that they shrug their shoulders. We did have some discussions and raised the issue that maybe shareholders should be involved in the selection and appointment of auditors, using a model similar to Sweden. I have to say that the reaction among the investment community was less than enthusiastic. I think there is a certain element of truth that currently the investment industry doesn’t have the resources, time or the skills or indeed inclination to do that but it’s certainly something that might be thought about in the future.

Mr Jubb: This relates to the suggestion, as previously mentioned, that as the Stewardship Code evolves—because auditing is central to good stewardship—there should be a principle in the Stewardship Code that provides that those institutions who sign up to it do adopt a higher duty of care and engagement on audit and corporate reporting matters.

Q428 The Chairman: I’m very anxious that we shouldn’t take up recommendations that will lead, as in the past, to nothing happening in practice. If I could just explore this one a little bit further. I think it would be fair to say that the item at the annual general meeting dealing with the appointment of the auditors is the one that goes through fastest and without any questioning in practically every case. Would recommendations along any of these lines make any difference?

Mr Jubb: I believe that they would in terms of the engagement and the understanding that goes into the decision that institutional shareholders make to approve or otherwise the election of auditors at the AGM. You will be familiar with the way in which corporate governance and stewardship operates in the UK, whereby part of the role of the institutional investors is to exercise influence so that resolutions that come to the AGM meet with their approval. At the moment, as colleagues have indicated, we do not...
have sufficient information. By putting into the code a principle that we subscribe to, it gives our clients and others a basis on which to hold us to account as time goes by. That hook of accountability is not currently there and if it were adopted, in that way or some other way, it would enable progress to be achieved.

Q429 The Chairman: Would that be a general view of the other four or other three institutions?  
Mr Pitt-Watson: Yes. I was a partner in Deloitte for a number of years. I work for Hermes now and I speak very much here in a personal capacity. I think there are things that you can do—it’s really important that they are done—that nudge the audit towards doing what it “says on the tin”: (That is the governance role we discussed earlier) But that is quite difficult to bring about. Some nudges could be structural with the involvement and shareholders and all the rest of it. I think probably many more of them have to do with the role of the audit and the regulator, which I know Lord Lawson has taken a great interest in, and also what the audit is and the insistence for example, that the audit is, for the shareholders. What Paul did at the FRC is extremely important: that the Big 4 don’t think that the client is the company but they do think that it’s the shareholder; that the principles are true and fair. We’ve talked a lot about prudence, but the accounting principle of prudence is a principle that’s been changed for neutrality. That needs review. We want to watch out for those sorts of things and I think that your Committee might want to focus on those as well as on the structure of the industry.

Q430 Lord Moonie: What, if anything, do you think can or should be done to promote shareholder engagement in the appointment and reappointment of auditors?  
Mr Jubb: It has been suggested in this Institute of Chartered Accountants of Scotland report that every five years the audit committee should engage with its principal shareholders about the quality of service and other aspects surrounding the auditors and the relationship that subsists. If that approach were adopted as a matter of good practice, it should enable a sensible dialogue to take place and enable shareholders to exercise influence, consistent with their responsibilities, either to institute change or otherwise. At the moment, sadly, that dialogue, as we have represented, doesn’t take place.

Q431 Lord Best: You think that UK corporate governance is too light in this regard. What changes would you wish to see; aspects of the UK Corporate Governance Code becoming mandatory; in particular the question of whether every FTSE 350 company should have an audit committee? I am just picking up various points that you were making on audit committees. Mr Jubb was saying that they don’t consult and talk to the investors. The audit committees don’t add that line of communication and Mr Richards was saying that they sometimes are the ones that insist on the Big 4, on continuing the concentration. I didn’t get the impression that you felt very strongly that audit committees, as such, would make a huge difference to anything; a mandatory requirement for them.

Lord Smith of Clifton: The problem is that one reads countless articles in the financial press of shareholder passivity, which you gentlemen represent presumably, and you can’t have it both ways. Either you are going to be active or some other check has to come in.
Mr Lee: My colleagues have already suggested that there is an appetite among shareholders to be more active on these issues around audit. The problem historically has been that investors simply don’t have the information, either about individual companies or frankly about the market as a whole. That means that the individuals who might become more active in particular institutions feel uneducated, under-informed and, therefore, unable to make difficult judgements. That is now changing. We hope it will change further as audit committee reports improve and as audit reports also improve. Once we have the basis to take judgements and decisions, those judgements and decisions will be taken and they will be taken actively.

Mr Pitt-Watson: But even at that, Paul, we still need to address the issue of investor passivity. I’d have to say I would excuse my four colleagues here; these are people in the investment industry that devote their lives to trying to be proper active investors and hold companies to account. But I think if the Committee is thinking about how much you can place on investors picking up the baton and running with it, I think you need to have a degree of scepticism about just how much will be done. I think the story that Mr Richards told you about an audit appointment would be one that I would bear in mind in thinking about this. It’s not that all of us in this room wouldn’t want to see more action. It is just that the fact of the matter is the structure of the market is mainly about the trading of shares rather than about the owning of shares and it’s in that ownership function that the audit is fundamental to the integrity of the capital markets.

Q434 Lord Lawson of Blaby: I absolutely agree with you and I agree with Lord Smith. Investor passivity is the rule and activity is the very small exception. My very dear friend, Alastair Ross Goobey, who used to work for me before he went on to higher things, blazed a trail in investor activism. But although he blazed that trail, and this was a long time ago now, very few followed him. Therefore, I have to say I am not optimistic of anything happening on that front although it would be very desirable if it did.

Mr Lee: A few of us had the privilege to work with Alastair.

Q435 Lord Lawson of Blaby: Perhaps I may move on to the issue of the banks, which is certainly the area that concerns me most. We have been through a real banking disaster and although there is no evidence at all to suggest that the auditors were responsible for the disaster, there is equally no evidence that they, in any way, reduced the disaster. What is to be done to prevent a similar disaster in the future? I’d like to start by referring back—I hope I’ve not misunderstood or am misquoting—to something that Mr Richards said in this very context. He said that there should have been some signalling by the auditors. I should like to know exactly what he meant.

Mr Richards: If you look at banks, and many people have, there were a number of issues that were very apparent in the banking system that were of concern. Some of those were the result of imprudent standards. I would highlight specifically loan loss provisioning as an example of that. Some of the concerns were slightly harder to put your finger on around things like going concern. The issue has been that the audit has been rather compromised in terms of the impact that IFRS has had on what scope the auditor has to play. Just using the loan loss provision example, if the standard says, “You will not make any provision until the loss occurs”, which is ultimately what IFRS IAS 39 says, there is very little that the auditor can do to say, “Listen management, you’re not being very prudent about it”. Having said that, I noticed in the Daily Telegraph yesterday there was a very interesting article about Santander finding its way around IFRS to ensure that it remained prudent. I suppose technically they may have been in breach of the standards; in this case, good for them. The other issue within that context is that the standards specify a process that shall be followed and then allow huge discretion in the assumptions used. I’m thinking fair valuation here on the mark to model basis. I will give an example. We had a company chairman come in to see us—a company we held more than 10% of—and I will characterise it slightly—a finance director who of the profession about this, you get—and I will highlights the issue and, having spoken to members of the board who have, there were a number of issues that were very apparent in the banking system that were of concern. Some of those were the result of imprudent assumptions used in it. The actual final number that we agreed on was slightly over a third less in terms of the valuation of the instruments. This highlights the issue and, having spoken to members of the profession about this, you get—and I will characterise it slightly—a finance director who approaches the auditor and says, “What’s the range of fair values that would be acceptable under the standards?” The auditor might say, “Well, it’s between 70 and 140 and we think the reasonable prudent number would be about 95”. The FD says, “Thanks, 140 is just what I was looking for. Thank you very much”, and it’s compliant with the standards. I’m exaggerating slightly but the auditor is then in the invidious position of having very little leverage under the way that the standards work to push back on that. I know there are many auditors who have done a very good job in some circumstances in trying to do just that, but the auditor is operating in a system and is somewhat
constrained by the standards framework and the way it has developed. Clearly the process-orientated model helps them with their liability exposures and every time there is an audit failure, “At all material times we complied with the standard”, is the first thing they will say.

Q436 Lord Lawson of Blaby: That is interesting, but may I come back to the more general point? If there is any signalling, if there is any querying of the going concern—and it is suggested that this, in general terms, should be nothing that shareholders should worry about—or if the accounts are qualified in any way—the Big 4, in their evidence to us, in fact, said, “We couldn’t do that because banks depend on confidence and the confidence effect would be so damaging to the banks”—do you believe that that is the whole truth or do you believe that they did not spot what was amiss?

Mr Pitt-Watson: There’s a sort of circularity in this as well. I made a point about information. The fact you know that information is going to be declared changes the way in which you behave. If you are a bank and you think there’s any difficulty about your loan book and that that’s going to be declared, you would change what you would do in your business practice. That is what we, as investors, and what we as society, are looking for; not something where somebody says, “Oh, you’re not a going concern any longer. You’re bust and the shareholders have to dive in”. So I would just think about that element. If you ask the auditors about this, particularly if you ask them privately, you might ask, “Look, I thought we had this true and fair view that was supposed to be an override”. In fact this weekend I was emailing one of my former colleagues who is a very senior auditor. He said he would agree that the true and fair view should override the rules but it’s difficult to put into effect when a general rule is laid down so emphatically by the standard setters. If you set that together with the point that Iain has made about the behavioural situation that you’re in, where the company manager may want an asset valued highly on their books, perhaps because their bonus might be based on that, you’ve got yourself a really difficult issue. The importance of being able to make sure that anything that we do is reinforcing professionalism and reinforcing principles and that the rules are there to help the principles is, I think, something that this Committee might want to focus on.

Mr Richards: The FSA has admitted that there was a problem here. There are areas that are properly accounting but the difficulty with them in saying that something is true and fair is that it doesn’t necessarily reflect the risk involved. This is where the concern around the relationship between the auditor and the regulatory authorities becomes so important, particularly in relation to things like prudential risk. IFRS is extremely procyclical. It facilitated and exacerbated the credit bubble and then brought it home to roost in the crash and crisis. The issue then is that there were some very clear risks inherent in what was reflected in bank accounts. They may not have justified a going concern statement at a given point in time but the risks were extremely material. There were valuations that frankly I’m not sure were necessarily rigorously carried out on some instruments where reliance on netting off against credit default swaps was fictional given that the CDS markets, which hit US$66 trillion at their peak, were 80% naked and the counterparties could never have met their exposures. Reliance on an instrument like that to support a toxic instrument that you are carrying on your balance sheets is imprudent, in my mind, but it’s acceptable and allowed under the standards. The difficulty is, as these issues emerge, over how they are addressed and just looking at a going concern statement isn’t necessarily the solution. There needs to be a much earlier stage of involvement where the prudential regulators can be involved. Equally, we would look to see the prudential regulators being much more forthright and open to talking to the auditors about their perception and awareness of risks that are relevant to the audit.

Mr Talbut: From my perspective I think effectively what I would guard against is the situation whereby we are afraid to alter anything because in a crisis situation there will be a problem. We would like to see changed behaviour in more normal circumstances that makes it less likely that we will end up in a crisis situation. Therefore, we think that the emphasis upon prudence and taking a conservative approach has been considerably lost in the way in which the accounting standards are operating and in which management want those accounting standards to operate.

Mr Richards: If I could add an extra point; in terms of sweeping everything under the carpets, that has had a material cost to the taxpayer and to shareholders. By sweeping some of these issues under the carpets, distributions have been made and bonuses had been paid that were imprudent. The gap and the hole, in terms of cash, that resulted has had to be plugged and double-digit billions of the money pumped into the banks went to plug the gap created by both the bonus distributions and the dividend distributions that were made just preceding the crisis and some fairly significant capital raisings.

Lord Lawson of Blaby: Everything you say seems to me to be absolutely fair and accurate and you have, in fact, said that there was clearly some degree of audit failure and yet nobody has been sued. It’s true that in the United States Ernst & Young have been sued over
the Lehman Brothers auditing but that’s an isolated incident, so far as I’m aware, on the banking front and it is in the United States. So maybe you accept the view and indeed Mr Jubb did suggest that there is a particular sensitivity in the financial services sector and, of course, that sensitivity is highest in the case of the banks. I do understand there is a point here about what would be the effect on confidence and on the share value and on the viability of the bank if there were to be a negative auditor’s report. So we come back, as a sort of fall back, to something you, Mr Richards, referred to a moment ago and something which I have been very concerned about, as you know, over a number of years—I think I introduced the requirement in the 1987 Bank Act—private discussions between the auditor and the regulator if the auditor has concerns about a bank, but he feels, for the reasons I have just indicated a moment ago, he should not qualify the accounts in any way but he will go and speak to the regulator. That means that the auditor is saying to the regulator things that he is not telling you, as shareholders. I hope that does not give you cause for concern. I don’t know what conclusion we will come to but it is very important that we should be satisfied that if we do think that this dialogue needs to be beefed up—it was rather watered down, so far as I can see, when the change of regulatory authority from the Bank of England to the FSA occurred; there was still an obligation but it was a weaker obligation and, indeed, very much less happened in the way of dialogue—that you would not be at all concerned as investors.

Mr Lee: We would not be concerned by such dialogue. We would welcome it.

Mr Pitt-Watson: Indeed, I think there might be more to your proposal as well, Lord Lawson, both in terms of what the issue is and what we might do about it. Also I think it is something on which we might be able to get political consensus. In the first half of last year I was part of the Future of Banking Commission. It was sponsored by Which?, but it was chaired by David Davis, Vince Cable was one of the members, as was John McFall. So it was a cross-party commission and, like you, we were investigating the role of audit; although not in as much detail. I noted and we were concerned that the managing director of the FSA told us that, in thinking about the audits of banks, it is not the purpose of the audited accounts to forecast potential losses on loans. It seemed to us that if that was what the regulator thought a year ago, after the crisis, we have a problem here. Because it means that absolutely safe loans and absolutely unsafe loans, in the mind of the regulator as well as in the mind of the auditor, could conceivably have been put on the balance sheet at the same value and, therefore, encouraged poor lending which generated the “profits” and, therefore, the bonuses. If we’re thinking about what we do—I was reminded of my old textbook on that auditing and accounting term: There seems to be no limit to the optimism of businessmen; the first line of defence for investors and creditors is the vigilance of the practising accountant. How is it that we manage to get that vigilance back? I should have thought a huge focus on principles over rules. Opposition to such a proposal creates a really ironic debate, “If we do this on principle and then we measure something wrong, then shareholders come back and sue the auditor”. So instead of doing what it is that the shareholders and the governance system need, which is the rules helping the principles auditors say, “Well, we’d rather do just the rules”. That was the quote that you had from your former colleague. I think, also, you could question the principles themselves. In particular I learned in accounting, that it should be prudent and objective rather than neutral. Again, prudence we have talked about and I think most investors would say, “Gosh, prudence and objectivity; that would be something that we would want to see”. Then the final thing is the reinstatement of discussions. If I was advising this Committee, I think you might think about how extensive you want these discussions to be. I think they could be quite extensive. Not just simply the auditor going and seeing the regulator and saying, “I’m a bit concerned about this”, but something that is reasonably formal; that should perhaps include the audited entity, perhaps the chair of the audit committee of the audited entity. It used to in the past, for example, include commissioning by the regulator of the auditor. I don’t think that many investors would object if the regulator was to say, “Look, the auditor is going to charge for this but we’re going to make sure that this system is stable”.

As I say, those were the sort of things that we were discussing in what was a cross-party group, and I think they may have some relevance for the sort of issues that you are thinking about.

Q437 The Chairman: On that last point, just to be clear, these discussions that you are talking about, between the auditor or the chairman of the Audit Commission and the regulator, would be in private.

Mr Pitt-Watson: Would be in private, yes.

Q438 The Chairman: And you were quite happy with that as investors?

Mr Pitt-Watson: Yes.

Mr Jubb: There is one supplementary, if I may, however. The institutions represented here are long-term investors. When a bank is failing, other than the exceptional circumstances, it is our clients who have to provide that additional capital to support the entity going forward. One of the aspects of the discussions that has to be contemplated, as well as
being bilateral between the regulators and the auditors, is that there should be some understanding of the mechanism that enables long-term institutions—long-term institutions—to be brought into that dialogue in a regulatory compliant way to help formulate the solution if additional capital is required to enable the company to continue forward. Most of the institutions here, I am sure, will have capability to deal with such information in a regulatory ring-fenced, compliant basis to enable that to happen.

Mr Richards: If I may add one extra thing to this dynamic that we are all supportive of. In the Equitable Life case, Lord Penrose, even though the standards were not within his locus, went to great pains to point out that the standards set the threshold so high that, for all material purposes, it was very hard for the auditor to ever justify talking to the regulator. The report is quite revealing and I think Lord Penrose made a rather tart aside at the end of his recommendations to note that it seems that the auditors can say they complied with the standards at all material times. I think, in looking at this, we have no insight in terms of what dialogue did take place between the auditors and the regulator. But I think, in looking at this area, it is important not to take for granted that the obligations on the auditor at the moment are necessarily correct and it is something that is worth examining to ensure that they would be effective and were effective.

Mr Talbut: From my perspective, we certainly have, when we have spoken to the regulator and also to many other financial organisations—I suspect others have as well—expressed our scepticism with the issue of fair value accounting and the part that it played in the lead-up to the crisis and then in the crisis and even after it. We are still dealing with the crisis. So our scepticism—this is not allowing us to get to what we think is the correct answer in terms of the valuation of these organisations—is something that we have expressed.

Q439 Lord Hollick: There is quite a degree of unanimity among you about the emphasis on prudence in terms of accounting and re-examining the rules. Is that unanimity expressing itself in dialogue with the audit firms, with the banks that you are continuing to be a shareholder in? Is your enthusiasm for this change of direction, change of emphasis, re-examining the rules, shared by the banks and the financial institutions in which you invest? Have you had discussions with the FSA about these matters?

Mr Jubb: Just yesterday I had a working lunch with the chairman of one of the major British banks and the aspect of prudence and the importance of prudence was emphasised in our discussions. If I could take this further into the market conditions, one thing that markets do not like is after the audited accounts come out, you then have further provisions that are made on a drip-feed basis thereafter. We were emphasising the importance of this, to the chairman of the bank’s board, to ensure that appropriate prudence is put into place. So I use that as timely evidence that this is more than rhetoric; it is in fact put into practice.

Mr Talbut: That one is exactly true. You couldn’t square the two and that was a significant element, we would suggest, behind the troubles that led up to the crisis.

Q440 Lord Lawson of Blaby: Following on from that, the emphasis on prudence and the move from neutrality to prudence, as Mr Pitt-Watson said in the very interesting evidence he gave a little while back, I think probably most of us would think that is right. But how do you square that—and maybe this is what you are getting at—with mark-to-market accounting? Because at the height of the financial boom, at the height of the financial bubble, nothing could be less prudent than mark-to-market. So how do you square that circle?

Mr Talbut: That one is exactly true. You couldn’t square the two and that was a significant element, we would suggest, behind the troubles that led up to the crisis.

Q441 Lord Lawson of Blaby: So what is the solution?

Mr Lee: The one regulator that Lord Hollick did not ask whether we were having dialogue with was the International Accounting Standards Board—as was, now the IFRS Board—and we are certainly having dialogue with that board. They were, historically, very much in favour of fair-value accounting, mark-to-market. That is changing and they have, in recent years, become much better at listening to investors. Investors, frankly, have become much better at talking to them and that dialogue is leading to a change in the sorts of standards that are coming forward. They are changing the way in which financial instruments will be dealt with; the way in which loans will be dealt with in the books. So, over time, those concerns are evaporating but we are continuing the dialogue with the board.

Mr Pitt-Watson: I think one must recognise, however, that it has to be the principle that has the override—objectivity says mark-to-market is pretty good; prudence says there may be some circumstances in which you want to be thinking about whether that is sensible or not. I think the danger, at a fundamental level, of hundreds and hundreds of rules is that you encourage innovation to go around the rules. So rules in a system don’t prevent people who are unprincipled within that system. I don’t mean that in a negative way, but rules encourage people to try and go around them. The
only way that you can overcome that, I think, is with principles and with professionalism. That is why the statement that I gave from my former colleague seems to me to be so informative; that if you have too much weight on the rules so that there is not an encouragement for the professional override of them, whether it is on banking loans or anything else that we are looking at in audit, then we will give ourselves a problem. We don’t have shareholders that are going to hold companies to account. We desperately depend on auditors being able to do that for us. We desperately depend on their judgement.

Q442 The Chairman: Of course, also the judgement of the chairmen, chief executives and boards of the companies concerned, which we are not dealing with at the moment.

Mr Pitt-Watson: Exactly. It needs to be right through the system, doesn’t it? And the role of the auditor within this system is to be able to be like the inspectorate, the eyes and ears, who, in extremis, reports back to the shareholder so that the shareholder takes action and changes the operations of the board of directors. But because the board of directors knows that this report is going to come out telling the truth, the whole truth and nothing but the truth, they will therefore run their company, naturally, in the way that they ought to, which is in the interests of the shareholders, taking into account wider society.

Mr Richards: It has always fascinated me that the purpose of the audits isn’t defined in legislation. There is no defined purpose for it although it is articulated, or it was articulated, by the Law Lords in the Caparo case. The auditors have two, if you like, objectives. The first one is to protect the company itself from errors, omissions or wrongdoing and the example that was given was improper distributions from capital. The second is to signal to the shareholders to enable them to enable them to carry out their stewardship duties of the company. It was rather well articulated and, alongside adopting the necessary principles to support the true and fair view. Having a clear articulation and effective purpose for the audit would be very useful as well because it’s often obfuscated in debates and its absence often leads to standards being interpreted in its particular way.

Mr Jubb: To take that one stage further, the Caparo judgement was the legal judgement that enshrined the responsibility of the auditors to the shareholders of the company collectively in that regard. If there were to be better articulation of the role and purpose of the audit, there should be also better articulation of to whom the auditors are accountable, because as we are currently sitting, it is in relation to the shareholders taken as a whole. In terms of litigation, this is one reason why in the United Kingdom it is primarily in relation to rights issue documents, where the audit report is enshrined, that litigation arises, rather than in relation to the individual audit reports on individual sets of accounts. The Caparo judgement is something that needs to be considered within that wider review.

Q443 The Chairman: I do not want to prolong this too long but this has been a very interesting session for us. Can I just ask a couple of questions to be absolutely clear about the last part of the discussion we have been having and particularly to Mr Richards? In terms of the position of the auditors in relation to the banks at the end of 2007 and the end of 2008—I am summarising very briefly and probably inadequately—the evidence we were getting from the auditors on that was that in 2007 they were working according to the accounting rules and looking at the situation as it was before the end of 2007, at the end of the year-end. In terms of 2008, they were able to get comfort from the fact that they had discussions with certain Treasury Ministers who indicated to them what the Government would be prepared to do. Would you be criticising the auditors in both cases on that score?

Mr Richards: You touched on a number of issues; if I take them in reverse order. I think it is very dangerous to create a situation where going concern can be contingent on all sorts of unrealised discussions. Ultimately, what you might end up with is, “We are going to need a rescue rights issue but we reckon there’s a possibility the market will support it. Therefore, it’s a going concern”. I’ve replaced the taxpayer with the market in that case. We saw a couple of banks that ran into trouble trying to get their rights issues away and I think it’s very dangerous to start accepting implicit contingencies within the going concern concept. Going concern is already limited to a 12-month period. It’s quite a significant restriction. There are a lot of other things that going concern is important for and feeds into, not least distributions. I think if you start creating flaws within the going concern statement, we are looking for trouble. That is not to say that it is necessarily improper for prudential regulators and the authorities to be taking a more strategic view about issues. We don’t know what went on; so it’s very hard for us to comment. Coming back to the point-in-time position, this is one that is always very interesting. Let’s take fair value: mark-to-market as opposed to mark-to-model. This is something that can go terribly wrong and I think in the banking scenario we saw this, particularly around some of the toxic assets that were around. If we take just a simple one, the CDO; a lot of the values that were attached to that were not ones that could ever be realised in full
when there was a problem and reliance was placed, as I mentioned before, on credit default swaps and you get a mismatch. Fair value does not reflect the fact that you may be able to sell some of it in the market but if you tried to shift any significant amount, that value doesn’t apply. You have a very notional value, but you’re not looking at the depth and liquidity that underpins it. So I think there were question marks about whether some of the valuations of instruments were really substantive and true and fair.

**Q444 The Chairman:** Is that not also criticism of the rating agencies?

**Mr Richards:** I think the criticisms of the rating agencies are well-known. There was a very big problem; worse than a big problem. They were appalling.

**Mr Pitt-Watson:** Lord MacGregor, this is a cumulative thing, isn’t it? Actually, if we’d had more conservative accounting then the profits and the equity of the banks would have been lower; the bonuses wouldn’t have have been so big; they wouldn’t have loaned out so much more money. I am intrigued when HBOS was taken over by Lloyds that, of their £432 billion loan book, Lloyds said £186 billion of that was not business that they would have wished to do. It would have been helpful, maybe it did happen, if whoever was auditing HBOS had said, “Your loan book seems to us to be rather different from the loan books that we’re finding in other banks.” Perhaps there should be some provision behind this. But, of course, if the regulator was saying that the purpose of audited accounts is not to forecast potential losses on loans, you can see how it is that the auditor might prefer not to have that awkward conversation. And if that awkward conversation is not had, you then end up finally with collapse, rather than with having this sand in the machine that slows things down before you get to having to consider going concern issues, which come at the very end in 2008.

**Q445 The Chairman:** Normally, with some of our witnesses, we have asked them at the end a sort of all-embracing question, “If there was one measure that you would want this committee to recommend, what would it be?” I think as a result of this conversation, it is quite difficult to answer that but if any of you would like to try please do.

**Mr Richards:** If I can, it’s a package that involves the reference that was made earlier about setting a clear ultimatum to the Big 4 that is time-defined in terms of output. I think by making it an ultimatum, you have to look at the tangible actions that would be taken if the outcome sought wasn’t achieved—whether that would be the introduction of joint audits, mandatory tendering of audits, rotation or some other direct intervention—and support that ultimatum with a package of measures that I hope we have tried to outline in terms of seeking greater transparency in audit committee reports, more enhanced audit reports and increased governance arrangements, including changes to the Stewardship Code.

**Q446 The Chairman:** Anyone else, or are you happy with that?

**Mr Jubb:** I couldn’t have put it better myself.

**Mr Pitt-Watson:** I think, pragmatically, the way we can most easily get improvement is by focusing on how we get the principles and the professionalism back into this—and also I would follow up on some of the questions that Lord Lawson was asking about the reporting of the audit to the regulator—those two, I think, are pertinent and important issues where a push from the House of Lords would make a difference to the outcome of the debate.

**The Chairman:** Gentlemen, I think the length of the session demonstrates how helpful you have been to us. Thank you very much indeed.

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**Supplementary memorandum by Mr Paul Lee, Hermes (ADT 43)**

**A COMMENT ON INTERNATIONAL STANDARDS FOR AUDITING (ISAs)**

As I was the sole investor representative member of the Auditing Practices Board (APB) over the period when we took the bulk of the decisions on adopting ISAs in the UK, I thought it might be helpful to the committee to make a brief comment on ISAs, given that I am aware that they have received some criticism in some evidence to the committee.

The committee’s adviser, Andrew Chambers, was also a member of the APB throughout this period and as I recall supported adoption. I am sure he will have some reflections on this note.

_That train left the station some time ago_

Auditing standards in the UK long predate the ISAs. They were first created in 1980 and have been bolstered, both in terms of substance and in the framework surrounding them, over the years since (notably in 1991 when the APB as is was created, following Maxwell, Polly Peck and BCCI; and in 2003–04 after Enron, Worldcom and Parmalat).
So we have had standards which establish processes to be followed in auditing for some considerable period of time in the UK. This is not something which has changed through the adoption of ISAs – indeed UK auditing standards provided the backbone for the original ISAs. If process is the crime, ISAs are not the criminal.

**Adopting ISAs brings positives**

I have my own concerns about ISAs—not least the annoying tendency to attempt in standards on auditing to try to impose obligations on the management and boards of audited companies, and the markedly poor audit report standard—there is much of substance which is good. Notably, ISAs are marked improvements on prior UK standards in such areas as group audits and related parties, both vital issues.

UK endorsement of ISAs supports international acceptance of them, which should raise auditing standards in other markets, vital given the highly international nature of UK companies. The EU has declared its intention of adopting ISAs and UK endorsement gives us a stronger basis for helping the EU adopt in the most appropriate way.

**The source of ISAs**

ISAs are produced by the IAASB, one arm of IFAC, the audit firms’ global representative body. While the apparent independence of the IAASB has improved of late, with the insertion of a monitoring board, Hermes has repeatedly called for a more structural change such that the IAASB is no longer part of an auditor-led organisation. We believe this is needed in order to address the biggest failings in ISAs, which all appear to be aimed at liability limitation for the firms (certainly that seems to be the thinking behind the two particular problems noted above).

**Levels of detail**

Through the process of agreeing to adopt ISAs, I read each of them in considerable depth. They are certainly not principle-based standards, they are rule-based standards. But importantly, they do not exclude the exercise of professional judgement. The rules set out minimum expected procedures but they leave a great deal of space for firms to go further and certainly do not remove their responsibility to fulfil the obligations of the profession to exercise thought and judgement.

It is a failing of the profession to the extent that they fall into the trap of following a set of procedures blindly and do not ensure that the necessary time and space is kept available for exercises of judgement, not a failing of the ISAs themselves.

*13 January 2011*

**Supplementary memorandum by Mr Iain Richards (ADT 44)**

The views and opinions expressed below are personal.

1. **Does audit market concentration cause unease amongst investors? If so, why?**

1.1 From an investment perspective, the potential risks that the current level of audit market concentration creates are apparent—the FTSE350 audit market is characterised by a tight oligopoly, a renewed emphasis on non-audit services, high barriers to entry and the problem of “too-big-to-fail”. Although, the level of competition in the market has reduced compared to that seen in the 1980–90s that is not, of itself, necessarily a bad thing. From the early 1980s, audit firms came under tremendous pressure to lower their audit fees. Clients actively played the eight major audit firms against one another to lower their audit fees in bidding wars. As a result, audit fees became a “loss leader” and were not self-supporting.1 According to Yale University professor Shyam Sunder, the auditors responded to competitive pressures “by lowering their audit fees, lowering the quality of audit services they provided, and by turning to more lucrative consulting services.” Audits became a tool for attracting clients’ business for management consulting, information technology, tax advice and other services.2 It was not uncommon for the major accounting firms to under price (“lowball”) their audit services to gain other business from clients3 (see also paragraph 1.10 below).

1.2 The last major competition case that comes to mind was in Italy in 2000, when the Italian authorities levied fines on the Italian Association of Public Accountants and its members (ie the Big 6 firms) for violations of Italian antitrust law by concluding agreements that covered many aspects of competition between the auditing firms. The violations were of two distinct types: setting prices for the services offered on the market by the

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2 Shyam Sunder, “Collapse of Accounting: Causes and Cures”, Yale University, PowerPoint slides.
Association’s members and, more generally, coordinating competitive behaviour. Since around 2002 the Big 4 accounting firms appear to have been engaged in a milder form of competition for audit clients than was seen in the 1980s and 1990s, although Tier A and smaller accounting firms still face formidable barriers to entry in the larger company market. That is not to say, though that there are no extant concerns.

1.3 The principal interest of shareholders in a healthy audit market is on seeing the focus and dynamic squarely on robust and effective audits ie audit quality and I agree with the European Commission’s starting point in their Green Paper on audit:

“Robust audit is key to re-establishing trust and market confidence; it contributes to investor protection and reduces the cost of capital for companies.”

1.4 The collapse of Andersen gave new impetus to concerns about the level of concentration in the audit market, around questions of competition, choice and the problem of “too-big-to-fail”. A particularly good examination of the issues can be found in Bernard Ascher’s (The American Antitrust Institute) working paper: “The Audit Industry: World’s weakest Oligopoly?” (Aug 2008). It is fair to say that investors have a particular concern over the theoretical risk of another big firm failure and the consequent disruption and uncertainty that could create. In that context, the consideration that is reportedly being given to the possibility of introducing arrangements equivalent to “living wills”, to ensure that if another firm were to fail, the situation could be managed and addressed promptly, is particularly welcome. In taking that forward it will be important for particular thought to be given to the question of how to ensure that any such arrangements do not further exacerbate the current levels of concentration.

1.5 Beyond that though, the issues for investors around the current state of the audit market are perhaps more nuanced than a focus just on concentration might allow for. It is certainly true that the growth in international operations of businesses created a rational pressure for consolidation amongst audit firms, to enable them to address the increasingly international or, indeed, global scope and scale of the entities they were auditing, as well as to enable them to maintain specialist resources, be effective and profitable. However, the current state of the UK audit market and the current levels of concentration in the FTSE350 cannot be justified on that basis (see answer to Q.2).

1.6 Oxera’s report “Competition and choice in the UK audit market” (April 2006) found evidence that higher concentration has led to higher audit fees (in line with economic theory and with several other recent empirical studies) and that, in addition, the audit fees also seemed to have risen as a result of cost increases, caused by factors such as changes in regulation and the accounting rules. Analysing the effects of the merger of Price Waterhouse and Coopers & Lybrand, Oxera found the PwC merger led to a price increase which could have been in the order of around 12% from one year to the next—in the whole, and another 4% for the clients of the merged entity. Despite initial discounts being available though, actual levels of switching are low.

1.7 From a corporate perspective much emphasis continues to be placed on the wider range of non-audit, value-added services that can be obtained on top of the audit itself and this aligns with the overriding commercial priorities that seem apparent in audit firms (see answer to Q5 and, in particular, paragraphs 5.9 to 5.12). In addition, bargaining on fees takes place during the annual audit firm reappointment process to, as one director put it, “ensure pricing remains keen” (see also the Rentokil example in the answer to Q6).

1.8 Off-setting issues around increased audit costs (which perhaps more properly reflect the real cost of audits than has been the case in the past), in addition to the issue of discounting, there have been ongoing concerns over the practice of under-reporting time worked in the audit. Given that, US academics have again researched that phenomenon and found that “staff reporting accuracy and managers’ personal preference for the client interact to affect managers’ performance evaluations of staff, with the highest evaluations going to staff who underreport when the managers preference for the client is high, and the lowest going to staff who accurately report that they have exceeded budget when the manager’s preference for the client is high”. They also found that “managers are more likely to request an under-reporter on a different engagement, regardless of their preference for the current client”.

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8 Available from http://ssrn.com
9 http://www.bis.gov.uk/files/file28529.pdf
10 Agoglia, Hatfield and Lambert researched and published “When Do Audit Managers Prefer Staff to Underreport Time?” (Sept 2010).
1.9 When I wrote my paper “Bringing Audit Back from the Brink (Auditor liability and the need to overhaul a key investor protection framework)” in 2004, I highlighted related findings by Otley & Pierce\(^9\) (eg on the use of short-cuts) and Willett & Page\(^10\) (quantifying the incidence and reasons behind ‘speeding up of testing’), to emphasise the concerns that exist around this dynamic and from the increasingly formulaic audit approaches being used.

1.10 A key concern is that audit has to some extent become commoditized, in part for liability limitation purposes (eg helped by the auditing standards and development of related processes) and in part from being subordinated to wider commercial interests (eg higher margin non-audit work). Essentially there remains a real risk of the kind that led me, in 2004, to highlight the potential relevance of the Akerlof “market for lemons” model\(^11\) to the audit market, something that had not gone un-noticed by academics and not without reason. It only requires some “bad” audit opinions to create the dynamic that forces high quality audit opinions out of the market:

> “Consequently honest auditors are unable to compete in [the] market unless they decrease the quality of their own audit or supplement their (lack of) audit income with other revenue streams (eg non-audit services), which results in undermining auditors’ independence.”\(^12\)

1.11 It remains notable that 17% of audits reviewed by the FRC’s Audit Inspection Unit at major firms (including some in the FTSE100 and FTSE250) were deemed to require significant improvement (slightly up on the previous year), and a further 32% were rated acceptable but in need of improvement (a drop on the previous year). Given the purpose of the audit in protecting the company and its shareholders, this is an area of ongoing concern, particularly given the fact that the IFRS accounting and ISA auditing standards have de-emphasised prudence and substance over form in favour of a more process driven, compliance approach.

1.12 Moving on from this, Oxera’s 2006 report highlighted that reputation was a significant driver in the choice of auditor, “favouring the Big Four”. Much emphasis is often placed on the apparent preference of markets and investors for the use of Big 4 firms and this needs some clarification. Investors and shareholders in particular, while attaching considerable value to having an audit, have very little true insight or transparency on the audit and its dynamics. It is often difficult for shareholders to form substantive views or make well informed decisions about audit firms, audit relationships, the audit itself or the routinely bland audit outputs (eg the audit report—see the answer to Q8). As a result big becomes a proxy for safe, akin to the old adage that no one ever got fired for buying IBM (see, however, paragraphs 2.6 and 2.7).

1.13 The same is true of bankers and other market participants. The American Assembly, an influential public policy forum (associated with Columbia University), noted the effect of a more diffuse snobbery in a 2005 report\(^13\) that said a “patina of authority and confidence” surrounded the Big 4: “Analysts and investment bankers are often concerned that the presence of a mid-tier firm as auditor will negatively impact a company’s marketability, either by creating the perception that the company was shed by a big four because of high risk, or raising a spectre of doubt about the validity of its financial statements”.

1.14 In addition, despite the notional appointment of auditors by shareholders, this is in reality more a matter of form, rather than of substance. Auditors are recommended to Boards by audit committees and shareholders are then given a binary decision to address—‘here are the proposed auditors, appoint them’ (see the answer to Q6).

1.15 The lack of transparency and related substance in current disclosures is something that needs to be addressed, both in relation to disclosures by businesses (eg in relation to their audit committee reports and the types of fees being paid to audit firms) and by auditors in relation to the audit reports they produce for shareholders (see the answers to Qs 4 and 8).

1.16 Looking at another of the factors that can create barriers to entry to non-Big 4 firms (see the reference to the American Assembly report in paragraph 1.13 above). Although the extent of the issue is not clear, credit agreements are emerging that put pressure either explicitly or implicitly on businesses to use a Big 4 audit firm.

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\(^12\) “Audit Opinions or Lemons? Insights from Andersen and the Enron Audit” P Roush and L Thorne, University of Central Florida and York University Ontario.

In this context we would note that research undertaken by Grant Thornton’s US arm, conducted last year identified more than 450 restrictions applying to at least 220 companies in the Russell 2,000 index. While widely available on the public record in the US, in Europe such covenants are not transparent or easily recognised, although I understand from press reports that the audit firms have acknowledge to the OECD the existence of restrictive covenants in the UK. I am also aware that other comments have been made to the effect that actors in this market do not actually stipulate the use of a Big 4 firm. A Spanish example highlighted by BDO International may add some colour to that, as the terms included the provision that: “The parent company, although not legally obliged to do so, undertakes to submit its individual and consolidated annual accounts to an annual audit by one of the four most solvent and internationally renowned audit firms (the Big Four)” —it may not be expressly stipulated but would be hard to ignore. Similarly I understand that the Loan Market Association, defines an “auditor” as one of either PricewaterhouseCoopers, Ernst & Young, KPMG or Deloitte or “any other firm approved in advance by the majority lenders.” Again, this is not a stipulation per se.

1.17 Some commentators in this debate have suggested enabling Audit firms to raise external capital as a way to enhance competition with the Big 4. When the EU Commission published a summary of the replies received to its consultation on control structures in audit firms and their consequences, which it had launched in November 2008 (IP/08/1727), most of the respondents considered that lack of access to external financial capital was not the most important barrier preventing emergence of new players. Bear in mind also, that audit firms are allowed to incorporate to move from the existing limited liability partnership structure to a public limited company one, list on the market and raise capital. RSM Tenon Group Plc is an example. The main reasons that this has not been used more are generally believed to be due the tax consequences and greater transparency obligations that would ensue. One might say that there are those who want the benefits of external capital (and indeed further liability protection) without any of the tax and other obligations that would normally go hand in hand with that. Indeed unless a compelling case was made that this would enhance audit quality (which has not been done to date), this does not appear to be a priority. This should be borne in mind alongside the other concerns that have been raised about potential impacts on audit quality (eg see the answer to Q5 and Q10).

1.18 Finally, it is worth touching on the question of auditor liability. Unlike the US, in the UK, this has not been a material issue. Audit firms already effectively have proportionate liability, as can be seen from the Barings case. Discussions with a number of QCs have confirmed that in settlement negotiations, drawing on the statutory provisions on relief and other matters (see list below), proportionate liability does hold in practice. That is true even before, and as well as, taking account of the new provisions introduced in the Companies Act 2006. Other arrangements include:

(i) The limitation imposed in the Caparo case, which means that any plaintiff would have to demonstrate: (a) forseeability—that the loss would result from a failure of the duty; (b) proximity—a tangible (contractual or special) relationship with the auditor other than just their role as auditor; and (c) fairness—that it is just and reasonable to impose the duty in that case.

(ii) Linked to (i), the fact they only owe their duty of care only to the conceptual body of shareholders as a whole, and not to individual shareholders or others and, in the absence of any contractual or other special relationship with an investor, potential investor or other third party, no duty of care will be owed.

(iii) The introduction of Limited Liability Partnerships (offering the protections of limited companies without the same transparency and disclosure obligations).

(iv) The principle of contributory negligence, which enables auditors to make a defence based on the negligence of other parties. The ICAEW itself has acknowledged that this would have “a dramatic effect on limiting the effect of negligence”.

(v) The right of action by auditors against other parties (eg in the Wallace Smith Trust or Sound Diffusion cases).

See sections 1157 of the Companies act 2006.

See sections 332 to 336 of the Companies act 2006.

See the “Limited Liability Partnerships (LLP) Act 2000” and associated regulations.


The Accountant, August 1996 (page 11).
2. What would you say would be the minimum number of active audit firms needed to constitute a genuinely competitive market for the audits of FTSE 350 companies?

2.1 Although it would be easy to refer to an ideal scenario, such as the position we had up to 1987 with the Big 8 + 2 firms, it is by no means clear that it would be feasible (particularly given the international dimension of the audit firms/networks), even with aggressive intervention to restructure the market, to achieve that today. Nor, given the problems and risks involved, has a case been made as yet to warrant that level of intervention. More practically I would hope that, supported by a range of reforms and pressure, over time, we might see the market change, resulting in the emergence of a fifth and maybe even a sixth “big” firm.

2.2 It has been suggested that Tier A firms should be merged to create a new Big 5 player. I do not, however, believe that it would sensible or beneficial to force this issue. In terms of total UK fee income, based on 2010 data, it would require the merger of the next six Tier A firms (In the UK: Grant Thornton, BDO, Baker Tilly, Smith & Williamson, RSM Tenon and PKF) to create a firm large enough to equal even the smallest of the Big 4, which would leave the market with an even greater deficit in choice between the Big firms and the rest.

2.3 Picking up on the point made in paragraphs 1.7, 1.12 and 1.13, it seems to me that one of the key hindrances to increased choice (and competition) derives from the perceptions and attitudes (eg a default preference for the Big 4) that I’ve referred to. Coming back to the point that there are some businesses, which due to their size and scope and type of business, need to use a Big 4 firm, that does not provide a reason or justification for the situation found by Oxera in its 2006 report in terms of the dominance of the Big 4 in the FTSE 100 or, even more to the point, the FTSE Mid250, which is neither warranted nor in any way really justified on that basis.

2.4 Looking at the top 15 accounting networks provides a quick snapshot of the international capacity that is currently available:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Firm</th>
<th>Annual Turnover (£ms)</th>
<th>No Countries</th>
<th>No Partners</th>
<th>No Prof Staff</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>PwC</td>
<td>26,171</td>
<td>151</td>
<td>8,552</td>
<td>123,548</td>
</tr>
<tr>
<td>2</td>
<td>Deloitte</td>
<td>26,100</td>
<td>140</td>
<td>9,555</td>
<td>130,208</td>
</tr>
<tr>
<td>3</td>
<td>E&amp;Y</td>
<td>21,440</td>
<td>140</td>
<td>8,715</td>
<td>114,536</td>
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<tr>
<td>4</td>
<td>KPMG</td>
<td>20,110</td>
<td>145</td>
<td>7,953</td>
<td>106,973</td>
</tr>
<tr>
<td>5</td>
<td>BDO</td>
<td>5,027</td>
<td>115</td>
<td>4,098</td>
<td>34,156</td>
</tr>
</tbody>
</table>

26 See paragraph 8.6.
27 In this case, although the Statement of Standard Accounting Practice were accepted as not being rigid rules, they were held to very strong evidence as to what was the proper standard to be adopted. While a departure from them might be regarded as a breach of duty unless there was some justification, conformity to them might be used as a defence that the duty of care was satisfied.
28 “Limited Liability Partnerships and Other Hybrid Business Entities” (March 1998).
29 “Liability of Auditors in light of Parmalat” RREV newsletter (Feb 2004).
30 According to Oxera’s 2006 report switching rates are low (around 4% on average for all listed companies, 2% on average for FTSE 100 companies), and competitive tendering does not occur frequently.
31 “Competition and choice in the UK audit market” April 2006.
2.5 Clearly there is real scope outside the very largest companies, for a more open minded approach by Audit Committees to the choice of auditors that is available and that would be welcome. The results of the Autumn 2009 study undertaken by Accountancy Age and Financial Director of audit firms’ service to their clients offers encouragement in this regard that needs to be built upon. That study encompassed 635 financial directors, CFOs and financial controllers—a representative cross-section of UK plc—and graded firms on five distinct aspects of service as well as drawing out qualitative comments. The results, illustrated in the overall ranking below, highlight the scope for and merit in more audit committees actively considering Tier A firms:

<table>
<thead>
<tr>
<th>Rank</th>
<th>Firm</th>
<th>Annual Turnover ($ms)</th>
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<th>No Partners</th>
<th>No Prof Staff</th>
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<tbody>
<tr>
<td>6</td>
<td>Geneva Group</td>
<td>4,052</td>
<td>79</td>
<td>1,795</td>
<td>14,612</td>
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<tr>
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Source: Accountancy Age’s International Networks Survey Results 2010

2.6 There is also academic evidence that questions the suggestion that Big4 firms provide higher quality audits (as opposed to markets preferring and responding more positively to them). A recent example is Boone, Khurana and Raman “Do the Big 4 and the Second-Tier Firms Provide Audits of Similar Quality?” (2010), which examined audit quality for Big 4 and Second-tier auditors during 2003–06 around the issue of going concern. Amongst other things, they confirmed the investor bias towards the Big 4 and concluded that: “Overall, our findings suggest little difference in actual audit quality but a more pronounced difference in perceived audit quality.”

2.7 Similarly Lawrence, Minutti-Meza and Zhang’s study “Can Big 4 Versus Non-Big 4 Differences in Audit-Quality Proxies be Attributed to Client Characteristics?”, compared Big 4 and non-Big 4 firms in relation to discretionary accruals, the ex ante cost of equity capital, and analyst forecast accuracy. They found that the effects of Big 4 auditors were insignificantly different from those of non-Big 4 auditors and that the differences largely reflect client characteristics and, more specifically, client size.

2.8 In terms of the issue of the perceived market/investor bias towards the use of Big 4 firms, to address this, in addition to a more open minded approach by audit committees, a key reform that is needed, is the provision of more meaningful transparency and visibility on the audit committee and the audit, as well as more substantive audit outputs/reporting, which would be a prerequisite for enabling effective shareholder engagement (see the answers to Q4 and Q8).

3. Would investors welcome mandatory rotation of audit firms, perhaps every five or seven years, to improve audit independence (perceived or real) and audit quality, and possibly leading to non-“Big 4” audit firms becoming more active in the large company audit market?

3.1 No. Mandatory rotation of auditors over a short time horizon, of the kind envisaged, might create risks for audit quality. Even if, for instance, rotation were required every nine years, you risk creating lower quality audits for the first two years, as the firm goes through its learning curve, as well as potentially for the last two years as the best quality audit staff are rotated off onto new and ongoing audit relationships. This would give you a cycle of four years of potentially lower quality audits, for a five-year period of “full service” audits. Better disclosure might be considered around audit partners’ identification, audit partners’ rotation, the duration of the audit relationship and tendering etc. More informative Audit Committee reports around these and other issues needs to be provided (see the answer to Q4).

4. How do you react to the suggestion that companies’ annual reports should include a more informative and direct report from the audit committee (not merely the board’s rather boilerplate report on its audit committee, as at present); and that this report should include the audit committee’s reasoning on the audit tendering and auditor choice decisions?

4.1 Current “boilerplate” disclosures do need to be revisited and improved and in that regard the Institute of Chartered Accountants of Scotland’s (ICAS) report: “The Future of Assurance” (2010), which both goes into further detail, expanding on the FRC’s current headline recommendation for change, is a welcome contribution on the kind of reporting needed in this area:

The following guidance should be enshrined in the FRC’s UK Corporate Governance Code and its associated Guidance on Audit Committees:

[Addition based on the FRC’s headline recommendation: The Audit Committee should produce a ( fuller) report on how it has discharged its responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors), [including]:]

In relation to risk management the audit committee (or risk committee) report should include:

— Confirmation it has received sufficient, reliable and timely information from management to allow it to discharge its duties;

— How it has satisfied itself that the risk and control processes are operating effectively. This should include a matrix-style report which maps the key risks disclosed by the Board in the corporate report to the assurance processes used to gain comfort over those risks;

— Confirmation that action has been taken where appropriate to address any significant weaknesses in the risk and control framework;

— How it satisfied itself of the appropriateness of management’s significant judgements—this should include a substantive discussion of those significant judgements (for example how the audit committee satisfied itself that the models used to value financial instruments are appropriate or how it determined that the value of a decommissioning provision was a reliable estimate of future costs).

In relation to the appointment of the external auditor the audit committee report should include:

— The date the audit firm was first appointed as the external auditor;

— The date the external audit appointment was last subject to a full tendering process;

— The policy on the expected timescale after which the company would normally expect to tender the audit appointment;

— Where the auditor has been subject to the normal annual review of effectiveness—the process by which the audit committee concluded that the external auditor was effective or otherwise and the conclusions of that review;
Where the auditor has been subject to the extended five yearly review process—the process by which the audit committee concluded that the external auditor was effective or otherwise, in particular how it engaged with the shareholders during this process; and the conclusions of that review process;

— The reasons for any decision to re-tender the audit other than simply compliance with the policy;

— The circumstances of any resignation or dismissal of the external auditor before the end of their term.

In relation to the external audit process the audit committee report should include:

— Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.

4.2 In addition, the APB itself has concluded that Audit Committees should exercise greater oversight over other services that auditors provide to the company they audit which are not audit-related (see the answer to Q5). Disappointingly though, only minor (albeit welcome) changes to the rules on non-audit services are proposed (re: contingent fees). Nevertheless, they have announced changes to the reporting regime to reinforce Audit Committee responsibility for such services and improvements are proposed to the regime for reporting on the fees in the Annual Report, which is something else that is clearly welcome.

5. Since the audit is an audit of the directors’ financial statements principally for the shareholders, do you consider auditors to be sufficiently aligned with shareholders and sufficiently independent of boards and managements? If not, what do you suggest?

5.1 I would highlight three perceived issues in this area:

1. Companies’ effective control of auditors’ appointment and dismissal—see paragraphs 1.7, 1.14, 2.3, 2.5 and the answers to Qs 4 and 6.

2. The dynamic around and extent of non-audit services—see below.

3. The constraints imposed on auditors as a result of IFRS and ISAs—addressed further under Q.10 and in Appendix 3.

5.2 On point 2, considerable emphasis is given by companies to the wider range of value-added services in their choice of audit firms, (ie non-audit services). While recognising the potential for conflicts to arise from non-audit work (either due, amongst other things, to the type of work undertaken or the economic interest in the revenues, giving rise to self-interest threats, self-review threats, management association threats and advocacy threats), a total prohibition of non-audit services would not be welcomed either by companies or their investors.

5.3 There are clearly “audit related” services that are appropriate for the auditor to provide, which are compatible and can be expected to enhance the knowledge and insights of auditors and the overall quality of the audit. Equally, there are areas of work that are undertaken that do raise concerns and can lead to conflicts. These include areas of potential concern, including around tax advice, corporate finance, internal audit and “consultancy” (IT, HR etc).

5.4 In passing I should also note that during the many discussions we have had with directors, anecdotally, a number have highlighted instances in which the accounting firms offer pro-bono services to companies (with, presumably, an expectation that chargeable work will ensue).

5.5 Recently much emphasis has been placed on the supposed fact that fees for non-audit services have decreased both in absolute terms and when expressed as a percentage of audit fees. I would note however, that this has gone through cycles in the past and, after the low point between 2004 and 2005, non-audit fees have been increasing again, albeit this slowed in 2009 presumably as a result of the economic downturn.

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<td>Total Fee Income</td>
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<td>+7.4%</td>
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</table>

Source: Professional Oversight Board—“Key Facts and Trends in the Accountancy Profession” (June 2010)

5.6 To offer some further granularity on these growth rates, Appendix 1 offers some additional observations on a firm by firm basis around 2009, 2007 and 2003.

32 We would count these, principally, as categories 1 to 3 in paragraph 2.2 of the Auditing Practices Board’s Consultation on audit firms providing non-audit services to listed companies that they audit (Oct 2009).
5.7 I would also note that the UK’s framework in this regard is relatively permissive compared to some. By comparison, harder lines have been taken in the US and in France:

— In the US, Sarbanes Oxley imposed broader prohibitions on non-audit services, which academics have found to have reduced perceived conflicts.

— French legislation prohibits the auditor from providing all services other than reporting on prospectuses and those that are directly relevant to the audit (The “Loi de Sécurité Financière” of August 2003; codified under article L 822-11.r of the Code of Commerce). In addition, services that are directly relevant to the audit can only be provided if they are performed in accordance with approved standards.

5.8 To contextualise this, in 2009 the Big 4’s average UK ratio of non-audit fees to audit fees was around 40%33 (and higher in the FTSE100). By comparison, in France the share of non-audit fees was decreasing every year after 2003 and has fluctuated between an average of 4% and 5% of total fees since 2005, although in 2009 they did rise above the 5% level.34 Looked at another way, in 2009 the highest single example of the ratio of the non-audit fees to the audit fee in the CAC 40 was 44%, which compared to 380% in the FTSE100. In the US the introduction of Sarbanes Oxley has seen the average ratio of fees for non-audit services fall from over 100% in 2003 to just around 26.6% in 2006, 2007 and 2008.35

5.9 The Audit Inspection Unit (AIU) has repeatedly highlighted related issues arising around audit firm priorities since its first public report in June 2005,36 when it noted that, in relation to non-audit services:

“The basis on which candidates for promotion to audit partner level are assessed was generally found to focus primarily on leadership skills and the ability to generate new business. Quality considerations did not appear to feature prominently.”

5.10 Although firms have clearly adapted their approach given the AIU’s inspections, it is notable that the AIU’s 2009–10 Annual Report, still notes that:

“Firms need to embrace more fully the principles underlying the Ethical Standards which require threats to be mitigated by appropriate safeguards if the work is to be undertaken. Firms are perhaps too ready to conclude that existing procedures, required in any event in the audit, provide that necessary degree of safeguard. They must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence.”

5.11 As reported in the press,37 the Audit Inspection unit found that, for example, PwC changed its bonus criteria to emphasise business growth, which jumped from 25% to 40% as a proportion of its KPIs. Meanwhile, the audit quality portion dropped from 25% to 20%. In relation to KPMG, it found that audit quality was not significantly represented in performance assessment:

“We concluded from our review… that the achievement of audit quality objectives does not have as significant an impact on partners’ overall performance assessment as their achievements in other roles.”

5.12 Adding context to this, in August 2009 The Times reported on the plans of the Big 4 firms to expand their consulting services.38

“PricewaterhouseCoopers (PwC), the UK’s largest professional services firm, plans to treble its fees from management consulting to more than £1.3 billion within the next four years and hire 2,000 staff, including more than 100 partners.

Three of the Big Four accounting firms—Ernst & Young, KPMG and PwC—sold their consultancy arms at the start of the decade after their growth led to clashes over business strategy. The Enron scandal also aroused concerns over conflicts of interest. Only Deloitte kept its consulting practice.

However, the big accountancy firms have been rebuilding their consulting arms and want to capture some of the market from strategy advisers, such as McKinsey, and providers of technology-oriented and outsourcing projects, such as Accenture and IBM.

PwC is counting on aggressive growth in its consulting practice to help it to keep its lead as the UK’s biggest professional services provider.”

33 Derived from the Professional Oversight Board’s “Key Facts and Trends in the Accountancy Profession” (June 2010).
34 Autorite Des Marches Financiers (AMF) annual studies of fees paid by French companies listed in the CAC40 index to statutory auditors and their networks.
35 Audit Analytics, Audit Fee and Non-Audit Fee Report.
37 Accountancy Age “Audit quality under pressure as firms cut costs” (12 Nov 2009).
38 PwC aims to treble its fees from consulting (4 Aug 2009) http://business.timesonline.co.uk/tol/business/industry_sectors/support_services/article6738036.ece
5.13 Although the debate about the extent to which the provision of non-audit services affects independence and audit quality, is often characterised by references to the fact that the evidence is mixed, the working paper by Paul Griffin and David Lont “Non-audit Fees and Auditor Independence: New evidence based on going concern Opinions for US Companies Under Stress” (Jan 2010), examines this problem. Noting that much of the confusion stems from studies of the US market, as opposed to those relating to the UK or Australian market, they specified and applied a potentially more powerful examination of the US data to shed light on those discrepant results. Their revisiting of the US market found a reliable negative relation between non-audit fees and auditors’ propensity to issue a going concern opinion, which is consistent with the results of certain prior studies on U.K. and Australian companies. They also found that in the period after Sarbanes Oxley this had been mitigated to some extent. There are several studies of the relation between non-audit fees and auditors’ opinions for UK and Australian companies (eg Wines 1994,43 Sharma and Sidhu 2001,44 Firth 2002,45 Pe et al 2006,46 Rosner et al 2007,47 Basioudis et al 2008,48 and Fargher and Jiang 2008),49 which challenge the confusion found in the US market research, reporting a significant negative association between non-audit fees and the quality of financial reporting or auditing.

5.14 Finally, I note that the AIU’s inspections in 2009–10 confirmed that major firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base, although it also noted that, “nevertheless, improvements to these policies and procedures have been recommended at all firms.” (the reports produced by the US Public Company Accounting Oversight Board (PCAOB)) have also highlighted the ongoing need to improve audit quality).

6. What should be done to promote shareholder engagement in the appointment and re-appointment of auditors?

6.1 Improved disclosure as suggested in the answers to Q4 and Q8 would be critical factors in enabling shareholders to engage effectively in this area.

6.2 Picking up the points noted in paragraph 1.14, about the notional appointment of auditors by shareholders being more a matter of form rather than substance and that from a corporate perspective the focus can be on non-audit, value-added services that can be obtained on top of the audit itself, the example of Rentokil was notable:

Rentokil’s 2009 Change of Auditor

Rentokil’s appointment of KPMG, mid-year, was a particularly contentious one, initially understood to have been initiated not by shareholders or the audit committee but by management, in a process which saw the auditors appointed by shareholders (PwC) forced to resign mid-year.

The precise origins of the proposal and nature of the deal struck with KPMG remain unclear, given the limited disclosures made by the company, which initially indicated that the proposal was attractive to them as it offered “a more integrated financial assurance process extending external audit coverage to some work undertaken by internal audit” and that as a result the combined internal and external audit costs would reduce by approximately 30% (reportedly making savings of £1 million).

Although PwC apparently did reluctantly tender against KPMG, it expressed public reservations, while KPMG’s UK head of audit was promoting the new package as a way for companies to cut costs, which they planned to discuss with others as well.46

Mixing internal and external audits has the potential to cause serious conflicts of interest in the audit, as well as reducing the effectiveness of internal controls and the management of risk. Internal audit is seen by shareholders as an important part of the management and the board’s own internal controls and governance frameworks, whereas the audit is undertaken for the members to ensure accurate financial information is being produced, so as to protect the company and provide its members with reliable intelligence.

45 Firth, M 2002. Auditor-provided consultancy services and their associations with audit fees and audit opinions. Journal of Business Finance & Accounting, 29 (5–6), 661–693.
47 Rosner, Markelovich, Ariel and Rebeca 2007. Auditor Fees and Fraud Firms.
The Financial Reporting Council itself warned that audit clients “may want to be cautious before entering into arrangements which stretch the internal/external audit boundary” (The Audit Inspection Unit had also, previously, raised concerns about the inverse practice, where internal audit staff are used in the audit process to cut costs).

The move also drew warnings from the Institute of Internal Auditors that highlighted the concerns that auditors risked becoming mired in “serious conflicts of interest” if they fuse internal and external audit roles and pointed out that “Internal auditors answer to management and the non-executive directors... external audit reports to shareholders.” Mixing these two important, but distinct functions has “the potential to cause serious conflicts of interest and reduce the effectiveness of internal controls and the management of risk.”

After all the furore, in engagement the company clarified the situation to argue that in fact the external auditors were not undertaking any internal audit work, the savings were to be made by reducing outsourced internal audit services being used on overseas control checks and relying instead on data collected during the course of the audit as a basis for prioritising the work of the internal audit department. Although this does not on the surface appear to impact the auditor’s independence or necessarily create conflicts that may depend on how the “relationship” is being operated.

6.3 Although the initial and significant concerns that arose around potential audit conflicts at Rentokil were somewhat mitigated, some concerns about the way the auditor switch took place and residual uncertainty about the potential impact remains.

6.4 For investors, it remains essential that auditors are not and are not perceived to be losing their independence from the management infrastructure. In addition, given the nature of audits, their focus and auditors' reliance on sample testing, a company’s shift to relying on audit derived data as a basis for managing internal audit raises some potential concerns in its own right. Added to this must be a recognition of the shortcomings that can arise in the audit processes (eg see Appendix 3 or, for example, the UK Audit Inspection Unit’s 2009 report on KPMG as well as that of the US PCAOB).

6.5 Once again I would point to the Institute of Chartered Accountants of Scotland’s (ICAS) report: “The Future of Assurance” (2010), which picks up the issue of the resignation or dismissal of an external auditor before the end of their term, recognising that it is potentially of particular concern to shareholders when it does happen. Company law provides for a statement of the circumstances of the resignation or dismissal to be provided to shareholders, but in practice these often shed little light on the real circumstances. As a result they recommend that audit the committee report should disclose sufficient details of the circumstances to provide that understanding. That would be useful and welcome.

6.6 More specifically on the point about promoting shareholder engagement, the ICAS report also proposes that an additional principle be added to the UK Stewardship Code, which I would endorse.

6.7 Going beyond the points noted above on audit related reporting and the Stewardship Code, if consideration was to be given to requiring a more active involvement of shareholders, then the experience of greater shareholder involvement in Sweden merits examination (if the option of introducing shareholder nominations committees were ever to be considered for auditors, it might consider (i) limiting it, initially at least, to a small defined group of companies and (ii) structuring such a committee to include, say, three shareholder representatives, one bondholder representative and one representative of the key regulator). That said, it is not clear to me that the investment community as a whole currently has the resources, time or inclination to take a more hands on role of this kind.

7. Do you think UK corporate governance is too light touch, and would you welcome aspects of the UK Corporate Governance Code being made mandatory—for instance, should there be a mandatory requirement for FTSE 350 or all listed companies to have audit committees?

7.1 No. As a practical matter, I am only immediately aware that, in the FTSE 350, Daejan Holdings Plc does not have an audit committee, although they assert compliance on the basis that the entire board fulfils the role of the Audit Committee (The board has a joint Chairman/CEO, one other executive director and three non-independent NEDs. Four are family members).

7.2 As previously indicated, the Institute of Chartered Accountants of Scotland has made a series of recommendations for improvements across a number of areas (two of which I have referred to above), which do merit being taken forward in this context. I would, however, note some reservations about its references to ISAs (see Appendix 3) and its assertion about the “true and fair view” being supported by the framework of International Financial Reporting Standards (IFRS) (both points are discussed further under Q10).

Companies Act 2006 s 520.
8. Do investors place significant reliance on the audit report, and could it be made more useful?

8.1 Investors attach considerable importance to audit and do value it. However, the audit report is largely boilerplate and rarely provides any timely or useful signaling of the kind envisaged by the Law Lords in the Caparo case. The experience over the crisis is renewed evidence of its limited use at present. The requirements for the audit report should be reviewed to remove boilerplate statements and with a view to introducing something along the following lines:

1. Include an Opinion that:
   (a) the accounts have been prepared on a prudent basis [requires acceptance that this principle is enshrined in Law] and that, notwithstanding anything else, provide a True & Fair View of the state of affairs of the business and its assets;
   (b) proper Accounting Records have been kept;
   (c) following the review of the assumptions made by the Board in their assessment of the going concern, the conclusion and disclosures of related judgments and contingencies are complete and reasonable;
   (d) distributions have been properly made in accordance with the Act, out of realized, distributable profits and reserves;
   (e) the accounts have been prepared in accordance with the Companies Act 2006;
   (f) the accounts have been prepared pursuant to relevant standards;
   (g) the (enhanced) Audit Committee report is complete and reasonable (including confirmation that it is an appropriate reflection of the key issues discussed between the audit committee and the external auditor); and
   (h) the annual report is balanced, reasonable and consistent with the audited financial statements.

2. Provide information:
   (a) on items that are the subject of significant accounting judgments or estimates (or confirm there were none);
   (b) on accounting judgments or estimates that are the subject of significant uncertainty or risk (or confirm there were none); and
   (c) on any areas or matters that the auditor has not obtained all the information it required (or confirm there were none).

3. Notwithstanding anything arising from 1(h) report by exception on Remuneration and the relevant Governance Code provisions.

4. State any matters of emphasis that the auditors should reasonably draw attention to given the purpose of the audit (as per Caparo) or in relation to any of the above (or confirm that there are none).

9. Would you welcome an extension of audit scope into aspects of corporate reporting outside of the financial statements?

9.1 The priority and focus of the audit should be on the core role and purpose of the audit and in ensuring audit quality. However, the work and recommendations produced by the Institute of Chartered Accountants of Scotland’s (ICAS) report: “The Future of Assurance” (2010), in relation to the provision of “assurance” on the corporate annual report (other than the financial statements) do merit being considered in this debate.

10. In your experience have IFRS hampered the exercise of prudence in financial reporting, especially of banks, and have ISAs made the audit more a matter of following a complex but routine box-ticking process with lessened judgement on whether the financial statements are true and fair?

10.1 Although IFRS may seem a diversion from the issue of the audit, it is not. The concerns underpinning the lobbying that was done in the run up to the Companies Act 2006, to reassert the unencumbered “True & Fair View” basis of accounts and auditing have been borne out (eg in relation to loan loss provisioning). IFRS are pro-cyclical and did play a role in facilitating and exacerbating both the credit bubble and subsequent crisis.

10.2 Despite a common assertion that is made by some, that IFRS are just presentational, in reality they have real world effects, such as on pensions, capital management, behaviours & risk taking, executive remuneration, valuations, profit recognition, loss provisioning, financial product innovation and I could go.

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on. They also impact significantly on the audit and to provide context for that I have touched upon some aspects of the effect of IFRSs below.

10.3 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 seems 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. This is evident both in the standards themselves and in the approach to them taken by the standard setters:

— It has frequently been asserted that IFRS embraces the principle of the True & Fair View. However the extent to which it actually embraces the principles of the True & Fair View and substance over form (compared to, say, the old FRSS), as opposed to seeking to re-define by reference to compliance with the standards, needs to be considered carefully. We went to great effort to get the move made by proponents of IFRS (to change company law to explicitly encumber the true and fair view as being in accordance with the standards) reversed, which it now is in the Companies Act 2006. There is a question mark, however, as to whether this is currently the case (clearly at least) in the EU framework.

In particular the emphasis in IAS1 on fair presentation and both the related constraints and emphasis that “In virtually all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs” and the process and rules orientated nature of much of the subsequent standards, clearly calls the claims in relation to the overriding true and fair view principle, into question. The emphasis on compliance is continued in relation to deviations from standards only being “allowed” “in the extremely rare circumstances in which management concludes that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements”. In that context it is worth noting that under IAS 1, “The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.” The paragraph continues in a more general way around other underlying elements, but without providing any more that might mitigate the restrictions outlined above.

— In relation to standard setters, their reaction to the commendable decision by Societe Generale and its auditors (E&Y) to use the accounting override so as to reflect the emergence in January 2008 of the Kerviel fraud in the December 2007 balance sheet, to show the weakened balance sheet with the recognition of a significant post-balance sheet event, is notable. 49 We considered the action taken to have been appropriate, both in relation to IAS 10 (Events after the Reporting Period) and the true & fair view principle (even IAS1). The “fraud” existed at the balance sheet date and it is worth noting that had the adjustment not been made that would have has an inflationary effect on the bonuses and potential dividend distributions. In terms of prudence the point should be obvious.

The paragraph continues in a more general way around other underlying elements, but without providing any more that might mitigate the restrictions outlined above.

10.4 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 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.

10.5 If it is not, IAS39’s approach to loan loss provisioning should make it obvious. Although IFRS seems all too ready to recognise unrealised profits given its commitment to, amongst other things, the layers of so called fair valuation (admittedly it also accepts the reversals), in contrast it is imprudently opposed to recognising real, anticipated expected losses to enable provisioning against them.

10.6 Even though the old UK GAAP SORP approach to loss provisioning may have been far from perfect, it still allowed scope for more reasonable and prudent provisioning than has been possible under IFRS (For illustrative purpose I have attached the comparative language from each in Appendix 2). As the December 2002 Bank of England article on dynamic provisioning\textsuperscript{50} noted:

“While in practice some banks have established provisioning policies with forward-looking elements that attempt to cover some expected losses over the life of a loan, general provisions are only a relatively small part of total provisions. This is probably in part because general provisions are not tax deductible, and the Basel Capital Accord (1988) limited the inclusion of general provisions in regulatory capital to 1.25% of risk-weighted assets.”

10.7 Nevertheless, the introduction of IFRS removed even that limited ability to make prudent general provisions by imposing a model that strictly limited incurred losses to those that had occurred. The result of that was that some loss provisions had to be unwound and, for example, PwC advised in its 2004 Financial Services Bulletin CP04/17—Implications of a changing accounting framework, that “it is expected that many banks and building societies will be required to release some of [general bad debt provisions] that they currently hold as a result of the tougher tests under IFRS for establishing provisions.”

10.8 Of the models I’ve looked at for loan loss provisioning, perhaps the Spanish one (dynamic provisioning) has been most notable in terms of the positive benefit it has offered and it is also, generally, well perceived by investors. In the Spanish model, loan loss provisions are fully transparent, with banks having to publish details of their general provisions so that investors and shareholders and others can easily factor in their impact. Moreover, the system is robustly structured, and there is a cap on the amount of the dynamic fund being built up, limiting any scope for the bank to use these provisions to game their numbers. Indeed the occasional discussion with analysts has highlighted no concerns about the use of the Spanish model of dynamic provisioning for earnings management. Given the clearly damaging effects of the IFRS approach it is notable that those coming from more prudent environments, appear to have sought to be prudent despite IFRS, as the recent Daily Telegraph article “Santander prudence highlights IAS risks” (10 January 2011)\textsuperscript{51} reports. By allowing earlier detection and coverage of credit losses in loan portfolios, the Spanish model allows banks to build up a buffer in good times against recognised problems and times of stress. The anti-cyclical nature of dynamic provisions enhances the resilience of individual banks as well as the banking system as a whole. That said they are no panacea, but still clearly help even in the kind of systemic crisis we have experienced.

10.9 Essentially IFRS places far too much emphasis on process, rules and compliance with the standards. Although enough has been said by a great many well regarded commentators about the shortcomings and issues with fair value accounting that I don’t propose to repeat them here, it does help illustrate a wider issue with IFRS. Either rules allow no leeway, such as on loan loss provisioning, inhibiting the ability of auditors to be robust despite the imprudence and risks associated with the IFRS model, or they set out process such as on fair valuation but leave very significant discretion to management, making it potentially extremely difficult for auditors to push back on imprudent or aggressive assumptions.

10.10 That problem with the standards has played into a wider dynamic (see points made about auditor liability in paragraphs 1.18 and 1.19). The cornerstone of the process by which auditors decide on the scope of their work is a risk model.\textsuperscript{52} There are questions on the effect of this in terms of ensuring a quality audit and the use of a formulaic model approach as a defence against the need to undertake fuller due diligence.\textsuperscript{53} Although the regime has changed since the imposition of ISA in the UK, there have been concerns in the past\textsuperscript{54} about whether some of the approaches to risk assessment used by large audit firms have been fully compatible with the, then applicable, SAS 300 risk model. The same might be said about the apparent approach taken to going concern in the recent crisis. This links to broader concerns that the profession uses formulaic guidance to leverage defences\textsuperscript{55} off the back of court cases such as Lloyd Cheyham & Co. v Littlejohn & Co. [1987] BCLC 303. This trend in the profession away from the use of judgement towards a formulaic rules orientated approach remains disturbing.

10.11 In light of the crisis and what has been seen over the last few years, it would seem that similar points might be made about the apparent impact that IFRS and ISAs have had on going concern assumptions and the audit of them.

\textsuperscript{50} Financial Stability Review: December 2002—Dynamic provisioning: issues and application.
\textsuperscript{51} See Appendix 3. Not published here.
\textsuperscript{52} eg of the kind required, say, of a reporting accounting in a Class 1 transaction under the Financial Services Authority’s Listing Rules, where proximity vis-à-vis individual shareholders and hence liability, is clearer.
\textsuperscript{54} “Auditor Liability: The Other Side of the Debate” J Cousins, A Mitchell and P Sikka.
10.12 Despite recognising that the standard setter is seeking to address individual concerns (e.g., accounting for own debt, incurred loss provisioning, to name but two), the fundamental structural problems of IFRS remain. To address the problems seen here, action needs to be taken at EU level, although some of the steps could be taken in the UK:

— The objectives of the audit should be explicitly define in legislation, which should build on the two principal purposes of the audit that was articulated in the Caparo case (Caparo Industries plc v Dickman, House of Lords (1990), 1 All ER 568 [1990] 2 WLR 358). Namely that it is the auditor’s function to ensure, so far as possible, that the financial information as to the company’s affairs prepared by the directors accurately reflects the company’s position in order,

“first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital)” and

“secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company’s affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided.”

— Within the European framework, the True & Fair View Principle needs to be unencumbered and overarching (although this is the case in the Companies Act 2006, the effects of the various EU provisions are not so clear and appear to undermine that), which will require changes to the EU’s 2nd and 4th Company Law Directives and related Regulations.

— The True & Fair View principle needs to be reinforced with an additional principles, such as on prudence and substance over form.

— Each standard considered for adoption by the EU should be reviewed and assessed in relation to these overarching principles.

— Just as was seen after Terry Smith’s publication of accounting for growth, a review (by fresh and independent eyes) of both the accounting and auditing problems encountered during the crisis, might be considered.

— The Audit Committee Report and the Audit Report arrangements should be overhauled in line with the recommendations set out in the answer to Qs 4 and 8.

11. One suggestion to improve banking regulation has been to restore two-way dialogue between regulators and auditors of banks. Does this raise any concerns for you as investors in banks?

11.1 In the UK, it has been acknowledged that the relationship between auditors and the regulators was not as effective as it might have been. This was particularly true in relation to the dialogue between the regulators and the auditors of major banks.

11.2 Although auditors do have a duty to report certain matters to the FSA (see below however), there is no reciprocal duty of the FSA to report matters to auditors. There is no logic in a regulator being aware of potential issues affecting the accounts and audit by virtue of its role (e.g., suspicions of serious fraud or criminal activity or, indeed, material risks), but not making the auditors aware of them. We understand that in the US, under the Federal Reserve system, banking supervisors are required to confirm to bank auditors that they are not aware of any matters that might impact upon the audit.

11.3 In relation to the auditors’ duty to report certain matters to the regulators, although there is no visibility for investors on how they worked over the recent crisis, I believe that they would be worth reviewing to ensure that the kind of situation apparent at Equitable Life did not and could not be repeated. In his report on Equitable Life56 The Rt Hon Lord Penrose highlighted the very real deleterious effect of a compliance orientated approach to standards. While Lord Penrose was clear that it was not for the inquiry to enter into the debate on the formulation of appropriate standards, he nevertheless deemed it appropriate to comment on some of the problems standards can create. One example of this related to SAS 620:

“The auditor’s independent obligation to report to the regulator could, in appropriate circumstances, involve investigations into the reserving policies and practices of the actuary. But the obstacles in the way of the auditor have at all material times been significant.”

11.4 In the preceding and subsequent paragraphs,57 Lord Penrose set out how the prescriptive drafting of the applicable standards and their thresholds and tests meant that the circumstances enabling an auditor to “justify” reporting to the regulator were likely to be “extreme”. Lord Penrose (perhaps slightly tartly?) also

noted in his final comment to his “Key Findings”\textsuperscript{58} that “It is also significant to note that at all material times … the auditors are able to claim that the discharge of their duties met all applicable standards.” Although standards have changed since then, given the recent financial crisis there would be merit in reviewing them.

11.5 Investors would positively welcome reforms to ensure that effective two-way dialogue between audit firms and the regulators happens and it should be an explicit objective for both.

12. \textit{If there were one measure you would propose that would most assist in widening choice in the audit market, what would it be?}

12.1 Leaving aside the option for aggressive intervention and restructuring of the market and firms, for which the case is not completely clear, I believe the various proposals suggested or outlined above should be taken forward to help enhance the audit market and audit quality. This should be done alongside a clear commitment by the authorities that, unless clear defined progress in made in opening up the FTSE Mid250 and to a lesser degree the bottom end of the FTSE100, they will make tangible interventions, such as the adoption of the joint audit model or mandatory rotation.

\textit{11 January 2011}

\textsuperscript{58} Ch 19, page 727.
APPENDIX 1

UK BIG 4 AUDIT & NON-Audit FEES

These Figures have been extracted (quickly), from survey’s undertaken by or for Financial Director, Accountancy Magazine, Accountancy Age and, for total fee income, the Financial Reporting Council. Given differences in the data sources and dates used within these surveys and differences in firm disclosures, the comparison should be taken as indicative.

<table>
<thead>
<tr>
<th>FTSE100</th>
<th>Audit fees (£ms)</th>
<th>Other fees—from audit clients (£ms)</th>
<th>Highest NAF ratio/Highest Non-audit fee **</th>
<th>Total UK Fee income (£ms)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Deloitte</td>
<td>99.8</td>
<td>54.4</td>
<td>42.31</td>
<td>80.7</td>
</tr>
<tr>
<td>E&amp;Y</td>
<td>68.4</td>
<td>71.8</td>
<td>25.92</td>
<td>56.4</td>
</tr>
<tr>
<td>KPMG</td>
<td>121.7</td>
<td>90.2</td>
<td>66.91</td>
<td>81.3</td>
</tr>
<tr>
<td>PwC</td>
<td>248.6</td>
<td>186</td>
<td>99.37</td>
<td>180.6</td>
</tr>
</tbody>
</table>

Note: the Big Four now organise themselves into service areas that do not exactly match with each other, or with smaller firms.

<table>
<thead>
<tr>
<th>UK</th>
<th>2009</th>
<th>2007</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Income</td>
<td>Consultancy</td>
<td>Corporate Finance</td>
<td>Tax Income</td>
</tr>
<tr>
<td>Deloitte</td>
<td>£523m</td>
<td>£737m</td>
<td>£321m</td>
</tr>
<tr>
<td>E&amp;Y</td>
<td>£392m</td>
<td>n/a</td>
<td>£289m</td>
</tr>
<tr>
<td>KPMG</td>
<td>£375m</td>
<td>£352m</td>
<td>£233m</td>
</tr>
<tr>
<td>PwC</td>
<td>£650m</td>
<td>£737m</td>
<td>n/a</td>
</tr>
</tbody>
</table>

Note: the Big Four now organise themselves into service areas that do not exactly match with each other, or with smaller firms.
APPENDIX 2

LOAN LOSS PROVISIONING (UK PRE/POST INTRODUCTION OF IFRS)

Unlike the IFRS’s backward looking incurred loss rules, the UK’s comparable 1997 Statements of Recommended Practice (SORP) on Advances were not as rigid in only allowing losses to be recognised when they could effectively be said to have actually occurred (a strict incurred loss model). The SORP model did allow for an element of forward looking provisioning and the difference in the wording of the provisions. Extracts from the SORP and IAS 39 (emphasis added) are included below:

Statement Of Recommended Practice (SORP) on Advances (November 1997)

[This old model looked at incurred losses that are “inherent” to a loan, allowing for example, forward looking statistical models to be used—emphasis added]

10. The methods for calculating the level of impairment inherent in a portfolio and, consequently, the appropriate provision are constantly evolving and are becoming increasingly sophisticated, with greater use of statistical and other modelling techniques. Such methods are compatible with the accounting framework established by this SORP.

12. A loan is impaired when, based on current information and events, the bank considers that the creditworthiness of a borrower has undergone a deterioration such that it no longer expects to recover the advance in full. In these circumstances, it is necessary to consider whether a specific provision should be made against the advance. Such advances are described in this SORP as “impaired”. A provision is generally only needed when the position deteriorates to an extent not foreseen when the advance was made, i.e. when recovery of the outstanding amount in terms of principal and interest due but unpaid at the balance sheet date, is no longer likely. Although it is often an event of default that serves as trigger, a provision should be considered whenever the information available to the bank suggests that the advance has become impaired.

17. Experience shows that portfolios of advances often contain advances which are in fact impaired at the balance sheet date, but which will not be specifically identified as such until sometime in the future. There will not usually be sufficient information to hand at the review of advances to be certain that all impaired advances have been identified. To cover the impaired advances which will only be identified as such in the future, a general provision should be made.

18. It is emphasised that the general provision relates to impairment already existing in the advances portfolio at the balance sheet date. It does not relate to advances which at the balance sheet date are subject to no more than normal credit risk, but which in the nature of things may become impaired in the future. [note the double negative]

19. Assessment of the appropriate level of general provision is the responsibility of the directors and is inevitably subjective. Past experience will provide some guide, but current economic and other factors affecting the business climate should be taken into account…specific and general provisions together represent the amount by which a bank considers that it needs to write down its loan portfolio in order to reflect bad and doubtful debts.

IAS 39—Financial Instruments: Recognition and Measurement

[This model looks strictly at incurred losses that have occurred, not allowing statistical models override that rule resulting in PwC advising in its 2004 Financial Services Bulletin—CP04/17—Implications of a changing accounting framework that “it is expected that many banks and building societies will be required to release some of [general bad debt provisions] that they currently hold as a result of the tougher tests under IFRS for establishing provisions.”]

59. “…impairment losses are incurred if, and only if, there is current observable data to reflect the effects of conditions in the historical experience or insufficient experience, use peer group assets with credit risk characteristics similar to those changes in unemployment rates, property prices, and other factors. Losses expected as a result of future events, no matter how likely, are not recognised.”

AG89 Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience to use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

AG90 As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the default rate is unchanged from one year to the next. Nevertheless, some of the borrowers in the entity’s group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these “incurred but not reported” losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.
Further supplementary memorandum by Mr Iain Richards (ADT 45)

Based upon my original written evidence and the Committee’s session on 11 January 2011, I offer the following suggested proposals for reform for inclusion in, or as, a package of measures to address the audit and audit market related concerns that have been highlighted. The views and opinions expressed below are personal.

**Options Relating to the Department for Business Innovation & Skills (BIS)**

*Audit market reform*

1.1 To the extent appropriate, consideration should either be given to a broad based competition review of the FTSE350 audit market or, alternatively, BIS, working with the Office of Fair Trading and the Financial Reporting Council should be asked to develop proposals to give the Big 4 firms five years to voluntarily address the current level of concentration in the FTSE350 audit market (over 90% of UK listed companies by market capitalisation) and to articulate indicative measures and objectives against which progress would be assessed. If those objectives are not suitably achieved, it should be agreed and understood that measures to effect change would be brought forward. These might include, for example, the introduction of joint-audits or requirements that there be both mandatory tendering of the audit at least every seven years and mandatory rotation at least every 14 years, along with provisions and safeguards to ensure that the issue of concentration would be addressed.

[Note: See paragraph 12.1 of my written evidence provided on 11 January 2011]

*The Companies Act 2006*

1.2 BIS should be asked to review the Companies Act 2006 (the Act) and, as Parliamentary time allows, bring forward amendments to:

(i) explicitly define the purpose and objectives of the statutory audit in the Act, building on the two principal purposes of the audit (to protect the company itself and to provide shareholders with reliable intelligence) that were articulated in the Caparo case (*Caparo Industries plc v Dickman*, House of Lords (1990), 1 All ER 568 [1990] 2 WLR 358);

[Note: See answer to Q.10, in particular paragraph 10.12, in my written evidence provided on 11 January 2011]

(ii) amend the provisions of the Act, including those relating to the duties to prepare accounts (eg section 394 on individual accounts and section 399 on group accounts), the duties of the auditor (eg section 498 on the duties of auditor), the True & Fair View basis of accounts and the audit opinion (eg section 393 on the requirements for accounts to give a true & fair view and other related provisions and section 495 on the auditor’s report on company’s annual accounts) and the justification of distributions (eg section 836 on the justification of distributions, as well as related provision and those relating to available capital), with a view to explicitly reflecting the principle of prudence within those provisions; and

[Note: See answer to Q10, in particular paragraph 10.12, in my written evidence provided on 11 January 2011]

(iii) significantly enhance the requirements on the auditor’s report (section 495 et al) with a view to introducing more comprehensive and positive requirements for opinions and related disclosures.

[Note: See answer to Q8 in my written evidence provided on 11 January 2011]

*IFRS standards*

1.3 Recalling the steps taken after the publication of Terry Smith’s “Accounting for Growth”, BIS and the appropriate body in the new regulatory structure being developed, should commission an independent and objective (“fresh set of eyes”) review of IFRS standards (including, in particular, IAS 1), the issues and risk they potentially give rise to (bearing in mind the experience of the crisis), the concerns and problems that are apparent around the issues of prudence, substance-over-form, the true and fair view principle and their impact on the auditors ability to undertake robust and effective audits, as well as their contribution to pro-cyclicality, with a view to making any further recommendations required to address these issues.
European Dimension

1.4 BIS should be asked to engage with the European Commission with a view to achieving similar reforms at EU level around the purpose and objectives of the audit, the adoption of the principle of prudence in accounting and auditing, as well enhanced audit reports. In doing so it should review the extent to which there is a clearly recognised separation in the European Company Law Directives and related regulations between the overarching true and fair view principle and the provisions on the adoption and use of standards, to ensure that the principle is not encumbered or perceived as encumbered, as essentially just requiring compliance with standards.

Monitoring progress

1.5 BIS should be asked to monitor action on the proposal made and to report back to the House of Lords Select Committee on Economic Affairs on the progress being made.

Options Relating to the Regulators

2.1 Effective two way dialogue between auditors and the regulatory authorities should be set as an objective for both. In doing so consideration should be give to the US model where, under the Federal Reserve system, banking supervisors are required to confirm to bank auditors that they are not aware of any matters that might impact upon the audit. In addition those standards applying to the auditors should be reviewed (i) in light of the crisis, to ensure that they operated effectively and ensured the regulators received appropriate and timely information from auditors as the crisis developed and progressed; and (ii) in light of the new regulatory structure being put in place.

[Note: See answer to Q11 in my written evidence provided on 11 January 2011]

2.2 The FSA should be asked to amend its Disclosure and Transparency Rules (D.T.R. 7.2.8 R) to include the new provisions proposed, including pursuant to the proposals in 3.4 to 3.8 below.

[Note: the FSA rule “DTR 7.2.7 R” requires a company’s governance statement to include a description of the composition and operation of, inter alia, its audit committee. DTR 7.2.8 R then states that compliance with the Governance Code provisions it lists will result in compliance with DTR 7.2.7 R. This element of the FSA Rules effectively underpins key elements of the Governance Code.]

2.3 The regulatory authorities should progress and develop arrangements equivalent to “living wills” to ensure that if another firm were to fail, the situation could be managed and addressed promptly. In taking this forward the authorities should give particular thought to the question of how to ensure that any such arrangements do not further exacerbate the current levels of concentration.

[Note: See answer to Q1 in my written evidence provided on 11 January 2011]

2.4 The regulatory authorities should investigate and review what other types of market practice might create barriers to entry to non-Big 4 firms, such as covenants or other provisions included in credit agreements or other debt arrangements.

[Note: See paragraph 1.16 of my written evidence provided on 11 January 2011]

Options Relating to the Financial Reporting Council (FRC)

Audit Inspection Unit

3.1 The FRC should be asked to review the Audit Inspection Unit’s objectives and the scope of its monitoring, which currently give the appearance of only encompassing Regulatory Standards and Audit Regulations issued by the relevant professional bodies, to ensure it clearly encompasses relevant provisions of the Companies Act as they apply to auditors and the audit.

[Note: Given the concerns and potential limitations about some of the standards, as well as the proposal in 1.2 above, the Audit Inspection Unit should be given a clear mandate to include consideration of the Companies Act provisions in its work. See the answer to Q10 in my written evidence provided on 11 January 2011]
AUDITORS: MARKET CONCENTRATION: EVIDENCE

Audit Committees

3.2 The FRC should be asked to review and bring forward proposals on what steps it or others can and should take to address the apparent perception issues that exist (including amongst audit committee members, other directors, shareholders, advisers and other market participants) and that exacerbate concentration in the audit market, as well as creating unwarranted barriers to entry for non-Big4 firms.

[Note: See paragraphs 1.7, 1.12, 1.13 and 2.5 to 2.8 of my written evidence from 11 January 2011]

3.3 The FRC should be asked to review and bring forward proposals to amend the UK Corporate Governance Code, to require pre-approval by the Audit Committee or, in de-minimis cases, the chair of the Audit Committee, of all non-audit services that are not activities arising directly from an audit of a company’s financial statement or they are not services required to be provided by the auditor by law or in regulations (see also proposal 4.1, second bullet point).

[Note: At present the Code just requires the terms of reference to include a provision “to review and monitor the external auditor….” And the amendment seeks to enhance that and reflect the comparable proposal in the recommendations in ICAS Report “The Future of Assurance” (Dec 2010). See paragraph 1.7 and the answer to Q5 in my written evidence provided on 11 January 2011]

Audit Committee Reports

3.4 The FRC should be asked to amend Provision C.3.3 of the UK Corporate Governance Code, to formally recognise and constitute the requirement for an audit committee report, which should be included in the annual report and signed by the Chair of the Audit Committee.

[Note: At present the provision only requires that a separate section of the annual report should describe the work of the committee in discharging those responsibilities. See paragraph 4.1 of my written evidence provided on 11 January 2011]

3.5 The FRC should be asked to introduce new provisions on the audit committee report in the UK Corporate Governance Code, building on the recommendations on disclosures set out in the ICAS Report “The Future of Assurance” (Dec 2010) and other disclosures in relation to:

— risk management, including: (i) any other key areas of sensitivity or risk, including the choice of accounting policies, that they identified to the integrity of the Annual Report and Accounts, and (ii) the conclusions of its review of the effectiveness of the company’s internal audit function;

— the appointment of the external auditor, including: (i) an explanation for any change in that expected timescale or if they do not comply with the policy explain why on that occasion they have chosen not to; (ii) its policy for ensuring an effective external audit process; (iii) any additional considerations not otherwise disclosed for the recommendation to appoint or re-appoint (as the case may be) the company’s external auditors;

— the external audit process, including details of any other relevant key matters included in reports by the auditors, but which have not been discussed with them.

[Note: See paragraph 4.1 of my written evidence provided on 11 January 2011. To create an effective and robust model of disclosure and accountability, which is linked to the FSA rules (see recommendation 2.2), I would not propose including the ICAS option that some of this could be relegated to the Guidance on Audit Committees (which only “contain further suggestions as to information that might usefully be disclosed” or that parts might be addressed to risks committees, which are not covered by the Code and may be constituted with executives and other senior employees.).]

3.6 The FRC should be asked to review Provision C.3.7 of the UK Corporate Governance Code with a view to making the requirement to explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded, part of the content of the audit committee report.

[Note: At present the requirement is only that the annual report should contain this explanation]

3.7 The FRC’s review of the Turnbull guidance on risk and internal controls should examine what elements of that guidance should be elevated into the UK’s Corporate Governance and what related additions should be made to the content of the audit committee report to improve transparency and assurance, in keeping with and to enhance the approach proposed in recommendation 3.5 above.

3.8 Similarly, the FRC should review its “Guidance for Audit Committees” with a view to including any other key provisions from it within the UK Corporate Governance Code.
Annual Report

3.9 The FRC, working with BIS, should review the proposals set in the ICAS Report “The Future of Assurance” (Dec 2010), on assurance on the corporate annual report (Other than the Financial Statements), with a view to developing and consulting on them.

[Note: See paragraph 9.1 of my written evidence from 11 January 2011]

Stewardship Code

3.10 The FRC should review the UK Stewardship Code with a view to suitably reflecting and building on the recommendations made in Part 8 of the ICAS Report “The Future of Assurance” (Dec 2010), in an appropriate form, to address institutional investors role in relation to the quality of reporting and the audit/assurance.

[Note: See paragraph 6.6 of my written evidence from 11 January 2011]

Options Relating to the FRC’s Auditing Practices Board

4.1 Given the clear concerns that exist over non-audit services and their potential to create mis-aligned incentives in the audit market and around audit quality, as well as unnecessary, potential conflicts, the FRC’s Auditing Practices Board should, in addition to implementing its proposed, enhanced disclosures around the types and level of non-audit fees:

— produce a more detailed report on the concerns raised by respondents to its recent consultation on non-audit services and in the academic literature, with particular emphasis on the views of and potential effects for shareholders, audit quality and the dynamic of the audit market;

— re-examine those non-audit services that may be provided by auditors, which are not activities arising directly from an audit of a company’s financial statements or are not services required to be provided by the auditor by law or regulation. Where there is not a compelling case that the provision of such services is likely to be compatible with and contribute to achieving the purpose and objective of the audit, such as in reporting on prospectuses, or providing reports pursuant to the requirements of capital markets regulators (eg working capital reports), those services (including, but not limited to, tax planning and advice) should be not be allowed to be provided by the auditor.

[Note: See paragraph 1.7 and the answer to Q.5 of my written evidence from 11 January 2011]

27 January 2010

Supplementary letter from Mr Guy Jubb, Standard Life Investments (ADT 46)

Thank you, once again, for giving me the opportunity to share our views on the matters discussed. I undertook to provide additional written evidence, which is enclosed with this letter. It comprises:

— An overview of the key points in the evidence I provided, directly or indirectly on Tuesday.

— Our letter dated 2 December 2010[^59] to the European Commission in response to its invitation to comment on its Green Paper on Audit Policy. This letter and its attachments address many of the matters we discussed on Tuesday and touch on a number of additional matters which may be relevant to the Committee’s deliberations.

— Our letter of 12 March 2009[^60] to the European Commission in response to its Consultation on the Ownership and Control Structures of Audit Firms. Our views on the matters set out in this letter have not changed fundamentally. It incorporates comments regarding the structure of audit markets.

— Guidelines for Enhanced Disclosure[^61] to assist boards, audit committees and investors. These Guidelines were developed by a Working Group that I convened in 2008. You will note that they have been endorsed by a number of organisations including the Association of British Insurers, the International Corporate Governance Network (ICGN) and Railpen Investments. It is planned that these Guidelines will be refreshed in 2011. They can be found at www.enhanceddisclosure.org.

— My article entitled “Viva la audit revolution” which was published by AccountancyAge on 20 May 2010.[^62] It sets out views on the statutory audit report and provides context in respect of stewardship responsibilities.

[^59]: Not published here.
[^60]: Not published here.
[^61]: Not published here.
[^62]: Not published here.
— The Objectives and Advantages of Audit Committees.63 This article was published in the Journal of Accountancy in 1979. Arguably its content has stood the test of time rather better than its author!

— Our letter of 27 November 2009 to IOSCO.64 This sets out our views on the content of audit reports.

I shall contact the Institute of Chartered Accountants of Scotland to ask them to submit to you their report on the Future of Assurance. This Report was referred to several times during the meeting on Tuesday. It is appropriate to emphasise that the Working Group that developed the proposals, which include a recommendation pertaining to the UK Stewardship Code, comprised a broad spectrum of perspectives which served to underpin the Institute’s commitment to the public interest.

If, when you consider the transcript of the Committee meeting you feel that I have omitted any evidence that I undertook to submit, then do please get in touch.

It was a privilege to be asked to give evidence. Drawing on the Chairman’s concluding remarks, I am pleased that the Committee found the meeting useful. I remain at its disposal should it wish clarification, supplementary evidence or other assistance, as time goes by.

14 January 2011

Evidence provided by Guy Jubb, Investment Director & Head of Corporate Governance, Standard Life Investments, at a meeting of the Committee on 11 January 2011

Overview

Standard Life Investments believes that the concentration of the audit market in the Big 4 global auditing networks is fundamentally unhealthy and presents a systemic risk which has the potential to undermine financial stability and the confidence of capital markets. Market measures have proved ineffective in changing the status quo; the time for constructive intervention by governmental and regulatory authorities is overdue.

We should like to see the Big 4 global networks given a reasonable time to organise their affairs with the objective of enabling companies to have improved choice of audit supplier without prejudice to audit quality. It should be made clear to the networks that if they do not respond constructively then governmental and regulatory authorities are prepared to intervene with a view to achieving the objective. This approach should be championed at G8 and G20 levels to provide leadership and the requisite commitment.

Standard Life Investments believes the role of the auditor needs to be strengthened in tandem with strengthening the role of the audit committee in order to provide a robust framework for assuring shareholders and others that the information provided in a company’s annual report is ‘reasonable and balanced’ in respect of the business review, and ‘true and fair’ in respect of the financial statements. We believe that minimum standards of audit committee reporting need to be established and that the auditors should refer explicitly in their report to their review of the audit committee report and their concurrence with its content.

Standard Life Investments does not support mandatory rotation of auditors or joint audits. We are concerned that these will result in a lower quality of audit—not an improvement. Rather, we should like to see more transparency by audit committees regarding their policy approach towards audit tendering. In our experience, investors are not involved in the process. As the principles and practice of stewardship evolve, this needs to be addressed so that institutional investors engage effectively to ensure there is a mutual understanding of the audit tendering policy, process and outcome.

11 January 2011

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63 Not published here.
64 Not published here.
Present  Lord MacGregor of Pulham Market (Chairman)  Lord Levene of Portsoken
Lord Best  Lord Moonie
Lord Forsyth of Drumlean  Lord Shipley
Lord Hollick  Lord Smith of Clifton
Lord Forsyth of Drumlean  Lord Tugendhat

Examination of Witnesses

Witnesses: Professor David Myddelton [Chairman, Institute of Economic Affairs], Mr Steve Cooper [Member, IASB], and Mr Roger Marshall [Interim Chair, Accounting Standards Board].

Q447 The Chairman: Good morning, gentlemen. Thank you very much for coming. We have quite a lot to go through this afternoon. We have three sets of witnesses, so we will try to keep the questions as short as possible and fairly concise with the answers, if that is possible. If you are asked a question and the person who goes first covers it and the other two are happy with it, please do not feel obliged to follow in. We just assume you are content with the answer. I would be grateful if you would identify yourselves when first speaking and speak loudly and clearly for the benefit of the webcast and the shorthand writer. Would you like to make an opening statement or will we go straight to questions?

Professor Myddelton: I wouldn't mind making a brief opening statement, which is that I think there should not be any accounting standards at all.

Q448 The Chairman: That is very brief. Thank you very much. We will come to it no doubt in the questions. Can I start off by asking this question, because you will know we had quite a lot of focus on the accounts in the banks? Supposing the management of a UK bank in 1990 presented a set of accounts that contained leverage similar to that in 2010 or even 2009, would the auditor have qualified the audit report? If so, what has changed? What is now missing from the auditors' appraisals and judgments?

Mr Marshall: Shall I take a stab at that, as an ex-auditor? I do not think the auditor would have qualified the audit report purely because of leverage then or now, providing the leverage was properly disclosed in the financial statements, but clearly the leverage would put them on notice to make more inquiries about the sources of financing and the durability of financing. I don’t think then there would have been quite so much leverage. The securitisation market hadn’t opened at that point; there wasn’t the same amount of interbank lending. But as I say, I don’t think that leverage on its own would have led to a qualification then or now.

Mr Cooper: This is not perhaps so much a question for the IASB as a standard setter. The question of whether an audit report is qualified is an issue for the auditors. As Roger said, so long as the leverage, the appropriate disclosures, are provided in the financial statements, then that will be it in terms of compliance with the accounting standards, so probably not so much of a question from an accounting standards perspective.

Q449 Lord Tugendhat: Mark-to-market and mark-to-model have also featured quite a lot in our inquiry, and there have been those who have argued that perhaps inappropriate IFRS innovations have led to correspondingly inappropriate volatility in financial results from one period to another. How, may I ask, do you feel about this?

Mr Cooper: Perhaps I will take that one first. Mark-to-market accounting has been around for a long, long while. Even before the IFRS was used in the UK, we have had the use of fair value for trading assets for many years. I think most people believe it to be entirely appropriate that we should have fair value in some circumstances. The IFRS is a mixed measurement model. We have some things at amortised cost, and some things add a fair value. In fact, for many banks, the majority of their assets are measured at cost with impairments not at fair value. Certainly the crisis has presented many challenges, and there have been challenges for us as well. We have certainly reviewed very carefully the standards that we have. We look very carefully at where fair value should be used, and where it shouldn’t be used. We have, in fact, revised the rules for bodies at fair value fairly recently. We’ve issued what is called IFRS 9 to replace the previous rules. It hasn’t changed it dramatically. Many of the things that were at fair value still are. I think it is perfectly appropriate that they should be. A failure to recognise changes in value won’t provide a true and fair view in company financial statements in many cases. We have changed the position slightly. Some things that were at fair value are now at cost and vice versa. We have
Q450 Lord Smith of Clifton: Gentlemen, are we correct in believing that there used to be a true and fair override, which took precedence over whether or not the financial statements were consistent with the accounting standards, but that now the reverse is the case?

Professor Myddelton: I believe the Companies Act still requires company accounts to give a true and fair view. It’s true there was a judge, Mary Arden, nearly 20 years ago, who said that, in her opinion, giving a true and fair view would mean only complying with accounting standards, but that has not been tested in the courts as far as I know. It is a legal question, so there still is, as far as I understand it, a requirement for a true and fair view. In my opinion, that is the only bit of regulation of accounting there should be—a requirement in the Companies Act for company accounts to give a true and fair view, full stop.

Mr Marshall: May I say something? The FRC did actually get a Counsel’s opinion from Mr Moore after the IFRS came in to confirm that the true and fair view is the overriding feature of companies’ accounts. I think companies have to pay attention to a true and fair view, which actually takes precedence over the accounting standards. Now, there have been quite rare cases under the IFRS of companies using the true and fair override to depart from the accounting standard, but they are not unique. Indeed, HSBC, in 2009, used a true and fair override to depart from one of the IFRS accounting standards. So I think that the true and fair view concept is still very much in the centre of UK accounting.

Professor Myddelton: Chairman, can I say one other thing? Of course, there can be more than one true and fair view. For example, most companies use straight line depreciation, but if another company wanted to use declining balance, that would be perfectly appropriate, though different. So there isn’t a single true and fair view.

Mr Cooper: I think there is a perception that has come from somewhere that IFRSs do not have a true and fair basis, which I think is completely untrue. Paragraph 15 of IAS 1 says that financial statements shall “fairly present the financial position, financial performance” et cetera. We don’t use the words “true and fair view”. Those originated in this country. We write international standards that are used right across the world. One of the key issues that we have is translation and making sure that things translate well into other languages, and “fairly present” is the phrase that we have used, but I think everybody identifies that to mean “true and fair view”. The true and fair override is in IFRS. It is in IAS 1. It is on the same page. 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 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 Marshall: If I may just add one other thing briefly, the opinion I quoted from Counsel says, “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”, so I think we understand what the IFRS says as identical to a true and fair view.

Q451 Lord Forsyth of Drumlean: I wonder if you have had an opportunity to read some of the evidence that has been presented to the Committee, which might be summarised as the IFRS encouraging a kind of box-ticking approach as opposed to a judgment approach. Now, you have not really addressed that in your answer to the question.

Mr Marshall: I am happy to. Shall I start on that? I think the IFRS is a more complete set of accounting standards, so it probably ties the company, the preparer and the auditor down a bit more on how best to express the results of the company in the accounts. But the IFRS also has more requirements on the company and the auditors to make judgments, for example on fair values and on estimates, so I do not think the IFRS on its own creates more of a box-ticking approach. In fact, the opposite may be the case.

Q452 Lord Shipley: It has been put to us that accounting standards contributed to the global financial crisis by disallowing companies from providing prudently for expected future losses, which weren’t then apparent in the current performance of an asset. So, for example, a sub-prime mortgage book that had not started to be significantly impaired would have been overvalued, profits overstated and perhaps bonuses and distributions excessive. Have you a view on this?

Professor Myddelton: Yes. I think prudence is a very valuable concept in accounting, based on hundreds of years of commercial experience, but standard setters don’t like it. They can speak for themselves, but it is asymmetrical. It basically says that, if
anything, understate the position; don’t report
profits before you are absolutely sure they have
arrived. Most commercial people think prudence is
important, but as I say, standard setters don’t like it
and have really tried to outlaw it.

Mr Cooper: Perhaps I can deal with the prudence issue
and then I will come on to the expected losses.
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 underestimate 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.

Going on to the incurred losses, the expected losses,
the current model that we have and the UK had
before is an incurred loss model, and the idea is to
wait for a triggering event before you can recognise a
loss on a loan. Now, you could argue that that means
that you have to wait. Now, to a certain extent,
you can look forward. You have concepts of collective
provisioning of IBNR—incurred but not reported—
and people do look forward to a certain extent within
the existing model. But 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 extra of your loans will go bad in
three years and that it wouldn’t be possible to provide
now. As a result of that, we have been looking now
for more than a year at the incurred loss model with
a view to modifying it and looking much more at
expected losses. We issued an exposure draft, a draft
accounting standard on this last year. We spent six
months consulting on that, particularly with the
banks, to make sure that a more forward-looking
expected cash flow model, as we described it, would
be operational. There were certainly many
operational challenges in applying that to open
portfolios. We have been redeliberating that since.

Mr Cooper: We were talking about this earlier. I am
not sure it would have—it’s difficult to tell, of course,
because you can try to put yourself in the mind of
somebody at that time and what losses were expected.
When the crisis first hit people weren’t necessarily
talking in terms of the severe downturn or the
consequential effects on the mortgages and the
reduction in house prices. So losses might have been
reported earlier, but one would have to look very
closely at the exact timeline of the events at the time
to see whether perhaps things would have come in
one, two or three quarters, whatever it was, earlier as
a result of an expected loss model.

Q454 The Chairman: What is the expected timetable
and programme on the discussions you are having at
the moment?

Mr Cooper: We are going to issue a supplementary
document quite shortly that looks at trying to modify
what we had originally to make it more operational.

Mr Cooper: We are talking about this earlier. I am
not sure it would have—it’s difficult to tell, of course,
because you can try to put yourself in the mind of
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to see whether perhaps things would have come in
one, two or three quarters, whatever it was, earlier as
a result of an expected loss model.

Q455 Lord Hollick: I think that brings us to the
question of judgment. One of the key judgments,
of course, is around going concern. A number of
witnesses have said how important that is to their
usage of company accounts, and yet going concern
judgments that were made around banks at the end of
2007 and 2008 have proved, in retrospect—in pretty
short order in some cases—to be completely wrong.
How valid and helpful do you think it is and what can
be done to improve matters?
Mr Marshall: I think the going concern clearly is a forecast and so it cannot be treated as completely as reliable as, say, the historical financial information, which is backward-looking. I think that first management have to form a view as to whether the accounts are prepared on a going concern basis and they have to back that up. Perhaps a paper goes to the board explaining why there is no reasonable doubt about the validity of the going concern basis. I think the auditors then have to challenge the assumptions there. They have to go and talk to the various people involved and make sure that, in their view, there is reasonable evidence that finance will be available to the company or to the bank at least for the next 12 months or the foreseeable future. Whether or not those judgments were correct at the time, I can’t tell, because I wasn’t involved, but it is for the auditors to test those judgments.

Professor Myddelton: The future is uncertain, so you cannot expect auditors or anyone else to guarantee to make correct forecasts. It is rather like providing for a bad debt. You may say, “I don’t think it will turn out bad”, and then be wrong. There may not be a systemic problem with that; it’s just the nature of the uncertain future.

Mr Cooper: I think from the IASB’s perspective, we would regard that as an audit issue, not something that really relates to accounting standards.

Q456 Lord Moonie: Staying with going concerns, we understand that auditors would deem a company to be a going concern even if its continuance is dependent upon an expected major capital restructuring, even a nationalisation, under which existing shareholders may lose almost everything. Is that so, and do you consider it to be satisfactory? Does this relate to accounting standards or auditing standards or both?

Mr Marshall: It relates to both. Accounting standards require the accounts to be prepared on a going concern basis unless that’s manifestly not the case. I think the reason is that accounts on a going concern basis are much more useful than on a break-up basis. On a break-up basis, many of the assets would be written off; there would be provisions for lots of closure costs, and so on. I am thinking perhaps more about a manufacturing company than a bank, but there would be similar sorts of issues. So the convention is, and I think the Companies Act requires, that accounts are prepared on a going concern basis. Now, if there is no material uncertainty about the going concern basis, the directors would prepare the accounts on that basis; the auditors would accept them. If there are material doubts, then the rule is that those uncertainties have to be explained in the accounts and the auditor then refers to them in the audit opinion. Clearly, if the auditor is not happy with the explanation or, indeed, the preparation of the accounts on a going concern basis, then the auditor has to qualify his opinion. So I think it is more to make sure there is proper disclosure in the accounts of those uncertainties and probably the way in which the directors are proposing to resolve those uncertainties, perhaps a capital reconstruction.

Q457 Lord Forsyth of Drumlean: Could you tell us what the position is with the IFRS being adopted in the United States?

Mr Cooper: I’ll take this one. We are eight years into a nine-year programme of converging the IFRS and the US GAAP. We meet the FASB on a very regular basis and are making very good progress. We have converged in a number of areas: share-based payments and business combinations. We are working on issuing some new standards on fair value measurement and other areas shortly. We have a number of challenging projects on the go at the moment with respect to revenue recognition, leasing, financial instruments, which we were talking about, but the objective is to achieve greater convergence there. Convergence, however, is only part of this. The key question is adoption of the IFRS in the United States. That is an issue, of course, for the US and not for the IASB directly, although of course we work closely with the US and the SEC and talk to them on a regular basis. My understanding is that the US SEC will make a decision later this year. That decision may not be the simple adoption of the IFRS in the US. It may involve allowing certain US companies to use the IFRS and maybe set some date in the future for making it mandatory either for a certain group or for all listed companies. There are a number of options that the US SEC might choose to take in this regard. From our perspective, we are making a lot of progress in converging and achieving the ultimate goal, which is a single set of global high-quality accounting standards to enable investors to make better investment decisions, to be able to compare across borders, to support an international capital market. That’s the whole objective of the exercise.

Q458 Lord Forsyth of Drumlean: If you had to bet your shirt on it, when would you say it would be adopted by the US?

Mr Cooper: I am reluctant to speculate. A decision will be made, I think, at the end of this year. I think it is perfectly possible that we might see, in the fairly short term, the permission for certain US companies to adopt IFRS. We may well see a date set for when the US will adopt IFRS for all companies. I do not know. I am not in a position to give a view on it. It could go different ways. There is strong lobbying in the US pro-IFRS adoption. Many, particularly the larger companies, see enormous benefits in having a single accounting system for all of their subsidiaries.
throughout the world. At the moment, obviously, using different accounting systems and different places and training people on different systems is an enormous cost for them, so some of the larger companies in particular are very pro adopting IFRS. Some of the smaller and medium-sized US companies do not see the benefit. They have US GAAP. They have all their systems set up. They are not raising capital in the international capital markets, so for many other companies there is far less of a benefit. There is clearly a lot of lobbying going on in the US to influence that decision. I am not in a position to say which way that is going to go.

Professor Myddelton: Chairman, could I make two points really? One is that there are important philosophical differences between particularly the American and the British traditional sets of accounting. It is not just a technical thing that can be sorted out, and it has taken many years. I can quite understand Mr Cooper being unwilling to speculate on when it will happen. The second point I want to make is that I think it’s extremely undesirable. International harmonisation is a smooth sort of phrase, but I think a global monopoly on accounting is very undesirable. I like the idea of competition and continual evolution. Some of the changes in fair value accounting that were referred to earlier came about, in my opinion, only because the Americans had already, and ahead of IFRS, come to a more satisfactory conclusion. If we hadn’t had that competition, if we had already had a global monopoly, IFRS may never have changed.

Q459 Lord Forsyth of Drumlean: So do you think it is never going to happen?

Professor Myddelton: I think it is inevitable that it won’t happen, because the differences, political and philosophical, are too big, and I’m pleased if that’s the case.

Mr Cooper: Many, many countries throughout the world have decided to adopt IFRS or are in the process of going through that, so Korea is applying IFRS for the first time this coming year, as are Brazil, Argentina, Mexico, Japan. Japan has a convergence process. They are now permitting IFRS to be used in Japan and I understand quite a number of countries will be using it next year. They will be taking a decision, I think, in 2012 or after, about mandating. Canada is using IFRS for the first time this year. Of course, the whole of the European Union is using IFRS. The cultural business differences amongst all of those countries are quite diverse, and yet people recognise the benefit of having a single set of high-quality standards, having comparability, facilitating cross-border investment. Many of the differences that Professor Myddelton talks about have been overcome in the interests of having this comparability. Sure, there are challenges with the US. The US legal system in particular presents enormous challenges when reporting litigation liabilities, for example, and there is the whole issue of disclosure, so there are certainly massive challenges that we have in trying to harmonise with the US. I wouldn’t minimise those, but there are also challenges in many other countries and we have successfully dealt with those. Even China has essentially adopted IFRS. It’s not full adoption. There are one or two things that they are not so confident about. They don’t have a sort of evaluation community that is well-developed, so there are certain things that they scope out of IFRS. We hope that they will fully adopt in the future, but in most respects, most Chinese companies that report on Chinese accounting and separately on IFRS—the ones which are listed in Hong Kong—do not have a difference at all. So even China has effectively adopted IFRS, in spite of the obvious differences in the political, legal systems and business approach in that country.

Q460 The Chairman: Professor Myddelton, given the increasingly international and global reach of companies and economies in a world in which you didn’t have IFRS but you had a whole load of different accounting systems, how would you deal with that?

Professor Myddelton: I’m not against voluntary guidelines. Don’t forget that we are talking in the context of compulsory instructions. When I was a young accountant, we had what were called recommendations: voluntary guidelines. I have brought them with me and here they are; the whole lot. We didn’t have 2,000 pages of regulations as we have now. We had 150 pages. I think it worked perfectly well, because it enabled, indeed it required, accountants and auditors to use their professional judgment. It was up to them—ultimately the courts, not the standard setters—to decide what a true and fair view consisted of. I think that could work perfectly well, because it enabled, indeed it required, accountants and auditors to use their professional judgment. It was up to them—ultimately the courts, not the standard setters—to decide what a true and fair view consisted of. I think that could work perfectly well. Let’s not kid ourselves; producing accounts, whether internationally or not, is an extremely complex business. First of all, annual accounts are only interim accounts in the ongoing life of a business, and, for all sorts of reasons, they cannot be completely accurate. My latest book, which I’m not trying to sell, is called *Margins of Error in Accounting*. It hasn’t in fact sold very well, and I think I can understand why, but the point is that there will always be margins of error. So there isn’t a perfect solution just waiting if only the IFRS and the US authorities can get together. There never will be a perfect solution, so I am quite happy to allow evolution and trial and error—experimentation—to see what other people are doing. I think that’s the best way to progress. Your question implies, “Oh my goodness, I’m suggesting a system that won’t be perfect”. Yes, I am, and that’s inevitable. I may have
misread it, but that’s inevitable. There’s no way around that. I can live with that.

Q461 Lord Moonie: Is the corollary of that that if we rely too much on a single set of standards we are more likely to get systemic errors in the system? Professor Myddelton: Absolutely. It’s a very high-risk strategy, as we saw in the financial crisis.

MR Cooper: I think, though, that the greater risk is not having these standards. A good example is share-based payments, when companies pay their employees by giving them free shares or stock options. Prior to the issuance of a standard seven or eight years ago, whenever it was, these things were not reported as expenses, either in UK company accounts or pretty much anywhere, and it wasn’t until the standard was issued that what was clearly a transfer of value to employees was actually reported as an expense in the profit and loss account. A failure to issue standards just doesn’t lead to people going towards the best accounting. I think people stick with the worst accounting in the vast majority of cases. That was a very good example of a positive effect from issuing an accounting standard. Financial statements became far more relevant, transparent and useful as a result of that standard being issued.

MR Marshall: As I say, I am not necessarily arguing for one set of accounting standards worldwide, but over the Christmas holidays I read two of Professor Myddelton’s books. In the previous book to the one he is selling at the moment, I think he gave six advantages of accounting standards. He gave them rather faint praise, and I’ll leave it to him to argue against them. But, clearly, to produce any sort of reasonable accounts without accounting standards you need either a well-meaning company or a robust auditor, and if you don’t have at least one of those it may lead to problems without standards. The standards, at least, provide a spur to those to get it right. You also need to protect investors by giving them certain minimum disclosures, which, without accounting standards, you’re not going to get. You want some sort of consistency, so if you are looking at two companies in the building industry, and one shows that profits are going up and one down, is that really what is happening or is it just that they’re using different standards and they’re actually doing about the same? There are a number of advantages for accounting standards that I won’t fully go into now. I’ll leave Professor Myddelton to provide the counterargument.

Professor Myddelton: It would take too long. Chairman, to go through all the disadvantages. I wanted to make two points. One, as Hayek points out, is that you can have generally accepted rules without any standard-setting body imposing them. Accounting is sometimes called “the language of business”, and I think that is a nice analogy, because language develops without any absurd French-style body trying to tell us what we should be using in our language. It gradually evolves, and that is very healthy. The second point I want to make is about share-based payments. Mr Cooper has done very well, and I congratulate him, to pick a standard whose content I happen to agree with, but let’s not forget that when the Americans tried to introduce it in the early 1990s, the American Government stepped in and prohibited it. That is one of the dangers of having a single standard-setting body. It makes it much easier for—a—forgive me, gentlemen—politicians to interfere. If you have lots and lots of independent people trying to decide how to prepare accounts, it’s very hard for Governments to know how to interfere.

Q462 Lord Best: Yes, staying with comparisons with the US, Tony Blair has said that the Sarbanes-Oxley Act was a bonanza for accountants and auditors, the very people who created the problems in the first place, as he said. In your opinion, is regulatory capture by the accountants of auditing regulations and by auditors of accounting standards a genuine concern?

Professor Myddelton: My concern is exactly the other way around: not that the regulators get captured by the accounting firms, but that the regulators ignore the opinions of the accounting firms. I will quote just one small bit. When the accounting standards board in this country issued its draft Statement of Principles for Financial Reporting in 1995, the then six main accountancy firms all had very serious objections, which I summarise in the book, which Mr Marshall kindly referred to, called Unshackling Accountants. Let me just quote Price Waterhouse. This was at the end, summarising all their comments. Price Waterhouse said: “Our reluctant conclusion is that the board must start again”. Now, that’s pretty devastating criticism. But the ASB took virtually no notice of what these six leading accountancy firms had said. So my position is that the so-called principles, the basis for thousands of pages of regulation on which accounting standards are now based, are not generally accepted, and that that is a serious problem. Accounting standards are being imposed that many, many people in business do not agree with. I’m chairman of a charity, the Institute of Economic Affairs, and it bitterly concerns me that I can’t ensure that we present our accounts in the way I think we should—I’m a professional accountant: 50 years a chartered accountant this year—because I have to follow a standard that tells me how to do it even if I disagree with the standard. Of course, this is where academics have an enormous advantage over mere auditors or finance directors. Academics are allowed, even encouraged, to think for themselves, whereas if you are a finance director or an auditor
and you don’t happen to agree with the standard—too bad, you’ve just got to obey orders. That strikes me as an unsatisfactory basis for a profession.

Mr Marshall: Could I also have a go at answering that? I suppose the nub of your question really is: are auditors or accountants overrepresented on these standard-setting bodies? I think the principle issue with Sarbanes-Oxley was auditing standards and, in fact, the necessity of auditing controls within American companies. The PCAOB, which sets those standards, is entirely full time. There are no practising auditors on it. Similarly, on the IASB—and Mr Cooper can talk for IASB himself—there are no practising auditors or accountants. They are, again, all full time. There are a number of practitioners on the International Auditing and Assurance Standards Board. I think that 50% of that body are practising auditors, and I think that the FRC has proposed or tried lobbying for fewer practitioners on that board. It is important, though, that you get the benefit of practising auditors involved on that, but perhaps not to the extent of 50%.

Mr Cooper: I just wanted to say that the IASB is an independent body. I am one of 15 members of the board from 10 or 11 different countries, a whole variety of backgrounds. I have an investor background, but we have regulators, people with audit experience, finance directors, and we are full time. 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. Professor Myddelton mentioned share-based payments—yes, that standard—and that some aspects of accounting have been bitterly opposed. That’s very true; share-based payments were bitterly opposed. The very fact that we are an independent international body enabled us to get that through. I think most people now believe that that was a good standard and that it did the right thing, but at the time there was enormous lobbying—particularly from the technology industry that made extensive use of these payments—against recognising these things within the financial statements. In terms of regulatory capture, we are certainly not captured by the auditing profession. We obviously 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. We are at the moment going through, I think, 700 comment letters from around the world on our insurance proposals. Four of those came from the Big Four auditing firms, and quite clearly those four particular letters will be scrutinised very, very closely, and we will meet those people. They will participate in our working group meetings. So we have extensive consultations with them, but we certainly are not captured by the audit firms. I for one have never worked for one of the Big Four, and a number of other members on the board haven’t either.

Q463 Lord Tugendhat: I was very interested in Professor Myddelton’s tirade—I put that in a friendly fashion—against what might be termed the “slavish application of standardised rules” rather than the application of judgment, but I wonder to what extent he thinks the standardised rules are an inevitable corollary of the globalisation of business. When 40%, 50%, 60% of a British company can be owned by foreign shareholders, likewise a French company or any other, where the accounts are pursued by shareholders in different jurisdictions and where the regulators are in different jurisdictions, in those circumstances, is it not the case that standardised rules are the corollary of that? I am not saying they are; I am searching after an answer.

Professor Myddelton: It may be that you can have competing potential rules, and any individual international group could pick one of those and apply to that, but to all the companies and subsidiaries in its group, but I think the essential problem is that there isn’t a single correct answer. The ultimate question is whose judgments should rule? Should it be the standard setters, or should it be the people running the company, subject to the acquiescence of their auditors? One of my main objections to compulsory accounting standards is nothing to do with the technical content; it’s to do with the effect on the public. It raises expectations. People sort of assume that all these experts are almost guaranteeing that these accounts are correct. That’s a million miles from the truth, as I’m sure both the standard setters will agree. Nevertheless, that impression is allowed to exist. If people were a lot less ready to believe accounts and were able to realise how difficult it is and that if we don’t do it quite right this year, maybe we will next year, we’d learn more. There is no point looking at a single year in the life of a company. That’s hopeless. One has to look over a much longer period. So to me, the most important thing is not comparability between one company and another, which I regard as unachievable in any case, but consistency within a single company or group over time so that a shareholder, looking at the accounts over a period of years, can be reasonably assured that the same accounting methods have been used every year. Otherwise, you can get into the kind of problems Mr Cooper was talking about of deliberately being overprudent one year so you can
borrow back some of the profits that you’ve not made in the next year. That would be very unfortunate.

Mr Cooper: It’s perfectly true that a false sense of precision is something that we want to avoid in financial statements, and it’s very important that we provide the users of financial statements with appropriate disclosure about the degree of subjectivity; the uncertainty in the measurement—for example, loan loss provisions; the uncertainty in some of the valuations of difficult-to-value assets; the risks that companies are running through the positions that they take. There is extensive disclosure; many people say too much disclosure. We are constantly criticised by putting in things that increase the length of annual reports, but we put these things in precisely to avoid this false sense of precision problem that Professor Myddelton identified. I would say that the real push for globally comparable financial statements comes from the investment community. I worked as an investor and as an adviser, and before 2005 it was just horrendous in Europe. The whole idea of trying to compare a French company, a UK company and an Italian company was just completely impossible. There was no transparency. You knew that different accounting systems were being used, but it was very, very difficult to really identify the effect of that. It was just a real brake on the willingness of people to invest internationally, so the whole idea of the international accounting list is to promote that greater flow of capital and people’s ability to make these comparisons on a level playing field.

The Chairman: I think we must move on. We have time for just one last question, Lord Levene.

Q464 Lord Levene of Portsoken: A paper in the journal of the Institute of Economic Affairs argued back in 2006 that government intervention has stifled competition in the audit market and is responsible for the market concentration. Do you agree that adoption of complex standards and regulation are causes of that concentration?

Mr Marshall: I think that standards have become more complex as businesses have become more complex, so I don’t think that more complex standards have just come in on their own. Those more complex standards do, though, require more skills from auditors. When I started as a very junior auditor, you might have got the tax department to come and look at the tax provision but that was about the only outside expert you might have needed. Now you’re getting share option valuation experts, pension actuaries and financial instrument specialists, so I think that the more complex standards, which were caused, I think, by more complex business, do bring in the need for an increased range of skills. That probably tends to push up the optimum size of audit firms, because they do need these specialists.

Q465 Lord Levene of Portsoken: Is that caused by government intervention?

Mr Marshall: I don’t think so. I think that auditing standard setters and regulators have obviously raised the bar on what auditors do, particularly on what they have to document. Auditors spend quite a lot of time now not only auditing but documenting what work they’ve done and the judgments they make. That sort of quasi-government intervention has done that, but I think it’s really the more complex business world that is causing the increased complexity of auditing.

The Chairman: No other comments. Well, gentlemen, thank you very much indeed. I am sorry time has prevented us from going on longer, but it has been very helpful to have you. Thank you.

Supplementary memorandum by the IASB/IFRS Foundation (ADT 50)

SUMMARY OF IFRSs UNDER REVIEW RELATED TO THE GLOBAL FINANCIAL CRISIS

CONTEXT
1. At the request of the Group of 20 (G20) Leaders, the Financial Stability Board, European Finance Ministers and others, the work programme of the IASB continues to be guided by the twin priorities of completing its comprehensive response to the financial crisis, and the completion of its joint work with the US Financial Accounting Standards Board (FASB) to improve International Financial Reporting Standards (IFRSs) and US generally accepted accounting principles (GAAP) and to bring about their convergence.

2. The G20 has called for convergence in global accounting standards to be completed by the end of 2011, as a precursor to the establishment of global accounting standards. The boards remain on track to achieve this goal.

3. IFRSs are now required or permitted by more than 120 countries. By 2012, two-thirds of G20 members will have mandated the use of IFRSs, with the remaining members having established time lines to adopt or converge with IFRSs.

4. This remainder of this summary provides a brief overview of the projects on the technical agenda of the IASB related to the global financial crisis.
Response to the Financial Crisis

5. In particular, the IASB was asked to accelerate the review of aspects of the standards related to:

   (a) financial instruments accounting, and in particular the complexity of IAS 39 Financial Instruments: Recognition and Measurement;
   (b) the effectiveness of the incurred loss model for loan provisions;
   (c) off balance sheet risks in particular related to securitisations (derecognition) and special purpose vehicles (consolidation); and
   (d) fair value measurement (otherwise known as mark-to-market accounting) of assets especially when markets became illiquid.

Reform of Financial Instruments Accounting

6. In order to undertake a comprehensive review of the accounting for financial instruments, while dealing with the most urgent issues in a timely manner, the IASB split the project to replace IAS 39 into three main phases—classification and measurement, impairment accounting (provisions) and hedge accounting.

Phase 1: Classification and Measurement

7. In November 2009 the IASB finalised new requirements for the classification and measurement of financial assets by issuing IFRS 9 Financial Instruments. Although the mandatory application date for IFRS 9 is 1 January 2013, it was made available for earlier application from when it was published. Many jurisdictions have already made IFRS 9 available for use by their registrants, including Australia and New Zealand, Brazil, Hong Kong, Japan (for those applying IFRSs from 2010) and South Africa. IFRS 9 has not yet been endorsed for application in Europe, which prevents European entities that want to apply the new requirements from doing so.

8. The IASB did not address the accounting for financial liabilities in IFRS 9. Most respondents to the exposure draft preceding IFRS 9 told us that the accounting for financial liabilities worked well except for one aspect—the volatility in net income that arises when an entity’s own debt is measured at fair value. In such cases, changes in the creditworthiness of the issuer give rise to net income volatility (the “own credit” question). There is particular concern that as an entity’s credit quality deteriorates, the entity reports accounting gains, which is counter-intuitive.

9. In May 2010 the IASB published an exposure draft proposing a solution to the own credit question. The comment period ended in mid-July and the proposals were well received. The IASB finalised and added these requirements to IFRS 9 in November 2010, with an application date of 1 January 2013 (although earlier application is permitted).

Phase 2: Impairment

10. In June 2009 the IASB sought views on moving to a more forward-looking expected loss impairment/provisions model. In November 2009 it published an exposure draft outlining such a model. Recognising the significant challenges of moving to such a model, the exposure draft had a long comment period of eight months, ending on 30 June 2010. During the comment period, the IASB set up a panel of credit and systems experts—the Expert Advisory Panel (EAP)—to advise the IASB on the operational issues associated with introducing an expected loss impairment model. Prudential regulators were active participants in the EAP, and the IASB and its staff have maintained an active dialogue with prudential supervisors, including regular meetings with the Accounting Task Force of the Basel Committee on Banking Supervision.

11. The IASB received broad support for a move to an expected loss impairment model. However, a number of operational challenges were identified, and the EAP has suggested solutions for many of them.

12. The IASB and FASB have been considering their impairment proposals. In doing so each board began to develop a model for impairment accounting that was a variant of its original proposal. However, both boards are committed to enhancing comparability internationally in the accounting for financial instruments. In particular, they are committed to seeking a common solution to the accounting for the impairment of financial assets. The importance of achieving a common solution to this particular issue has been stressed to the boards by the G20, regulators and others.

13. On 31 January 2011 the boards jointly published a supplement to the December 2009 exposure draft. This supplement presents an impairment model that the boards believe will enable them to satisfy their individual objectives for impairment accounting while achieving a common solution to impairment. The objective remains to complete this phase by 30 June 2011.
Phase 3: Hedge accounting

14. On 9 December 2010 the IASB published an exposure draft of proposals to revise hedge accounting. The proposals address hedge accounting for both financial and non-financial exposures. Of all the phases of this project, this phase is of the greatest relevance to (non-financial) corporate stakeholders. Comments are due by 9 March 2011. The FASB has plans to invite comments on the IASB document.

15. The IASB expects to publish proposals on portfolio hedging in the summer.

Other developments: Balance sheet netting of derivatives and other financial instruments

16. In response to stakeholders’ concerns (including those of the Basel Committee on Banking Supervision and the Financial Stability Board), the IASB and FASB expanded the scope of the joint project on financial instruments to address the netting or offsetting of financial assets. This is the single largest source of difference between the statements of financial position (balance sheets) of financial institutions using US GAAP and those using IFRSs. A common solution would be of great assistance to regulators and other users of financial statements.

17. On 28 January 2011 the boards published a joint exposure draft proposing changes to IFRSs and US GAAP that would align the reporting of offsetting financial assets and liabilities. The changes would be more significant for those entities currently applying US GAAP because, for some US banks, it would result in reporting significantly more assets and liabilities on their balance sheets. The boards have heard consistently from the G20, regulators and others that a common solution is preferable. The boards are aiming to finalise the proposals in the first half of 2011.

ACCOUNTING REQUIREMENTS FOR OFF BALANCE SHEET ACTIVITIES

Derecognition

18. At the time that the financial crisis developed, the requirements in IFRSs and US GAAP in relation to derecognition were different. US GAAP had an emphasis on legal isolation and also had a concept called a “qualifying special purpose entity” (QSPE) that was often used for securitisation arrangements. The IFRS approach is based on a combination of risks and rewards, control and continuing involvement. The financial crisis forced the FASB to make short-term amendments to its existing requirements (SFAS 140 and FIN46R) and improve the related disclosures. As a consequence, the FASB reduced the opportunities to move assets and liabilities off balance sheets by tightening the requirements and eliminating the concept of a QSPE.

19. At the same time as the FASB was making its changes, the IASB developed and exposed proposals aimed at improving the assessment of when a financial asset should be derecognised and also at providing users of financial statements with more and better information about an entity’s risk exposure. The overwhelming preponderance of the responses was that the existing requirements had stood up well during the crisis and that fundamental changes to the IASB derecognition criteria were not needed. However, the responses highlighted the need for improved disclosure to assist investors.

20. Even though some differences remain between the boards’ derecognition requirements, they thought that it would be more appropriate to conduct a post-implementation review of the FASB’s new requirements before conducting any additional work in this area. Instead, the IASB refocused its efforts on improving derecognition-related disclosures for both transferred assets that remain on the balance sheet and for those that are derecognised. The IASB completed and issued those improvements in October 2010 and they are effective for periods beginning on or after 1 July 2011.

Consolidation

21. In 2008, as part of its comprehensive review of off balance sheet activities, the IASB published an exposure draft of a comprehensive replacement of the consolidation requirements, including a new definition of control of an entity that would apply to all entities and that would be more difficult to evade by special structuring. The exposure draft also proposed enhanced disclosures about securitisation and investment vehicles (such as special purpose entities and structured investment vehicles) that an entity has sponsored (or with which it has a special relationship) but does not control.

22. In June 2009, the FASB completed a project that amended and improved US GAAP to address reporting issues in standards for consolidation of variable interest entities (and related disclosures). Those issues had been highlighted by the financial crisis.
23. In October 2010 the FASB, in conjunction with the IASB, held round-table meetings to consider a staff draft of the new Consolidations IFRS. The aim of the public meetings was to help the FASB to decide whether it should publish an exposure draft based on the IASB’s forthcoming IFRS, as a first step towards aligning the requirements for what US GAAP refers to as voting interest entities.

24. In the light of the responses, the FASB has decided to expose the principal-agent sections of the IFRS model. The IASB modified some wording in the staff draft to address matters raised at the round table. The IASB is now finalising what will become IFRS 10 Consolidated Financial Statements, which it plans to issue in late February in conjunction with IFRS 11 Joint Arrangements and IFRS 12 Disclosure of Interests in Other Entities.

25. Some small differences will remain in relation to voting interest entities. US GAAP will continue to allow some entities controlled by votes not to be consolidated. The FASB chose not to implement the full IFRS model now, but to review application of IFRS 10. Despite this gap, the changes made by both boards align the recognition and disclosure requirements for the areas that caused the greatest concern during the financial crisis.

FAIR VALUE MEASUREMENT

26. The objective of this project is to develop a common definition of fair value and common implementation guidance between the FASB and the IASB, such as guidance on measuring fair value when markets are illiquid. Achieving convergence of the definition of fair value is necessary to achieving full convergence of any standards that require a fair value measurement. The IASB standard will not, and the FASB standard did not, introduce any new requirements about when to use fair value. The fair value standards are concerned only with how to measure fair value.

27. In June 2010 the FASB published exposure drafts proposing minor amendments to the wording of the US GAAP requirements and the IASB exposed a proposal to clarify one disclosure requirement. The boards have considered the responses to those proposals and plan to finalise the new standard, which will be IFRS 13 Fair Value Measurement, early in the second quarter.

31 January 2011

Examination of Witness

Witness: Lord Myners [Financial Services Secretary and Government Spokesperson, HM Treasury 2008–10]

Q466 The Chairman: Lord Myners, thank you very much for coming. We are very grateful to you for being with us, because as you know, we had a discussion in particular with the Big Four auditors about the auditing of banks during the 2007 and 2008 financial years, and reference was made to meetings with you particularly in relation to the latter. It is very helpful indeed to have your input as to exactly what happened then. We will, if we may, divide the session into two parts. One is, first of all, to get your view about what happened with the banks during the financial crisis and to have the facts clear from your point of view. As you know, this is a much wider inquiry as well. From your long-standing position in the City, and in business and in government, it would be helpful to have your views on some of the issues that we’re investigating, such as the position of the Big Four and the lack of competition in the audit industry. So could I start with the questions on the banks? I think you’ve seen the transcript. Clearly, the going concern of banks was prominent in the minds of the Big Four when they were auditing the banks and asking to meet Ministers towards the end of 2008. Clearly, what must have transpired—and I think they gave an indication of this—allevied the auditors’ concerns so they were able to testify to going concern. Could you please describe exactly what happened, as far as you can, and the nature of the assurances that you and your colleagues gave the Big Four, which enabled them to take the view that they did on the 2008 year-end audits?

Lord Myners: Thank you very much, Chairman. I was the Financial Services Secretary in Her Majesty’s Treasury from 2 October 2008 until 13 May 2010. You already have, in the papers that have been submitted to the committee, a letter that the accounting profession sent through Mr Griffith-Jones of KPMG on 11 November 2008 to the Chancellor of the Exchequer. The Chancellor of the Exchequer passed that letter to my office and I handled the response from the Treasury. I went to the Treasury to re-examine the papers yesterday morning. I told the Treasury that I thought the papers it showed me were incomplete. It contacted me this morning to say that they were incomplete and that it had failed to show me some other papers that are relevant to this matter. If, after giving evidence and reading the transcript, I find that there is something that those papers cover that I would have given a slightly different or qualified answer to had I been reminded of it, I will of course write to the committee. I doubt whether that will be necessary. I met the
accountants—that is, representatives of KPMG, Deloitte, PricewaterhouseCoopers and Ernst & Young—at 8.00 am on 16 December, and I was accompanied at that meeting by two officials. I noted that going concern was a matter that ultimately required judgment by the board of directors and review by the auditors. I asked them whether the issues that they were raising with me, which are summarised in the letter from the accountants to the Chancellor, had been raised by them in other jurisdictions. They said that that was the case, although discussions were not as far advanced in other jurisdictions as they were in the UK, which I found somewhat surprising as they didn’t seem to be very advanced in the UK as this was the first meeting that I or anybody from the Treasury had had on this subject. They gave no examples of other jurisdictions.

I reminded the four accounting firms of the statements that had previously been made by the Chancellor of the Exchequer and the Prime Minister to the effect that the Government were committed to taking whatever action they regarded as necessary to maintain financial stability. I went on to say that I would like to maintain a regular dialogue with them on this issue relating to the preparation and completion of year-end accounts, and suggested that we have a further meeting at the end of January to review progress. I added that I would be available to meet them between the middle of December and the end of January should the matter become more urgent. They did not seek an additional meeting. I closed the meeting that we held on 16 December by restating that it was most important that the accounts that were produced were clear, fair and honest. I then wrote to the accountants on 17 December 2008. You have a copy of that letter, so I won’t repeat it. I think the only thing that I would emphasise is that I included in that letter a statement to the effect that the Government remain committed to discussions between the auditors, the regulator or the Bank of England. It would seem, however, that such discussions should take place and should be part of a two-way dialogue. To put it simply, it would seem sensible for the regulators, the banks, insurance companies and other financial sector companies to talk to the auditors about the conditions that they see as prevalent in the market place and the concerns that they have. For instance, talking about the valuation of mark-to-model assets, the reliability of market valuations that are struck on the basis of illiquid and infrequently traded instruments that are then applied to a larger pool of assets, and assumptions about the fragility of funding are the sort of things that the regulators should alert the auditors about. The auditors in turn should have a private dialogue with the regulators about any issues of concern that they have, either about the sector as a whole or about specific companies, although if they had concerns about a specific company it would probably be preferable that they expressed those views in the

Lord Myners: A particular issue with the auditing and accounting for banks is that there has to be an underlying assumption of continued confidence, because you have maturity transformation, which is evidence in illiquid longer-maturity assets being funded by quite liquid, short-term liabilities, although an assumption is required to support a bank’s audit that confidence will continue to exist in the depositor and interbank market. I think that’s inherent in the accounting for banks. Whether the directors or auditors should have included some comment in the 2008 accounts to the effect that they had had regard to the crisis in financial markets and had drawn comfort from the existence of committed lines of credit and other sources of funding—including the Special Liquidity Scheme that the Bank of England had set in place and the Credit Guarantee Scheme that the Treasury was operating as part of the package of measures that we announced on 8 October 2008—must be a matter for the judgment of directors and the auditors.
presence of the chairman of the audit committee of the company about which they were expressing concerns. I think that this is a case where more dialogue, more discussion and more exchange of views could only be helpful.

Q469 Lord Forsyth of Drumlean: It is a pretty rough position, two months into your job, to be faced with this dilemma. Clearly, the last thing you want is for the auditors not to be able to sign off the accounts for reasons of confidence, but were you not concerned about the position of the shareholders who were in the dark about these discussions? Lord Myners: It’s quite interesting. I read some of the evidence that the committee has already taken, in which there’s been a lot of focus upon the utility of the accounts to shareholders. I think there are others who rely upon the accounts as well: creditors, customers, depositors, funders, so one is concerned at all times about the strength of confidence that one can draw from the accounts. I think, Lord Forsyth, it was a matter for the judgment of the board of directors, who have ultimate responsibility for preparing the accounts, and the auditors for reviewing the core assumptions, as to whether something was a matter that should be disclosed. I personally was not of the view that some generic statement to the effect that all banks were at the moment exposed to a degree of systemic risk and contagion would either be particularly damaging or particularly alarming to people who could evidently see this with their own eyes. So for me, this was a matter for the judgment of the auditors. I think if they had wanted to put a statement to that effect in their audit report, providing it had been done across the sector—and it seemed to me this was not an idiosyncratic risk but a systemic risk—then I didn’t think that that would necessarily give rise to a further decline in confidence, but it wasn’t for me to put that view to them. That would be seeking to direct them in their professional work.

Q470 Lord Forsyth of Drumlean: Even if that was in the interests of all the stakeholders whom you’ve identified, including the shareholders? Lord Myners: I do not think, Lord Forsyth, it would be for me to alone draw that conclusion. I was meeting knowledgeable and informed people and, as I said, I subsequently met the chairmen of the audit committees because I wanted to make sure that they were focused on the importance of the year-end accounts, because these were critical documents towards restoring confidence in the financial sector.

Q471 Lord Hollick: At the meeting with the auditors, did they say or did they imply that the assurance that you were giving about taking “whatever action”—I think those were the words you used—to ensure financial stability, to protect depositors and to protect taxpayers was sufficient to enable them to sign off on a going concern basis? As Lord Forsyth has pointed out, you carefully did not talk about shareholders or bond holders, two groups that would look to the accounts to see whether their interests were, indeed, safe. Did you have the sense that they had gone away from that meeting comforted and in a position then to give that unqualified going concern, which they subsequently did?

Lord Myners: I hope they left the meeting better informed. It was not my task to give them comfort, and I very carefully in my letter to them did not seek to give them comfort that went beyond what we had already said. That is why I particularly reread that sentence, because, as Lord Hollick has quite correctly picked up, I was quite clear as to the people whom government felt were the focus of the protection of government action: depositors, taxpayers and enhancing general financial stability. This was one of the reasons why I left this meeting very open-ended, with a clear message that I would not have been surprised if they had sought further meetings, either as a group or individually. I did not want them to go away thinking, “That’s it. The weight of responsibility has been removed. We can rely upon the statements given by the Minister”.

Q472 Lord Levene of Portsoken: Lord Myners, just to continue a little bit on that theme, did the Big Four indicate to you that they considered that a letter was essential prior to their signing off the audit reports for the 2008 year-end?

Lord Myners: Not to the best of my recollection. I was clearly positioning my discussion with them on the basis that I did not want to give them anything that they judged essential, because I was very clear where the responsibility lay.

Q473 Lord Best: You did not have a subsequent meeting in January, but had there been a meeting prior to this one to look at the year-end accounts for 2007, and was there one afterwards to look at the year-end results from 2009, or was this event an absolute one-off?

Lord Myners: I obviously was not in office in 2007. One of the notes that I have not seen is the briefing note prepared by officials before my meeting with the accountants, but to the very best of my recollection—and I have a fairly high degree of confidence in this recollection—there had been no meeting in respect of 2007. And to the very best of my knowledge, there was no meeting in respect of 2009—certainly no meeting in which I was involved—and I’m sure that if this matter had been raised again with the Chancellor, he would have again very nimbly passed the file to me.
The Chairman: Are there any other questions on these events? Lord Forsyth.

Q474 Lord Forsyth of Drumlean: Had the Big Four left your meeting and you thought that they were not going to sign off the accounts, that would have been a disaster, wouldn’t it? So you must have had a degree of confidence as a result of that meeting that they were going to sign off the accounts.

Lord Myners: I think we would have waited to see, Lord Forsyth, and I think they would have come back. There was a very clear message, “If you’re having further difficulties and if there are further issues, if you feel you’d like to have a further discussion you know where to find me”. So I was acknowledging that there might be a continued difficulty, but they didn’t leave me with a sense that I had kept them in a position of an impossible dilemma.

Q475 The Chairman: Yet I think they made it clear to us that it was the words you had said to them at that meeting that gave them the comfort, one of the comforts, for signing off the accounts as a going concern.

Lord Myners: I would just remind the Committee that I repeated public statements. I drew their attention very clearly to the comments made by the Chancellor of the Exchequer and the Prime Minister. I think it may well have been the fact that I didn’t say we’re at the end of our tether, the end of our resource. They had a concern, for instance, that we had indicated that we had earmarked up to £50 billion of government funds for the recapitalisation of banks through primary equity, and they had some concern that that pool of money might be exhausted on a first come first served basis, but I don’t have a recollection that they pushed me particularly hard on that point. I think they saw in my eyes and heard repeated the comments by my more senior colleagues in government, that the Government were committed to taking action to ensure financial stability, on which basis I think they could draw some conclusions about continued funding to protect the interests of depositors and the taxpayer.

Q476 Lord Smith of Clifton: Lord Myners, as usual this is all very delphic, is it not? It’s all about nods, winks, intimations and eyebrows raised, or even not, and we all come away with what we want. I, on the part of the Government, have gone some way to intimate that if the worst came to the worst we would be in there. They come away saying, “Well, we’ve got the assurances”, but actually you would need an English literature or linguistic person to deconstruct this conversation. We have gone beyond accountants, economists and business anthropologists. It has become a very elaborate—if I can mix my metaphors—minuet, where we all know what we’re doing, but nothing is so substantive that future historians can do much more than try and feel their way through this and what’s happening. You are a past master of this, I’m sure, and so are those at the meeting in general, but it is terribly difficult to get a handle on what actually happened.

Lord Myners: I am sorry if that’s the case, Lord Smith. As Lord Forsyth said, this is quite a tricky situation for me, still fairly early into my ministerial mini-career. The one thing I was absolutely clear that I was not going to do—they didn’t press me to do it, but if they had done—was to have given some all-embracing guarantee that, come what may, the banks’ shareholders and accounts would be protected. We, as a Government, had been very disappointed when the Irish Government had introduced blanket guarantees to depositors, and the German Government had done something similar. We were very concerned to ensure that the medicine we administered was appropriate to the patient in the form of equity, access to liquidity and assurance to support the taking of deposits. It was focused upon each individual bank according to that bank’s particular needs, I was not giving some across-the-sector guarantee or assurance. I met the senior partners, or close to senior partners, of our major four accounting firms. I think that if they had found me too Sir Humphrey-like, or too delphic, it was incumbent on them to press me. And if they thought that my letter was in some way more conditional than the one they had expected, it was very clear that they could come back to me, and they didn’t do so.

Lord Smith of Clifton: Thank you very much.

Q477 Lord Forsyth of Drumlean: Just to summarise, you were doing what you had to do to get those accounts signed off?

Lord Myners: I was ensuring, at all times, that we protected the interests of the taxpayer.

Q478 The Chairman: And you didn’t have individual talks with individual banks? I thought you—

Lord Myners: I did.

The Chairman: You did.

Lord Myners: They talked about how difficult it was to produce the accounts. This was aside from the issue about whether the Government would do whatever they thought might be necessary in hypothetical circumstances of further deterioration, but they talked about the general difficulty of valuing assets and the trouble their clients were having in this respect. They were always very clear that the primary responsibility lay with the client, so I thought it would be quite helpful and interesting to meet the
Auditors market concentration and their role: evidence

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Chairmen of the audit committees of our major banks. I invited them all in—I can’t remember if they all came—and I invited them to come on their own with a note-taker. They were all, without exception, quite alarmed about that and wanted to bring with them their CFO, their external auditors, their internal auditors and probably their legal advisers. I said, “No, this is just a chat over coffee”. I was, I have to say, Chairman, pretty disappointed with what I heard when I met these fellows—because they were all male, with one exception. When I started asking them about their understanding of the valuation models, the sensitivities of model assumptions, the CDOs; what a CDO² was; and about the limitations of VAR as a concept of risk, on the whole I got some pretty cloudy expressions. When I said, “How do you form a view on whether the assumptions that are being used in your valuation models are appropriate?”, I can best summarise the reaction as, “We’re pretty wise and experienced fellows. We look the executives in the eye and can tell whether they’re trying to pull the wool over us”. I wasn’t terribly impressed. There was one exception, but I am not going to name names.

Q479 The Chairman: Were these one to one discussions?
Lord Myners: Yes, they were. Each chairman of audit came with a note-taker, and I was accompanied at the meeting by one of my officials. In the case of one of the banks, both the incumbent chair of the audit committee and the person who was just about to take the chair came, but in all other cases it was simply one executive and a note-taker, a nice cup of coffee and Treasury biscuit in my small office. I’m sure they enjoyed the meeting, Chairman.

Q480 The Chairman: This is slightly going off on a different point, but do you think that this reflected the fact—and we have discussed this in the committee before with various witnesses—that non-executive directors, and very often, I suspect, senior executives, didn’t understand the complexity of some of the instruments with which the bank was dealing?
Lord Myners: I think that’s a conclusion that many people hold. Indeed I think it was one of the directions of thought in Sir David Walker’s rather good report on the governance of banks and financial institutions. It leads me to believe that this is not a task that can easily be done by a lay-person. I, for instance, am a strong believer that bank audit committees should consider appointing a professional adviser to guide the committee through the language and concepts to help the chairman of the committee to understand the issues on which they should be focused. I say this with the experience of having sat on the audit committee of a major American bank and a number of other financial institutions. My impression is that more can be done and that too much reliance is still placed on the fact that we look them in the eye and try to tell whether they are telling us everything that we should know, and then we look to the external auditors to see whether their eyebrows have gone up. I grossly oversimplify, but I think that that was at the heart of many of the processes that were being followed.

Q481 The Chairman: And the external adviser could either be someone from another audit firm or not from the audit side of the firms all together?
Lord Myners: It could be a retired CFO from another financial services organisation or it could be someone with an accounting qualification or regulatory experience. It seems to me that it would be helpful for lay members of an audit committee, who may well be men and women of considerable experience in the commercial and other sectors. Nevertheless, when you come to value a CDO² with multiple algorithms in support, this is going beyond the reach of a lay person and I think a professional guide could be quite helpful in that situation.

The Chairman: Well, that perhaps leads us to the second part of what we’d like to talk to you about, which is the inquiry more generally. I ask Lord Forsyth to kick off.

Q482 Lord Forsyth of Drumlean: What are your views on the scope, value and quality of the annual audit?
Lord Myners: I think there’s a danger—and here I’m picking up on listening to the end of the evidence given by your previous witnesses—of believing that accounts can convey a spurious accuracy. At best they are an indication of health, but they are critically dependant on a number of assumptions, many of which are qualitative in nature and allow scope for considerable movement within a fair and reasonable band of outcomes. I read the evidence given by the institutional investors, who I have to say were rather an unusual group of institutional investors. You selected the crème de la crème when it came to institutional investors who were interested in these subjects. It would have been very difficult to have assembled a group of similar size of other fund managers with a similar degree of knowledge and commitment to some of the issues that you were discussing. They obviously said that the accounts were important, and they clearly are. I would say that one should always read accounts in the knowledge that there is a high degree of judgment involved, particularly for banks and financial institutions, including insurance companies and insurance
syndicates. The pursuit of accuracy to the last penny may well give people a greater sense of comfort in accounts than accounts can possibly ever give.

Q483 Lord Moonie: Lord Myners, do you consider that the financial crisis reveals a failure of audit? Lord Myners: I think the financial crisis revealed the failure of just about everybody. At the heart of the financial crisis were failures of credit judgment, which were compounded by the fact that credit judgment was increasingly concealed within opaque instruments that were being bought and traded by people with a poor understanding. Central banks failed to see the build up of the asset bubble; Governments failed to give central banks and regulators the appropriate instruments to deal with asset bubbles and asset inflation; and regulators—and I'm not talking here specifically about the UK, although I am not excluding the UK—really weren't up to speed with what was going on. You're hearing in a moment from the credit rating agencies, and I suspect that you'll have some questions as to whether they fell short of the expectations of some, although I'm sure they will tell you that those expectations were falsely assumed. As far as auditors are concerned, I think it's quite interesting that the auditing profession has got off quite lightly. It's quite striking that Bear Stearns collapsed within six weeks of getting an audit sign-off, and Lehman collapsed within five or six weeks of an interim statement that had an auditors' light form report, so I think the auditing profession, the accounting profession, cannot be excluded from those who must share responsibility and, more importantly, seek to learn lessons.

Q484 Lord Tugendhat: Lord Myers, you have almost answered the question I was going to ask you because you said it was a failure on the part of everyone, with which I completely agree—and you went through it in a manner with which I completely agree—and in relation to everybody else conclusions are being drawn. Some of the conclusions, no doubt, you do not entirely agree with, but conclusions have been drawn in relation to regulators and the behaviour of the banks and boards and everything else. The one area in which conclusions do not seem to have been drawn is the auditors. Here we are conducting this inquiry, but so far no very tangible conclusion has been drawn, or change recommended, or anything else. They just sail serenely on. Lord Myners: I agree entirely with the noble Lord. In America, Ernst and Young has been exposed to the consequences of Repo 105, but we've had nothing similar here. In a moment I think you are going to come to the issue of the concentration of the auditing profession, and I think there's a factor at work there. I put a Written Question to the Government two or three weeks ago, asking about the reports that the Financial Services Authority commissions when a regulatory firm or individual gets into difficulty. I believe, from recollection, that they're called section 166 reports. I asked the Government, who passed the letter on to the FSA, for a reply as to what percentage of those reports had been commissioned from the Big Four. And it's an extraordinarily high number. In some years 100% of these reports had been commissioned from the Big Four in terms of fees paid, and I think the lowest percentage in recent years was of the order of 50% of the fees went to the Big Four. So I wonder whether one of the reasons why the auditing profession has not being subject to more scrutiny is because part of the scrutiny exercise has been in the hands of the auditing profession. As we know, the report that has been done for the FSA on RBS—which has not been published and will not be published—was commissioned by the FSA from PwC. I would like to see the FSA broaden the range of people that it commissions, I would like to see it less dependent on external input, and I certainly would like to see it much less dependent on the Big Four than it has become in recent years.

Q485 Lord Tugendhat: Could I add a supplementary to what I said. In the case of regulators, for instance, it lies within the power of government—this Government or any other Government—to change the regulatory system. If that is what it wants to do, it can do it. In the case of the bank boards, you can set up a report by Sir David Walker and he will come up with suggestions for altering bank boards that are very interesting. The problem with the auditors is there they are—the three of them, in effect, with banks—and it's very difficult for anybody to think of an alternative. That is one reason why suggestions are not made. Lord Myners: I think your observation may well be correct. The entire auditing accounting and governance structure is also out with direct government intervention, rather like the Basel III regulatory process, which is also one that is out with direct government involvement.

The Chairman: Well, I think that leads to the last question that we would like to explore with you. Lord Hollick.

Q486 Lord Hollick: You have already touched upon the issue of dominance. Lord Tugendhat says it's the Big Three in the case of financial institutions rather than the Big Four. This clearly worries us and clearly worries a lot of witnesses. What measures do you feel could be taken to reduce the dominant position of the Big Three? How can we bring in other firms, other expertise, to deal with what you have quite rightly described as an extremely complex issue?
Lord Myners: The standard measure of economic concentration in business is the Herfindahl Index, and the Herfindahl Index for auditing is very high and for auditing of banks it is extremely high. The choice available to a bank is very limited by virtue of the fact that in some cases a firm is already auditing a major competitor, and that competitor will not allow the audit firm to take on the audit for another business with a very similar profile. The industry has become very concentrated because it has suited the accountants. They have combined and combined and combined because it has made good economic sense for them to do so to a point where, I think, there is a degree of systemic risk. Can we cope if the Big Four goes to the Big Three, or the Big Two plus one? I think there is a point, Lord Hollick, at which one has gone too far. We may already have passed that point, so what can we do? Enlightened self-interest should be the response. When the investors came to see you they spoke about their encouragement to the tier-A firms, but my sense is that that encouragement has been pretty insipid. The shareholders own the businesses; if they think there's a risk here of concentration, then they should begin to say to companies, “We want you to put your audit out to tender, and we want you to ensure that, as part of that tender process, you give serious consideration to taking a non-Big Four firm. And by the way, we will draw no adverse conclusions from the fact that it’s a BDO audit rather than a PwC audit”. Government can also do something here. When I was on the audit committee of the Bank of England and we were changing the auditors there, I made a strong case for us to include the tier-A firms in those who pitched for the business, although from recollection it went to another Big Four firm. Government as a major commissioner of auditing and accounting services—and conceivably even more with some of the coalition Government’s programme—can be doing much more to reach out to the next-tier firms and giving them greater opportunity. If that doesn’t work, then one has to consider whether there should be an OFT reference and whether—as in the words of Lord Lawson of Blaby when he was at an earlier meeting of the committee—there should be some action to “trust bust”. I, personally, would hope that would not be necessary, and enlightened self-interest should be the first step. But there’s a paradox that everybody believes that it will be good to have more choice but nobody seems to be willing to be the first mover, evidencing a willingness to make that choice and encourage more optionality.

The Chairman: Various inquiries over the last 10 years that have looked at this have come up with recommendations that have made very little difference to the actual situation in relation to the monopoly of the Big Four.

Lord Myners: Which is why I am delighted that your Committee is looking at this matter, because I am sure your recommendations will have an effect.

Q487 The Chairman: What would be the ones that you would most recommend to us?

Lord Myners: I’m going to side-step that one. Chairman, because I think the issues here are so complex that there isn’t a single solution. There are a whole range of issues that will need to be addressed if we are to have a better understanding of the health of companies—particularly of financial service companies—can place greater reliance upon the accounts, and believe that those accounts have been prepared objectively, fairly and through a process that focuses on the end user of the accounts rather than the dominance of the executives, and includes a strengthened role for investors and a strengthened and more effective involvement for the audit committee. I should add one final comment. I believe I asked all the chairmen of the audit committees had they had any meetings with their shareholders because there was a lot of discussion in the press. One bank in particular was being regularly referred to as overvaluing assets, valuing them at a higher level than other banks that were holding the same assets. There was much talk in the financial sector about this, so I asked the audit committee chairmen, “Have your shareholders been to see you? Have they been asking the sort of questions that I’m asking?” Not a single one of them said that they had had a meeting with a shareholder, and I would venture to suggest that if you were to call them all in tomorrow, you would again find that not a single one of them had had a meeting in connection with their year-end accounts with their shareholders.

Q488 The Chairman: But isn’t that one of the weaknesses of the present situation? You rightly said that the investors we had before us last week were a particular pick of those who were most interested in this issue, but even they did not feel that there was a great deal of action that they could take.

Lord Myners: I think the good news for the Committee is that I’m overrunning on my time because I’m about to go on to my favourite subject of the “Ownerless Corporation”. I believe that most of our large companies have such distributed ownership, through diversified portfolio management, that they don’t have anyone who thinks and behaves as an economic model would assume an owner would do. To put it in the words of Rupert Pennant-Rea, “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”.

**The Chairman:** Any other questions? Well on that note, Lord Myners, we thank you very much indeed, particularly for the evidence you have given us on your meetings with the banks. You have left us with a clear feeling that it is a very important topic we’re discussing, but I don’t think we have had any clear guidelines from you as to major recommendations to make.

*Lord Myners:* That was my intention. Thank you, Chairman.

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**Examination of Witnesses**

Witnesses: Mr Paul Taylor [President, Fitch Ratings], Mr Alastair Wilson [Chief Credit Officer, Credit Policy, Moody’s Ratings], Mr Dominic Crawley [Managing Director and Head of Financial Institutions Ratings, EMEA, Standard & Poor’s].

**Q489** The Chairman: Gentlemen, thank you very much indeed for coming in. I apologise for the fact that we are starting a bit late but, as you can see, we have tried to combine a number of different witnesses this afternoon because we are coming towards the end of our inquiry. Thank you for your patience. When you first speak, could I ask you to give your names for the benefit of the recording of this session, and to speak fairly loud and clearly? In order to not prolong the discussion, if in answer to a particular question, the person who first answers is covering the subject completely, or you are happy with the answer, please don’t feel that you need to supplement it, but we are very happy to hear from you in any way you wish. Could I begin with the first question? In the same way as an audit opinion, a rating agency’s rating is relied upon by parties as a form of assurance. In parallel with auditing, is it satisfactory that companies needing such a rating can both shop around between rating agencies and pay the rating agency for their work in rating? How do you preserve your independence and that of the auditors?

Mr Taylor: I’m Paul Taylor; I’m President of Fitch Ratings. I think it’s very important to start with, to go back to your word of “assured”, assurance in rating. There’s a fundamental difference between a credit rating and an audit report. A credit rating is a forward-looking view: we’re trying to predict the future. You can’t have assurance in trying to predict the future so, at some stage some ratings will always be wrong. You look at default data going back 40 or 50 years, and an investment grade rating doesn’t say there’s no risk; it tells you there is a level of risk and the risk should go down as the level of rating comes down. So, you can’t take an assurance from a credit rating; you can use it as a guide, as one of the inputs into the process of assessing a particular situation or company or debt instrument. Perhaps I should stop now and pass over to someone else to speak.

Mr Crawley: Dominic Crawley, I head up the Financial Services Rating Business for Standard & Poor’s for Europe, Middle East and Africa. I would concur with what Paul has said, but I would just add something on the particular question of shopping around. As Paul has said, ratings are forward-looking opinions and they are derived from sourcing information from a wide variety of sources, but they are used against a framework of published, public criteria and analytical methodologies. We stand and we fall based on the criteria we use, which is public. So it isn’t as if we offer different levels of service or product to different people dependent on what they might or might not pay us.

Mr Wilson: Alistair Wilson, Moody’s. I agree with both of the previous comments. I only add that whatever you think of our performance over the past two, three, four years, rating agencies have a very, very strong incentive to build and to try to maintain a strong reputation. That reputation will rest on the accuracy, however defined, of its ratings. That reputation will, in the long term, ensure that the rating agency overcomes any short-term incentives it might have to accommodate issuers.

**Q490** Lord Tugendhat: You heard what we were talking about with Lord Myners; the auditing profession is very highly regulated. You are very much less regulated. When you look at your position and the work you do and the auditing profession and the work it does, would you feel the auditing profession is over-regulated, too prescriptive as we heard earlier this afternoon, or what do you think the balance might be?

Mr Taylor: I think your statement was correct two years ago. I think it’s not correct now. Rating agencies have become very heavily regulated over the last couple of years. It started four or five years ago. We’ve just finished a consultancy period with the European Commission, who have just launched their third round of suggested regulation within the last couple of years. Interestingly, most of the market—the market in terms of treasury associations bank and investor organisations,—and the UK Government came out with a statement; I think I saw it today—are really pushing back quite strongly against the commission in particular, because they are starting to try to interfere with how we do the work, how we reach our decision and how we assign ratings. To give you a specific example, the commission is suggesting that we should give sovereign nations extra time to think about a decision we’ve come up with. So dictat
that we can’t announce the decision we’ve come to until three days after we’ve told the sovereign. We think that opens up all kinds of potential problems. Dodd-Frank in the US is another good example; of increased regulation. You can look at Japan and Australia and many other jurisdictions. We are very heavily regulated now. I’m not sure the sum total of that new regulation is going to add any more than the lessons we’ve applied ourselves from what we’ve learned from what’s happened in this crisis that we have been living through. It helps to give a framework of regulatory confidence around the industry and some of the ideas are sensible, but a lot of it is just simply bureaucracy for the sake of it.

Q491 Lord Tugendhat: So, you are more regulated than you used to be, but you think that the auditors are over-regulated, or not?
Mr Crawley: For the record I would have to say that I’m certainly not qualified to make that observation.

Q492 Lord Smith of Clifton: Gentlemen, do you consider that a rating agency’s rating of a securitisation, for instance, can be regarded by auditors as a reliable guide to asset quality?
Mr Crawley: Let me take that first. Paul has already said that ratings are forward-looking opinions of uncertain future events. Certainly, we do not carry out due diligence on assets or pools of assets; that is not the role we play in the market. What we are assessing is relative credit-worthiness; we are looking at the potential of default. We are not looking at many other factors that go into the assessment of assets in terms of liquidity, value and so on.
Mr Wilson: It’s probably worth adding that credit ratings are usually intended to reflect more than one objective. For example, credit rating agencies will try to ensure that their ratings are both accurate, but stable—which is a balance that needs to be achieved—and the ratings that come from those objectives will not be necessarily directly related to an asset’s value at any one point in time. By “value” you mean its market price, because market prices will reflect a range of factors that are not germane to a credit rating.

Q493 Lord Smith of Clifton: Could you give me some indication of what methodologies you do employ? You just don’t go in and feel the seaweed and say, “up market” or “down market”. What do you actually do at nine in the morning? How do you start your day?
Mr Wilson: If by that you mean how does the credit rating process work, we have a range of methodologies that apply to industries—to particular sectors, particular types of issuer. These are intended to enable us to standardise and systematise the way in which we credit-assess issuers, whether those issuers are from the financial institution sector, structured finance or corporate finance.

Q494 Lord Smith of Clifton: Is it largely a mathematical analysis you’re going for?
Mr Wilson: No, there’s a significant degree of judgment involved in assessing credit-worthiness. The methodologies will employ some mathematical models, but even the methodologies themselves are about trying to systematise judgment, and the rating that ultimately comes from those methodologies will reflect the judgmental overlay from the rating committee. The methodologies are intended to be a starting point for any analysis of credit-worthiness.

Q495 Lord Smith of Clifton: So there is still a lot of tea leaves and seaweed around?
Mr Wilson: There’s a lot of judgment.

Q496 The Chairman: What view do you take, for example, in looking at a company’s accounts, and what the auditor says about the accounts? Is that of great value to you in making your judgment?
Mr Crawley: We would look at a wide range of information that we will then bring and apply against the framework of our criteria. We will look at a wide range of information that’s provided directly from the company that we’re engaged with; we will look at audited financial statements; we will look at market information. Certainly—in terms of the question that was asked earlier on—it is not our role and we do not carry out due diligence, but, when we look at audited financial statements, we clearly will be looking at the audit certificate and will be taking a certain level of comfort or validation from who that audit is conducted by, and the facts of the audit certificate.

Q497 Lord Hollick: Mr Crawley, you made a couple of remarks, which I hope I noted down correctly, which puzzle me. You said that when you do a rating, you are looking at a forward-looking opinion, and secondly, you said you don’t look at the underlying assets in a bond. My source on this is Mr Michael Lewis’s book, The Big Short, and he describes the rating agencies giving AA ratings to bonds where the information was available by careful and diligent inquiry, that the underlying assets in the bonds—the CDOs—were already not performing properly, keys were already being handed back in, and that enabled those who did that work to make a fortune by betting against those bonds. I’m puzzled at how you can form a judgment as to a rated bond without doing diligent inquiry as to the assets that underlie it. It’s nothing to do with a forward opinion; it’s actually what happened today and what happened yesterday.
Lord Hollick: To pick a couple of examples, and as well, though some of the stories are What was interesting in the Sorry, Mr Crawley, are you—

Mr Taylor: Let me try and answer it. We do look at the underlying assets, of course we do. If you take a mortgage bond, for example, it’s a transaction which is, say, several thousand individual mortgages packaged into a cash-flow instrument. We look at the mortgages in aggregate and you rely upon the data given to you, which is generally audited so it is checked. We don’t, for example, go and revalue several thousand properties; we rely upon that data being accurate. We then apply stresses to it, but we are looking at underlying data. The fact that our assumptions on the underlying data prove to be incorrect, or not stressful enough, was the issue that caused all the problems—I enjoyed reading The Big Short as well, though some of the stories are embellished. There are always a few people who take the counterargument, of course. Time has passed and it’s amazing how many people now say they saw the problem coming.

Q498 Lord Hollick: What was interesting in the book is that they did so based upon publicly available information, rather than guesswork.

Mr Taylor: To keep things in context here, the major problem in the US housing market was the sub-prime assets, the lower quality assets. For prime assets—normal US mortgages—the typical loss number for AAA credits was something like 3% to 5%, so we assumed a loss level of 3% or 5%, which compares to less than 1% historically. For sub-prime assets, the average assumption was something like 20% to 25%, and the number was increased between 2004 and 2006. It went up by a few per cent; it went from 25% to 26% or 27%, so we were building in the declining quality of asset analysis. What we should have done is to build in a 50% enhancement level. The level of meltdown was way in excess of our worst-case assumptions.

Q499 Lord Shipley: By support do you mean support from the Government?

Mr Taylor: We are rating the debt instrument. Will you get your money back on a particular bond or security?

Lord Shipley: Sorry, Mr Crawley, are you—

Mr Crawley: My Lord, I wish to be helpful to your question, but what you are referring to is the structured finance side of the ratings business, which is not my area of responsibility or my area of specialisation so it is difficult for me to comment on that. I don’t know whether—

Mr Taylor: Let me try and answer it. We do look at the underlying assets, of course we do. If you take a mortgage bond, for example, it’s a transaction which is, say, several thousand individual mortgages packaged into a cash-flow instrument. We look at the mortgages in aggregate and you rely upon the data given to you, which is generally audited so it is checked. We don’t, for example, go and revalue several thousand properties; we rely upon that data being accurate. We then apply stresses to it, but we are looking at underlying data. The fact that our assumptions on the underlying data prove to be incorrect, or not stressful enough, was the issue that caused all the problems—I enjoyed reading The Big Short as well, though some of the stories are embellished. There are always a few people who take the counterargument, of course. Time has passed and it’s amazing how many people now say they saw the problem coming.

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highly rated securities are able to perform with a high level of stability demonstrable by the high ratings that they are given.

**The Chairman:** Do you want to go on to the next question about Big Four?

**Q501 Lord Shipley:** Do any of you employ Big Four firms to assist you with any of your work and, if so, do you find market concentration of public accounting firms sometimes unduly restricts your choice?

**Mr Crawley:** The straight answer is, no, we don’t. We make use of audited financial statements, but we do not engage in a contractual sense with firms of auditors.

**Mr Wilson:** We occasionally use consultancy arms to carry out small projects—

**Lord Shipley:** Sorry, I missed that.

**Mr Wilson:** Sorry, we occasionally use consultancy arms of the Big Four to carry out projects for us, but as regards the audit practice, it’s precisely as Dominic says.

**Q502 Lord Hollick:** When we talked about the Big Four’s concentration, we referred to concentration in other parts of market, and obviously the rating agencies are a case in point. How did the concentration come about? Do you feel it acts against public interest, that there is lack of choice? For instance, why isn’t there a rating agency that has a different economic model that is paid for by investors rather than the banks themselves, which might lend it a greater degree of independence?

**Mr Crawley:** There are two questions. Perhaps if I take the first one. I think how we have a fairly small number of large rating agencies probably comes from two basic characteristics. One is that our relevance in the market is built upon reputation and it’s built upon performance, and therefore a long-time series track record of our ratings performance and ratings transition is important and clearly that is something that is established over a long time. I think the other issue is that a relationship between an entity and ourselves—whether it’s a large corporation or insurance company, bank, local authority, whatever it is—is a fairly intense relationship. It is regular contact, a lot of dialogue and, therefore, from the client’s side, so to speak, it’s fairly intensive. Therefore to have a large number of similar individual types of relationships from their side probably would not make sense. I think an element of the concentration has developed as a result of those two features.

**Mr Wilson:** Yes, I would say I agree with Dominic. The concentration has risen to a large extent because of the way commercial firms have responded to what they think their clients’ investors want. Investors want ratings that are comparable across regions, globally comparable, comparable across time. That tends to be best delivered by large firms with large global resources. I think it’s also, and this is long before my time, fair to point out that originally—certainly for Moody’s; I am not sure about the other two—the model was “issuer pays” until the early 1970s, but it moved away from that towards “issuer pays”. As I understand it, and, as I say, this is way before my time, that was to enable Moody’s to help meet investor needs and wishes for more research. So we have moved from the “issuer pays” model to the “issuer pays” model.

**Mr Taylor:** Sir, our current industry structure is largely a result of inertia. We always have here the Big Three; actually we’re a third the size of these two guys. We’re the new player in this market and we have only really existed in this form for about 10 years. We’re the result of putting together some of the smaller agencies in the market to try and compete with the big two players. The inertia in our market and the inclusion in investor guidelines, for example, is immense. There are thousands of individual accounts that we have to get out to. We were doing pretty well at that until a few years ago when the whole market had its own problems. So a lot of it is inertia. There are something like 150 rating agencies in the world, of which a good number are “issuer pays”, so that model does exist. There’s nothing stopping that model. It comes down to economics at the end of the day. It’s very, very hard to build up a significant team with just an “issuer pays” model, because investors are used to getting things for free. Even the new players that have been announced—there have been a number of new launches, pretty high-profile launches with significant financial support behind them—have all launched as “issuer pays” models. It comes down to us to manage the conflicts inherent in that model. There are conflicts in the “issuer pays” model as well. If you have an investor who is providing a large proportion of your revenue, the investor might have an interest whether your rating goes up or down, so there are conflicts whichever way you look at it. If you use a government-funded approach, that’s probably the most conflicted path you could go down. So what does the UK Government-funded agency do when it wants to take action on the UK, or a big UK bank? You can imagine the conflict. In our industry there are lots of players; the challenge you have is how many ratings does an entity want? You can push hard to get in there as an additional rating if you’re the third player coming in; if you’re a bank do you really want four, five, six credit ratings? The answer is, no, you don’t. Really the first two places are taken and it’s incredibly difficult to get rid of an S&P or Moody’s rating if you are a rated entity. That was just beginning to happen a few years ago, and we’ve just started to see the signs of that happening again.
**Q503 Lord Moonie:** Do auditors have access to any information from the rating agencies beside published ratings? Is there any dialogue between auditors and rating agencies about the quality of assets and bank balance sheets? Do you consider such a dialogue needs to be developed, or perhaps institutionalised?

**Mr Crawley:** My Lord, there were two or three questions there. To answer the first one, no, they do not. Like everyone else in the market they have access to the ratings and the information and research opinions and analysis that gets published and placed on our public website. I think in response to the second question what I would say is the market knows what we do and the market understands what we do, and the market knows what auditors do and understands what auditors do. We talked earlier on about what our ratings are and how we go about constructing them, and we don’t see there would be any benefit through additional dialogue. They do what they do, and they’ve done it for a long time, they’ve established processes, procedures, resourcing and everything, and that is their specialisation. Our specialisation is what we do.

**Mr Wilson:** I think you could imagine a situation in which an issuer was prepared, or wanted its auditors to talk to the rating agencies in order that the rating agencies had a better understanding of, for example, the control framework in the issuer. So I can imagine a situation in which the information flow would usefully work in that direction. I think it’s very difficult to imagine a situation in which information was flowing in the opposite direction because it would raise some real confidentiality independence issues.

**The Chairman:** Any other questions? Gentlemen, thank you very much indeed for coming. We are very grateful to you for giving an insight from your point of view, and apologies again for a late start. Thank you.
GOVERNMENT MEMORANDUM OF EVIDENCE

INTRODUCTION

1. The Government welcomes this inquiry, which is one of a number of initiatives looking at the role of audit in the aftermath of the financial crisis. The Government has not reached firm conclusions on the need for changes to the present role of audit, since it would be wrong to do so until the conclusions of the present debates are clear. Any response to the financial crisis needs to be based on sound evidence, not knee jerk reactions or partial analysis. The Government is willing to consider alternatives, with the aim of ensuring high quality, but cost effective audit assurance for UK companies, in order to ensure the maximum economic benefits to companies and the UK economy.

2. Apart from the work of the Select Committee, there are several other important streams of work presently ongoing, amongst which are:

(a) the Financial Services Authority (FSA) and the Financial Reporting Council (FRC) have issued a Discussion Paper on “Enhancing the auditor’s contribution to prudential regulation”;

(b) the European Commission is scheduled to publish a wide ranging Green Paper on audit in the Autumn; and

(c) the FRC has announced that it expects to publish, also in the Autumn, a discussion document to examine the lessons learned from the credit crisis and other market developments as they impact corporate reporting, accounting and auditing of non-financial services companies.

3. The Government asked its officials to review the evidence base on the role and value of audit in order to assist in determining the direction of future policy. The discussion of the academic and other papers referred to in this memorandum is a result of this exercise. The results of the review of the evidence base have also been sent to the European Commission and the FRC.

THE REGULATION OF AUDIT AND THE GOVERNMENT’S ROLE

4. The present structure for statutory audit in the UK is based on the Companies Act 2006. Shareholders of companies (unless exempt—such as most small companies) are required to appoint external auditors for each financial year. The auditor is required to report to shareholders on whether the accounts have been properly prepared and constitute a true and fair view of the state of the company’s affairs.

5. The auditor is required to follow the technical and ethical standards as set by the Auditing Practices Board, and an audit firm wishing to be appointed as a statutory auditor in the UK must be registered with, and supervised by, their Recognised Supervisory Body.1 Auditors are subject to inspection by the Recognised Supervisory Body (RSB) to which they belong, and these RSBs are in turn overseen by the Professional Oversight Board (POB), part of the FRC. Through its own Audit Inspection Unit, the POB reviews the quality of the audits of listed and other major public interest entities. Smaller audits are subject to review by the monitoring units of the RSBs. A further part of the FRC, the Accounting and Actuarial Discipline Board provides for independent investigation of important cases of poor auditing.

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1 Association of Chartered Certified Accountants (ACCA); Institute of Chartered Accountants in England and Wales (ICAEW); Chartered Accountants Ireland (CAI); Institute of Chartered Accountants of Scotland (ICAS); Association of Authorised Public Accountants (AAPA).
6. The Department for Business, Innovation and Skills has the following roles in relation to audit:
   (a) It is responsible for the Companies Act 2006 and associated regulations.
   (b) It takes the UK seat on the Audit Regulatory Committee, which assists the European Commission
       in its adoption of measures under the Statutory Audit Directive using the comitology procedure.
   (c) It is responsible for the regulatory framework of UK law on audit, and for ensuring that it remains
       consistent with EU law, by implementing into UK law the 2006 EU Statutory Audit Directive and
       associated Commission Decisions.
   (d) It keeps abreast of audit issues as an observer on the UK’s Auditing Practices Board and through
       contacts with stakeholders.
   (e) It sponsors the Financial Reporting Council.

7. We have attempted to estimate the costs of audit in the UK: information provided to the Professional
   Oversight Board by 31 of the larger UK audit firms, shows that together they earned in excess of £2 billion in
   2009 in audit fees.2

THE PRESENT CHALLENGE

8. The aftermath of the financial crisis has raised questions about the role of audit, in particular why banks
   failed shortly after having clean audit reports, and what the role of audit is, if it is unable to warn of such
   incidents. These questions were articulated very clearly by the 2009 report of the House of Commons Treasury
   Select Committee. Alongside the questions raised by the economic crisis, there are other current pressures for
   change: the investor community has been expressing concern about audit reports, including that they should
   contain much more useful qualitative information about the company, rather than just the “pass or fail”
   opinion on the numbers in the accounts that is currently provided. Alongside that, there is the longstanding
   concern, discussed later in this evidence, about the concentration of supply of major audits in the hands of a
   very small number of audit firms.

9. The present crisis is not, of course, the first to result in challenges to the audit structure. It is notable that
   the reaction to this and previous crises or scandals has been to tighten the regulation of accounting and audit.
   The present system came into being largely as a result of the Enron and other corporate scandals in the last
   decade: amongst other measures, the ethical standards of the Auditing Practices Board have been revised; the
   Audit Inspection Unit was formed for monitoring the audits of all listed and other major public companies;
   and law now contained in the Companies Act 2006 increased the rights and powers of auditors in relation to
   information from employees, officers, directors and subsidiaries. Nevertheless, these steps have not prevented
   some parties from criticising audit and the auditors for failing to stop the most recent crisis from occurring.
   Others feel that the crisis cannot be attributed to a failure in audit and auditors.

10. As a result, the Government is inclined to be cautious about adding to the role of audit or its regulation
    in relation to published accounts enhancements, which have the potential to increase costs to the economy,
    unless it is clear there are significant benefits, and these have been demonstrated by a robust assessment of the
    economic impacts, in line with the Government’s commitment to better regulation. The outcome of this, and
    other current debates will inform Government thinking.

THE ROLE OF AUDIT

11. Ideally, the current debate on the role of audit would be based on a clear understanding of exactly what
    value audit adds to the economy. Unfortunately, the academic and other evidence on this is not conclusive.

12. The theoretical rationale3 for audit is that it is demanded under two conditions:
   (a) accountability, whereby an agent gives an account of his actions to a principal; and
   (b) complexity, where principals are distant from the actions of an agent and unable to verify them.

   This leads to two consequences:
   (a) moral hazard, when agents may act against the principals’ interests; and
   (b) information asymmetries, when agents know more than principals.

   Thus audit is a risk reduction practice which benefits the principal because it inhibits the value reducing actions
   by agents. The categories of principal and agent can be filled out in a variety of ways. Principals can comprise,
   for example shareholders, creditors and tax authorities.

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2 UK Professional Oversight Board Key Facts and Trends in the Accountancy Profession calculated from p.46 http://www.frc.org.uk/pob/publications/pub2301.html
13. In voluntary audit environments:4
— where a company has an audit voluntarily, it does benefit from a reduction in its cost of capital because of the signalling effect of the audit,5 and the bigger the company the more likely it is to have a voluntary audit.6

14. The theoretical justification for mandating audit is that it increases confidence in, and the strength of, the financial system, but it is not clear, for instance, what value is added by a mandatory (rather than voluntary) audit regime: for example, whether mandating audit works to decrease the cost of capital across the economy.7

15. In mandatory audit environments, the signalling effect of voluntary audit is lost, because all comparable firms have to have an audit, but voluntarily opting for higher quality audit8 enables companies to regain some of the effect. This research also demonstrates that bigger companies gain disproportionately more from higher quality audits than smaller companies do. Bigger audit firms are perceived to offer higher quality audits9 partly because of their increased expenditure on training, systems and branding, partly because they have more to lose in reputation10 and partly because they have more to lose via litigation11 (auditor liability). It is difficult to split these effects.12 There is some evidence that audit firms that specialise in industry sectors deliver audits that are acknowledged to be higher quality, but the effect is reduced in regulated industries (eg banking) because regulation acts as another substitute.13 Financial directors and investors do however find audit valuable in checking company compliance with accounting standards and other regulatory requirements,14 while they do not find value in the very limited (and often boiler-plate) qualitative assessment currently provided.15

16. There are other modes of assurance available for regulators, companies and investors as an additional support or substitute for audit and vice versa. These include accounting standards, dispersed ownership, risk management committees, audit committees,16 internal auditors, credit ratings, insurance markets, investment

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analysts, or additional disclosures above those mandated by accounting standards and the law, and regulatory and supervisory bodies. Hence, rather than having a unique role to play in corporate reporting, the importance of audit is as one element in a multi-faceted regime of corporate governance and regulation.17

17. Mautz and Sharaf, in their seminal work on auditing (1961),18 suggest that audit works best in normal environments—that is, in non-collapsing systems and non-fraudulent firms—where auditors can expect that normal audit procedures will uncover normal errors and normal managerial misstatements. This suggests that audit cannot provide a defence against systemic risk in an economy.19 Audit also provides only a limited defence against material fraud in a company, especially where there is significant collusion by senior management. These issues give rise to the much quoted expectation gap, which arises where people expect to get more assurance out of an audit than is in reality provided, or can be provided—there is an expectation gap in as much as the audit is often assumed to provide a greater degree of assurance than it can actually provide.

WAY FORWARD—DEBATE ON MANDATING AUDIT?

18. Given this evidence, it seems to the Government that there is value in a debate about the extent to which audit should be mandatory, and what the nature of any mandated audit should be. The Government’s view is that audit has an important but not unique role to play in ensuring vibrant capital markets. It is less clear that a modern audit, designed largely for listed companies with diverse shareholders, should necessarily be imposed on, for instance, a medium sized owner-managed company. This is a debate which will need to take place at EU level; the current accounting directives do not allow the audit requirement to be lifted, other than from small companies or subsidiaries. At the same time, given the importance of key financial institutions to the economy, the Government recognises the need for auditors to contribute to prudential supervision as described in the FSA/FRC Discussion Paper.

AUDITOR INDEPENDENCE

19. Professor Ray Ball suggested that both the fact that auditors are remunerated by companies and the total level of that remuneration inevitably affect auditor independence and judgement.20 This has the potential to make it hard for auditors, who are in reality selected by management,21 and who are commercial organisations, to stand up to management, particularly when financial results are poor.22 Lennox (2000) shows that companies are able to engage in opinion shopping23 in their choice of auditor. However, opinion shopping in the UK is likely to be infrequent, given the very low switching rates for auditors described later in this paper. Geiger and Raghunandan (2002) find some supporting evidence that auditors are more likely to issue a clean audit report prior to a bankruptcy filing in the early years of the auditor-client relationship.24 However, there are a number of reasons that there may be problems in the first year of an audit relationship, as the auditor builds familiarity with the client’s business, and audit and its regulation have changed significantly since Enron.25

20. The Government’s view is that while there is no evidence of systematic problems of auditor independence, the body best placed to bolster auditor independence is a strong audit committee.

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21. Geiger and Raghunandan (2002) find some supporting evidence that auditors are more likely to issue a clean audit report prior to a bankruptcy filing in the early years of the auditor-client relationship.

22. However, there are a number of reasons that there may be problems in the first year of an audit relationship, as the auditor builds familiarity with the client’s business, and audit and its regulation have changed significantly since Enron.


24. The audit crunch: reforming auditing in Managerial Auditing Journal Vol. 24 No 2, 2009 p.135–155

Way Forward—What should be in the Report?

21. The challenge to auditors that they should have seen the bank collapse coming is linked to the question about what should be said in the audit report, which has been raised by investors and other users. Elements of the developing investor view are that the standard audit report is not very useful at present in that it is of standardised form, and could be reformed to include useful company-specific information and the auditor’s view as to the degree of aggression in the company’s accounting choices. There could also be more disclosure about the risk position of the company, and the key judgements taken during the course of the audit. Such an approach, it could be argued, might have provided some forewarning of the collapse of the banks, but it is hard to see that audit alone could provide a defence against systemic risk of that kind. However, the Government is committed to the objective of improving bank corporate governance and will continue to work closely with the EU and internationally to increase transparency and accountability in a consistent and proportionate manner. The joint Discussion Paper by the FSA and FRC already referred to explores wider ideas about the contribution of audit to prudential regulation.

22. The audit profession concedes that there may be some room for improvement in making audit reports more informative, but it has concerns that by providing more information or assurance, it will be exposed to greater liability. This could tend to push up fees, or increase pressure for more liability protection for auditors, or both. Ian Powell, the Chairman of PWC in the UK is quoted as saying “On a bilateral basis, you will not see an auditor start making a more informative audit report while the rules are as they are and there’s unlimited liability”. There would need to be clear evidence that the information benefit exceeded the cost either in fees or liability capping before Government would act.

23. It is not clear that the company specific information sought by users is best provided by an auditor. There is an argument that such issues and information about the company are more properly disclosed by the audit committee and management, with the auditors then possibly providing some assurance over the accuracy of the information. Whether information were to be disclosed by the company or by the auditor, it would be a challenge to ensure that genuinely useful company specific information is provided, and not just boiler plate. It is by no means clear that a mandatory requirement is the best route to securing disclosure of the information. Some form of voluntary route could be considered, perhaps by an amendment to the UK Corporate Governance Code.

24. Research on a sample of listed companies published in 2009 by the Financial Reporting Council shows that for many listed companies there is much room for improvement in their narrative reporting as required by the Companies Act. In the reporting of the principal risks facing their business, 66% of companies were technically compliant with the law, but fell short of the spirit of the requirements. In providing a description of their business, 58% of companies were either not compliant with the law, or were technically compliant but fell short of the spirit.

25. It is therefore not obvious exactly how to achieve more informative disclosure of the affairs of companies, either by management or by the auditors. There are clearly costs associated with the various routes, and it may be hard to achieve the benefits desired. It is for these reasons that the Government has not come to a firm view on the way forward, and wishes to see the outcome of this inquiry by the House of Lords and other debates.

Audit Market

26. The market for the supply of audit for public interest companies in the UK is very concentrated. Just four firms undertake the audits of 99% of FTSE100 companies and 95% of FTSE 350 companies. Complex sectors such as finance are already reduced to two or three audit firms that have the necessary expertise to undertake these audits while auditor independence rules can further reduce this choice.

27. In the late 1980s there were eight major accounting firms that provided audit services. Since 2003, there have only been four. This is a result of a series of mergers including Price Waterhouse and Coopers & Lybrand, which was approved by the EU in 1998 and the collapse of Arthur Andersen in 2002, which resulted in the UK firm merging with Deloitte. The Deloitte merger was approved by the EU who raised competition concerns but concluded there was no better alternative as the international Andersen network had effectively collapsed.

28. The share of the audit market held by the Big 4 differs across G8 countries. In 2007, Canada, Italy, UK and US had the greatest concentration of the Big 4, accounting for a market share of 95% or higher, followed by Russia at 90%, Japan at 84% and France at 61%.

26 Financial Times 7 June 2010 PWC boss seeks an open debate on regulation by Rachel Sanderson
29. The high concentration levels in the UK audit market are limited to the audit of FTSE 350 companies. Smaller companies have access to a much wider selection of firms, for example there are 119 medium sized audit firms with between 11 and 50 Principals.  

30. The Government has been concerned about competition for FTSE 350 audits for some time. BIS and the FRC jointly commissioned an independent analysis of competition in the audit market. This paper was published in April 2006 and the main findings were:

(a) The FTSE350 market for audit services is highly concentrated.
(b) Switching rates are low at around 4% on average for all listed companies, and 2% on average for FTSE100 companies.
(c) A limited number of UK listed companies, primarily in the financial services sector of the FTSE100, have no effective choice of auditor in the short run. This elimination of choice is driven by high market concentration, auditor independence rules, supply-side constraints, and the need for sector expertise.
(d) Higher concentration has led to higher audit fees (although this finding of the report has been disputed). While there is a degree of price sensitivity among companies, and some bargaining on fees takes place during the annual audit firm reappointment process, in general the focus of audit committee chairs is more on quality (and reputation) than on price. Separately from the impact of concentration, audit fees seem to have risen in recent years as a result of cost increases, caused by factors such as change in regulation.
(e) A range of barriers to entry to new competitors helps to sustain this concentration, in particular:
   (i) Acquiring a credible reputation/perception of reputation;
   (ii) Establishing an extensive, integrated network; and
   (iii) Resource and technical expertise in audit.

31. In response to the competition issue, the FRC established the Market Participants Group (MPG), which comprised representatives from companies, investors and audit firms. They were tasked with advising the FRC on possible action to mitigate the risks arising from the concentration. Their advice was limited to market-led solutions with responsibility for implementation of their recommendations falling to the FRC. Most of the recommendations have now been implemented and the FRC recently published their fifth progress report. They have found that the market-led approach has not had a significant impact on market concentration and the FRC are currently undertaking a review with the aim of developing further proposals. This review, alongside the Commission Green Paper, will feed into HMG’s future policy on competition in the audit market.

32. The Government will be working closely with the FRC on its review. Without in any way wishing to prejudice the outcome of that review, the Government’s initial view is that, with the current (four-player) state of the audit market, it may be difficult to identify measures that will be effective in increasing choice for the largest audits without also imposing major costs. Those costs might be hard to justify.

10 September 2010

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28 Professional Oversight Board Key Facts and Trends in the Accountancy Profession June 2010 p 20  


http://www.frc.org.uk/publications/pub2289.html
Examination of Witnesses

Witnesses: Mark Hoban MP, [Financial Secretary, HM Treasury], Edward Davey MP, [Minister for Employment Relations, Consumer and Postal Affairs, Department for Business, Innovation and Skills], and Richard Carter, [Director Business Environment, Department for Business, Innovation and Skills].

Q504 The Chairman: Good afternoon, gentlemen, and thank you very much for coming. I think you know the form of these Select Committees extremely well, although the House of Lords Select Committees are not quite as rumbustious and political sometimes as those in the other place. The only thing I would ask you is to give your name when you first speak, for the benefit of the Hansard writers and the text we eventually publish. You will probably have seen a little bit of what we have been doing, and you will know that we are now concentrated on three main topics: the first is the topic that we started with and is the main topic, which is the issue of the Big 4, competition and choice. But we have also been looking quite heavily at auditors and the banking crisis and also at the impact of IFRS on auditing. Some of the questions we may ask you are pretty technical, so we are quite happy with short answers so that we can concentrate on the big issues. I want to kick off on the Big 4. I think the general attitude of most of our witnesses has been that this is a serious issue. Even the Big 4 were concerned about the risks and dangers of coming down to the Big 3. It is not too difficult to produce recommendations that have had or are likely to have little effect, so we are looking to see if we can find recommendations that might have some effect. But first I ask you to establish your position. Is the Government concerned by the domination of the Big 4 in the audit market, especially if—as seems possible—it were to be reduced to the Big 3? What measures would you support to increase choice in the audit market?

Edward Davey: Chairman, if I may, I’m Edward Davey. I’m the Minister for Employment, Postal Affairs and Consumer Affairs in the Department for Business, Innovation and Skills; and, yes, we do have concerns about this. We certainly welcome your inquiry to help shed more light on this debate and indeed extend that debate more widely. I would say we have some serious concerns, particularly on the effect on competition and the problems that that could cause, whether in terms of lack of choice or higher fees and so on. I’m very happy to lay out a whole number of measures that we are considering. I should say that I know some of your witnesses have suggested there is a huge systemic risk here. I’d like to say that we don’t see that quite in the way that I think some of your witnesses have done, partly because audit is only one element of the assurance that investors and capital markets can have. There are accounting standards; there is internal audit; there are audit committees; there are credit ratings; insurance markets, and so on, which will play a part of that wider assurance piece. I think we should be very clear that none of the Big 4 is too big to fail. But yes, we have some serious concerns. We do think there should be contingency planning but I think our major concern is to ensure there is improved competition. There are obviously two elements of that: the demand side and the supply side. On the demand side I think we can persuade firms to change their auditors more frequently and look at other auditors outside the Big 4, particularly obviously in the FTSE 100 and other big listed companies. There are some approaches that are quite regulatory, but we are not attracted to a very heavy-handed approach. I wouldn’t want to shut the door on it but that is not our first approach. We do believe that, by getting greater transparency and more disclosure by companies, particularly through the organ of the audit committee, we can give greater information to investors, to the capital markets, about how decisions are made when a firm takes on an auditor. I think we would be looking to see greater disclosure and transparency about the procedure adopted on taking on an auditor; how long a firm has used its existing auditor; what its policy is on testing the market for other auditors. I think we would like to encourage greater transparency and disclosure from audit committees—that would allow investors to have that information so they can challenge those decisions. Maybe there is a role for further development of the relative 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? So I think there are some ways we can tackle this from the demand side, and I’m particularly keen to do that. That is the real problem: I think a lot of the larger companies have wanted to seek security in going for one of the Big 4 and I think we have to challenge that culture, that status. On the supply side, I think there are companies in the UK which are more than capable of taking on some of the large, complex audits. I think people sometimes think that outside the Big 4 there aren’t the skills, but I believe—certainly from the evidence I’ve seen—that there are the skills there; there are British companies which are a very large footprint in audit; they operate in many different markets. There may be a lot of things that can be done there, but I would put a lot more emphasis on the demand side and the sorts of measures I’ve talked about with respect to transparency and disclosure.

Q505 The Chairman: We will come back to the supply side because we are very much aware of some of the difficulties facing the next tier of firms in competing in the Big 4 market, and I’m not sure I am quite so
sanguine as you are that there are possibilities there without help and assistance. But for the moment I want to focus on two things. You mentioned contingency planning in the possible situation of going down to the Big 3. I think it was the Big 4 auditors themselves, when asked this question, who said: “Well, contingency planning is for the Financial Reporting Council”. Don’t you think it is for Government?

Edward Davey: I think it is probably for all the players if they are meeting their responsibilities; Government would clearly have a role in thinking about what would happen in such an event. There are some obvious things that one would look at; extra time for filing, for example, when the contingency actually happened. You mentioned the supply side, and I don’t want to give you the impression that I don’t think there are some supply side responses, particularly with respect to contingency planning. So, for example, we could look again at the restrictions on shareholding by non-auditors in auditor companies because that might potentially provide capital, both for existing firms or firms that were struggling and needed recapitalising. So I think that those rules and flexing there could help the supply side, particularly in terms of contingency planning for this area. I would hope that the Big 4 would look at living wills. I think they have a responsibility to think about what would happen and to plan for that.

Q506 Lord Tugendhat: In view of the concern you expressed, I do think the Government itself could do a great deal more. Government departments and Government agencies make a great deal of use of auditing firms. At the moment I am chairman of Imperial College Healthcare—so I am involved in that world—and the Department of Health always uses the Big 4 in dealing with health trusts; Monitor always use the Big 4. There is a tremendous flow of business from the Department of Health and I think from other Government departments as well. I recognise some of it is quite complex stuff; some of it is quite high profile stuff like commercial concerns. You want the seal of good housekeeping that the Big 4 provide but it does seem to me that, in the light of the concern you express, the Government has plenty of scope to provide work for non-Big 4 firms in a variety of Government departments and Government agencies.

Edward Davey: I wouldn’t disagree with that. In general, the Government is very keen at looking at how we procure goods and services and to see if that can be improved, with a particular emphasis on seeing if we can ensure that SMEs—who often complain that the procurement system works against them—can access public procurement. I am working with the Minister for the Cabinet Office on this issue, both in terms of how it affects our domestic workings, and indeed with respect to reform proposals that are coming from Commissioner Barnier with the Single Market Act. So I think procurement generally is important and—to speak to your point—with respect to the procurement of business services, particularly audit. Indeed there is a role and I wouldn’t want to give you the impression we’re closing that off, far from it. We want to encourage a very competitive market for procurement of Government services including audit.

Lord Forsyth of Drumlean: We are talking as if there was a choice for most firms but in fact, if you take product or area specialisation and you take conflicts into account, actually choice is very limited. Listening to what you are saying, in terms of perhaps we could encourage people to look at wider alternatives when they come up for tender—I can’t remember the exact figure, I think it was every 48 years that an FTSE 100 company changes auditor—do you not think that perhaps the department is just a little bit complacent on this? Because listening to what you are saying I’m thinking, “Is it going to make any difference to the practical choices available to boards?” I suspect not. On the point about systemic risk, we had evidence earlier—I am sure we will come onto this—from one of the firms that they had signed off the accounts of the Royal Bank of Scotland, because they knew that the Government would be there to bail them out, without a word to shareholders. It is possible to get everyone in a room and for Lord Myners to give a nod and a wink and everyone to go out with a policy change, which no one is aware of. That does seem to me to indicate a degree of risk that we have seen in the past and I can’t, for the life of me, see why it couldn’t be repeated in the future.

Edward Davey: If I can deal with your suggestion that the Government is complacent on this and make it absolutely clear that we are not. That is why I am so welcoming of this Committee’s inquiry; why I was keen to come and give evidence and why we have been focusing on this within the department working with the FRC and others. The question is: what do you do? We think greater disclosure and transparency; to give greater publicity to this fact that some companies have used the same auditor for 48 years. That is information that I’m not sure how many investors, including institutional investors, are absolutely aware of. Getting audit committees to improve their communication with their investors I think is incredibly important and encouraging investors, through things like the Stewardship Code, to look at that information.

Q507 Lord Forsyth of Drumlean: Sorry to interrupt, but if there is only one other auditor you could appoint how does that solve the problem?

Edward Davey: Let me take some issue with that as well, because I made it clear that I do think there are—outside the Big 4—some very reputable, very professional and expert audit firms. The reason that
they aren’t chosen sometimes seems to be because of the purchasing propensities of the bigger companies, in order to try to say they have gone for one of the Big 4 so that must be okay, rather than going for another firm that might be equally as good or even better. So I think what we have to challenge is this culture and we’re determined to do that.

Q508 Lord Smith of Clifton: When we had the second-tier representatives here they showed a marked reluctance; certainly they didn’t want to touch the FTSE 100. They just wanted a little bit more share of the FTSE 250. So you had a rather cosy reinforced cartel of the Big 4, with the second-tier accountants not being that keen to have much more business.

Edward Davey: I am surprised to hear that. I didn’t read that in the evidence and it probably should have been brought to my attention. But certainly in our engagement with them I think we’ve taken away a slightly different message. It may be that this year and next year they couldn’t take on half of the audit contracts of the FTSE 100, but they seem to me to have the ambition to do an awful lot more than they’re currently doing, and the question is: what could Government policy do to assist that? And I think it’s trying to ensure that corporates are forced to disclose, and indeed therefore think about how they go about the process of appointing auditors, get their investors more involved in that decision process and asking the sort of tough questions that I think haven’t been asked in the past.

Q509 The Chairman: We had some of the investing institutions in front of us and I have to say they were highly critical of the present situation, and I rather doubt whether greater transparency or a bit more dialogue would solve the problem. I think if you simply went down some of those sorts of recommendations, they might help a little bit but the very strong position of the Big 4 would remain.

Edward Davey: I have to say I think that is contestable. I do think it’s up to shareholders to make the appointment of auditors, not Government. I think if they are given the information and Government assist them to have that information, and indeed, assist the process of communication by seeking that the audit committee thinks more carefully about its responsibilities, I think that can make a big difference and I don’t think we should underestimate it. Look at the other options: the other options that are being discussed are quite regulatory; mandatory rotation of auditors, for example. The question is: would that work? It would certainly impose an extra burden on the companies who are purchasing the auditing services, not just on the auditors. No doubt they would pass the extra costs on. Would it result in reduced concentration? I’m not so sure. I’m not sure if there would be evidence where that has been looked at, and I think I am right in saying it was looked at in Italy where they went down this road, but did it have the effect that some people thought it might? Actually, it had the reverse effect. So I think some of the alternatives that are put forward need very careful examination because there could be perverse effects.

Q510 The Chairman: Finally, can I just take you up on the shareholders appointing the auditors point. In theory, shareholders do appoint the auditors at the annual general meeting. I think in most annual general meetings—certainly all those I have attended—the item that goes through fastest is the appointment of the auditors. Has that ever been challenged by shareholders; a recommendation that is given?

Edward Davey: I certainly wouldn’t dispute that point and that observation; I’ve seen that observation myself. So the question is: how can we deal with that? I personally believe that the sort of disclosure and transparency we’re talking about—the changes to the code for the audit committees or making the FRC’s code mandatory—would have an impact. One other thing that we’re certainly thinking about is whether or not it is right to ensure that the auditor turns up to the AGM. Of course they can be heard. They have the right to be heard and the right to take questions, but as a normal practice maybe they should be obliged to turn up to the AGM. I think that sort of approach is the right way to try to change what we’ve seen in the past that, I agree with you, isn’t satisfactory.

The Chairman: I thought they usually did.

Q511 Lord Hollick: You mentioned that the Government had under consideration some measures that might increase the choice in the audit market. Could you share those with us and also could you say which of them you might support?

Edward Davey: In terms of helping the middle-size, middle-ranking, audit companies to grow, I do think the demand side is the most powerful side. I don’t want to reiterate the points I’ve made in that area, but they are going to grow if they have more contracts and if companies and their shareholders seek to ensure that it’s not just the Big 4 taking the big, juicy contracts. But I did say earlier, particularly in relation to the question on contingency planning, whether or not we could look again at the rules on non-auditors controlling shareholdings in auditor companies, and whether that could be reviewed so that they could attract more investment. I have to say—in parenthesis—that when we talk to some of the more likely candidates for expansion they don’t necessarily see that shortage of capital is their main problem.
They focus on the demand side, which is why I placed such emphasis on that.

Lord Lawson of Blaby: There are three issues on our plate: the oligopolistic nature of the audit business, so far as large companies of FTSE 100 are concerned, is one of them; accounting standards, which you mentioned en passant earlier on and about which we have received a lot of disquieting evidence, which reinforces the doubts that some of us had before we embarked on this inquiry; and perhaps most of all there is the question of the huge problem there is in the banking sector, which is a global problem but is particularly important to this country because of the ever importance of banking and financial services to our economy. I think those last two are bigger problems. Nevertheless, that doesn’t mean to say that the oligopolistic nature of the audit business for large companies is not a problem, not a cause for concern. It has been put to us that the Government—as part of its cull of quangos—is abolishing the Audit Commission. Here you have a resource, and it has been put to us that it might make sense for this resource to become a competitor of the Big 4, so that you have five and you have a greater degree of competition. I wonder whether you feel there is anything in that?

Edward Davey: If I can say initially—and I am sure your Lordships are aware—there is an inquiry in the other House, with the Select Committee on Communities and Local Government looking into that decision by the Secretary of State and asking some detailed questions. I certainly wouldn’t want to, in anything I say, make any prejudicial remarks with respect to that inquiry. But I did note when the Secretary of State announced his intention to do this that one of his key objectives was more competitive and open markets for auditor services for local authorities and other public bodies. I think that certainly speaks to your agenda and, as you would expect, I very strongly support the Secretary of State’s statement in this regard.

Q512 Lord Lawson of Blaby: I think that those who put this to us—and I am just repeating evidence that we have received—didn’t assume that the Audit Commission, which in some guise or other remains in being, building on the expertise it has acquired since Michael Heseltine proposed it should be set up in the 1980s; they didn’t assume that this would just be for local authorities and public bodies, but that it might compete with the Big 4 for all the sorts of clients that the Big 4 have, whether they are in the private sector or in the public sector.

Edward Davey: Well, I think the skills and the expertise and the track record that the Audit Commission has built up would certainly make it a competitor for not just public sector contracts. I wouldn’t disagree with the thrust of what you’re saying. I haven’t read all the evidence that you received, but no doubt some of us have made similar points. I think one should remind ourselves, though, that the Audit Commission doesn’t do all the audits itself, it contracts out audits to many other auditors. So it’s not as if you have a massive building with a whole set of auditors who now have nothing to do, and suddenly can be taken over or moved into another company. So, let’s look at the actual nature of how the Audit Commission contracts and encourages those audits to be undertaken. So, I’m not against the thrust of what you’re saying; far from it, and I’m pleased—very pleased—that the Secretary of State for the Department for Communities and Local Government has made the statements that he has.

Q513 Lord Forsyth of Drumlean: Chairman, just to follow up on Lord Lawson’s point. I think it was Baroness Hogg wearing her official hat who put this suggestion to the Committee, and the point that she was making was consistent with what the Secretary of State has said. A lot of this work will just leak out into the Big 4 and other accountants, and there is an opportunity here for the Government to seize the initiative and create a fifth force. But that would require proactive action by the Government, not just a general statement of, “We wish the private sector to—” The point that you make, Minister, is about the nature of the Audit Commission itself, in terms of the work that it contracts out. It would require a policy decision to go out and create a fifth force and not a decision to allow that work to be put out to tender and dispersed through the existing market. So, it does require proactive action. Would you be against that?

Edward Davey: As I said very clearly, we welcome this decision from the Department for Communities and Local Government.

Lord Forsyth of Drumlean: No, I am not asking about the decision on the Audit Commission. I’m asking what your view—

Edward Davey: I think you are asking me to make a decision on a matter for which I am not the responsible Minister. I’m not trying to not answer your question, Lord Forsyth. What I am not doing, as a Parliamentary Under-Secretary in the Department for Business, Innovation and Skills, is making a policy statement on behalf of the Department for Communities and Local Government. What I can say is: we very much support that decision to allow that work to be put out to tender and dispersed through the existing market. It does require proactive action. Would you be against that?

Q514 Lord Forsyth of Drumlean: Forgive me, I’m not asking you about the decision that has been taken by Eric Pickles. I am asking you whether your
Department support the idea of taking proactive action to create a fifth force, in line with what Baroness Hogg said. If you are not able to answer that question, I think it would be very useful to have a response that represents the Government’s view on what is a very important proposal, which is time limited.

Q515 Lord Lawson of Blaby: If I may supplement what Lord Forsyth is saying, I don’t think you can just say, “Well, this is a matter for the Department for Communities and Local Government”, because that is only the case for the Audit Commission as presently constituted. Of course you’re ending that, so if this new role were to receive governmental support it would not be a matter for the Department for Communities and Local Government.
Edward Davey: I accept that. I would repeat my remarks that I think somehow this is presented as, “Here is a fifth competitor that can suddenly be wheeled out”; it fails to understand the nature of how the Audit Commission commissions its work. It is not that there is a whole set of auditors that can suddenly be transformed into a fifth firm. I think that is the point I have made and I would ask you to reflect on that. Let me ask my colleague Richard Carter to maybe elaborate a little further.
Richard Carter: Thank you. Richard Carter, the Director of Business Environment in the Department for Business, Innovation and Skills. In terms of the future of the Audit Commission, in terms of its overall size, as the Minister has said, if you were to establish it as a stand-alone audit firm at the moment, we believe it would represent about 10% of the audit market in terms of revenue. So it will be a sizeable force but it wouldn’t necessarily be an enormous force. In terms of thinking about its future, of course, there are two questions. The first question is: who is going to do the auditing in the future? And part of the thrust of the Government’s proposals is that, in the longer term, the decision about who is the auditor will be taken by the public body that is being audited. So, that is one set of questions. Another crucial question is: what happens to the staff of the Audit Commission, in particular to make sure that there are arrangements for the continuation of audit services, in the short to medium term, until such time as the bodies re-let the audit contract? This is quite a complicated balancing act. In addition, there is also a concern—which will certainly be felt in the other place—about making sure that the full value is achieved for the taxpayer in terms of any transfer of the assets. But one of the things that the Secretary of State for Communities and Local Government is very much taking into account in his decision-making are the issues around audit competition, around the structure of the market, and so on. So, I’m not in a position to give you the complete answer now because that is work in hand. But I hope I can reassure you that issues around the structure of the market are, indeed, being taken into account.

The Chairman: Given that the suggestion came from the Chairman of the Financial Reporting Council and, therefore, should be taken seriously, we will obviously be doing just that and if there are any further points that you’d like to put to us in writing that would be very helpful. I think Lord Shipley wants to come in on this one.

Q516 Lord Shipley: Yes, because with my local government background I have a lot of experience of working with the Audit Commission. They do do a lot of work directly and they do have a lot of staff who are auditors, and the 10% figure has been very helpful. Of course one of the problems that we might get, if those staff are simply swallowed up in the main by the Big 4, would mean that we were going to have decreased competition rather than the potential for increased competition. The advantage of having a public sector body that might then start to do private sector work—because the quality of the auditors is such that they could do that, and to have a private sector company outside of the Big 4 that might then have a public sector expertise—is that everybody could gain from that situation. Now, I understand that it is difficult to make commitments given work going on in the other place, and so on, but it seems to me there is an opportunity here and I just wondered if you might agree.
Edward Davey: I entirely agree that there is an opportunity here. I hope that is helpful.

Q517 Lord Best: We are tackling this work from basically a national perspective, but we are well aware that the EU is looking at these matters as well. Do you think that the best level is the national, is it the European, or should we be looking up to the G8 and the G20 before making recommendations in a global economy?
Edward Davey: I think the national level is the appropriate level and I think that is for the foreseeable future. That is not to say that we could not improve the co-ordination between audit regulator supervisors, both within the EU and across the globe. As you know, there is quite a lot of co-operation already. That clearly needs to be built on and improved, but I certainly don’t see a role for an EU regulator here or, for that matter, a global regulator. I do think some sort of college or co-operation between the national bodies is the appropriate way forward, and I know that has quite a lot of support among the auditor community. I think the only other thing I would say is that in this area—because as you say it is quite complex and
many of these companies operate, the audit companies that is, all over the globe—decisions that happen, as a result of changes of auditors in this country, can have an impact across the globe as well. It is quite possible that if a few of the FTSE 350 changed their auditors that we’d see their subsidiaries around the world changing their auditors, too. So what we do in this country can have a big impact. We can’t always say that in every area of policy, but I think that is the case here.

Q518 The Chairman: I can see that in the case of some of the FTSE 350 companies but very often the real problem lies with the FTSE 100 companies, where the argument runs that they are global companies and they need auditors who have a global reach and, therefore, it isn’t just a problem that we can tackle here in the UK.
Edward Davey: The point I was making was that even for a FTSE 100, if they were to take a decision I think that would flow through to their subsidiaries elsewhere, and I do think there are audit companies outside the Big 4 who are capable of doing that. I want to say that quite firmly, because I think there is this impression around that that is not the case and we need to challenge that. I would urge you, if you feel the evidence is sufficient, to make that clear. That is certainly our finding in the analysis that we’ve done. Unless that is understood by FTSE 100 companies, and others, I don’t think we will change the purchasing behaviour and I don’t think we will improve competition and choice.

Q519 Lord Forsyth of Drumlean: I quite agree with what you said on that point, but just on this issue of increasing competition and choice, the EU ownership rules for auditing firms limit outside shareholders to 49% and require a majority of the management board to be EU-approved auditors. Are these restrictions really necessary?
Edward Davey: No.
Lord Forsyth of Drumlean: Splendid.
Edward Davey: Sorry, I thought I had covered the point earlier, so that is why I was restricting myself to a one word answer. We do think these rules should be changed and, of course, we will need to work with European partners to do that. I believe the European Commission has suggested that this measure should be changed themselves. I’m just looking to my colleague to check that that is what—
Richard Carter: It is one of the things that they are considering as part of their current Green Paper on Audit. The Minister has given you the Government’s response to the question.

Q520 Lord Forsyth of Drumlean: So when can we expect a result?
Edward Davey: I can’t give you an exact date. I am very happy to make some enquiries and see if there is a clear timetable, but I hope it won’t be too long. Probably months rather than years, I would hope, if we can get agreement.

Q521 The Chairman: But the UK Government is pressing for changes in this area?
Edward Davey: Yes, absolutely.

Q522 Lord Hollick: Is there a more fundamental change that could be introduced, which is to say that the annual audit would no longer be mandatory? For instance, should there be monopoly rights for the auditing profession? For instance, we have heard some suggestions that there might be an insurance product, which could be purchased by companies that would give the assurance to their stakeholders. Has the Government considered any of these options?
Edward Davey: First of all, as I am sure you know but it is worth stating for the record, the audit isn’t mandatory for many small companies at the moment. I believe, and the Government believes, there is a strong case for taking away the mandatory requirement for an audit from medium-sized companies, and I think that would have a real advantage. If a company decides to go for an audit voluntarily, I think that sends a very strong signal to investors and to the market. So I don’t see some systemic risk for deregulating here and taking away mandatory from medium-sized companies.

Q523 Lord Hollick: Can you give us a sense of how many companies that might cover if you were to apply it?
Edward Davey: I think it is a significant number, in tens of thousands not hundreds.
Richard Carter: We can give a note about it.
Edward Davey: We can give you an exact number. From my memory, I think the briefing I read some time ago talked about 32,000 companies but I would be very happy to come back for absolute clarification of the exact figure.
Lord Hollick: And what sort of—
Edward Davey: Our preliminary analysis shows it is 32,385.

Q524 Lord Hollick: Good memory. What sort of size of company would that take us up to then?
Edward Davey: We can give you figures on the turnover of what that would cover. It certainly wouldn’t cover the FTSE 100, of course, and I’m just reading the footnote of the briefing. That covers companies which meet two out of the three EU criteria of turnover more than £6.5 million and less or equal to £25.9 million; total assets of more than £3.26 million and turnover of over £6.5 million.
Q525 Lord Shipley: Could I ask you about the statutory annual audit and just refer briefly to your memorandum of evidence, and three very short extracts in paragraph 15 in which you say, at the very end, “Financial directors and investors do however find audit valuable in checking company compliance with accounting standards and other regulatory requirements, while they do not find value in the very limited—and often boiler-plate—qualitative assessment currently provided”. You then go on in paragraph 21 to say, “There could also be more disclosure about the risk position of the company, and key judgements taken during the course of the audit”. But in paragraph 25 you then go on to say, “It is therefore not obvious exactly how to achieve more informative disclosure of the affairs of companies, either by management or by the auditors”. And I think the question that the general public would be interested in—particularly those who went through the banking collapse, people who lost share investments, and so on—is the statutory annual audit enough to meet today’s needs, and should auditors provide assurance in other areas, such as risk management, corporate governance and the business model, as well as just financial statements?

Edward Davey: I think the annual audit for the larger companies is very important. Could the information, the communication to investors, shareholders and the wider markets, be improved? Yes, and the Government position is very clear that we believe the general public would be interested in—particularly those who went through the banking collapse, people who lost share investments, and so on—and the statutory annual audit enough to meet today’s needs, and should auditors provide assurance in other areas, such as risk management, corporate governance and the business model, as well as just financial statements? I think we ought to put their role in proper context and have realistic expectations of what they are able to deliver. In terms of what we can do to avoid such failures in the future?

Lord Shipley: I think the annual audit for the larger companies is very important. Could the information, the communication to investors, shareholders and the wider markets, be improved? Yes, and the Government position is very clear that we believe the general public would be interested in—particularly those who went through the banking collapse, people who lost share investments, and so on—and the statutory annual audit enough to meet today’s needs, and should auditors provide assurance in other areas, such as risk management, corporate governance and the business model, as well as just financial statements? I think we ought to put their role in proper context and have realistic expectations of what they are able to deliver. In terms of what we can do to avoid such failures in the future?

Q527 Lord Smith of Clifton: Minister, you will understand in asking this question I’m just a warm-up act for Lord Lawson. The auditors failed to warn of the impending financial crisis, even though they had more in-depth knowledge of their banking clients’ affairs than any other outside party. What changes would the Government like to see to avoid such failures in the future?

Edward Davey: Well, I am the warm-up act for my colleague here. Mark Hoban: I’m Mark Hoban. I’m the Financial Secretary to the Treasury. I’m responsible within the Treasury team for the financial services sector. For the sake of transparency, I also ought to add that I’m also a chartered accountant and—prior to coming to this House—I worked for PricewaterhouseCoopers. Having started my professional career with Deloitte Haskins & Sells, I’ve seen the concentration in the audit market from the Big 8 to the Big 4 at first hand. In the context of the question you asked, Lord Smith, I think that to be fair to auditors there are few that can claim with any conviction that they foresaw the impending financial crisis. There are a number of players one would have expected to have seen the signs: boards of directors; management; regulators; central banks, and so the auditors weren’t alone in not identifying the financial crisis. Of course, the role that auditors play is to comment on the financial statements rather than on financial stability. So I think we ought to put their role in proper context and have realistic expectations of what they are able to deliver. In terms of what we can do to avoid such
failures in the future, clearly the Government has set in train a wider series of reforms around financial regulation, including replacing the FSA with new regulators and giving the new regulators greater powers. There is clearly a debate going on at a global level around increased capital through Basel III, increasing liquidity, greater measures at a European and global level for co-ordination of regulation tackling crisis management. So a number of measures are in place already to look at these areas. But, as Ed has said, there are a number of areas in the audit field where there is work ongoing looking at some of the disclosure around narrative reporting; about risks and some of the judgements that are being made. But also I think an area that the FRC highlighted in their evidence to you, increased scepticism by auditors. But I suspect increased scepticism doesn’t just apply to auditors, it applies to others when dealing with financial institutions as well.

Q528 Lord Lawson of Blaby: May I follow that since Lord Smith mentioned me? Incidentally, it’s very good to have a Financial Secretary in front of us since it was a post I held a little over 30 years ago. I am very pleased we have a distant successor here. We are not interested primarily here in apportioning blame. We are interested in what to do. There is no doubt about it, that the auditors were among the dogs that didn’t bark and should have done but they weren’t alone in this. But the question is: what can be done to make it better in the future? Clearly, it is a very serious issue. Sir John Vickers made a speech over the weekend in which—I’m paraphrasing him—he said this wasn’t a storm of such great magnitude that any structure would have buckled. It was because there was a bit of a storm and the structure was so rickety that it failed. Therefore, it is very important that we put a more robust structure in place. I know that is something that the Government has very much in mind and so does the Bank of England and, of course, so does Sir John Vickers. Now, the question is: what is the place of auditors in this? On the evidence that we have had so far, I am not clear about whether the auditors recognised that there was something seriously amiss but didn’t do anything about it, partly because if you qualify or hint at any reservations about a bank’s accounts that could have a very serious effect in itself, or whether they just didn’t know, in which case clearly it is a bit alarming. What I am getting at is this: that one thing that I introduced, and I thought it was quite an important part of the 1987 Banking Act, was then and now is going to be—should say to the auditors, “There is a particular area that is of concern to us as the supervisory regulatory authority. Will you make a point of looking very closely at the banks that you audit, how they shape up in this area?” This worked for a number of years after the passing of the 1987 Act and then, as I understand it, with the transfer of responsibility for bank regulation, bank supervision, to the FSA the responsibility wasn’t altogether abolished but it was greatly watered down, and in practice this didn’t happen. As I understand it now, the Bank of England is looking at reinstating this very important safeguard, this process. I wonder if you could say, first of all, what your general views are on this important area and, secondly, if you could give us a progress report. I know you’re not the Bank of England but you’re obviously very much connected with what is going on. Can you say whether any progress is being made under these talks that, as I understand it, the Bank of England are having?

Mark Hoban: I agree with you, Lord Lawson. I think it is important that there is a dialogue between auditors and the regulators. I know, from a conversation I have had with auditors, that it is something that they felt was lacking in the existing regulatory regime. As you say, the requirement in the Banking Act was replaced in FSMA by an information gateway, which was meant to facilitate a dialogue, but I think it—

Q529 Lord Lawson of Blaby: But didn’t mandate it.

Mark Hoban: Absolutely, and I think it fell into not quite disrepair but—

Lord Lawson of Blaby: Desuetude?

Mark Hoban: Desuetude is a very good way of putting it. Clearly, the FSA and the FRC have looked at this and are looking to strengthen it. I don’t want to steal the Bank of England’s thunder. They are looking at this very carefully and they will make an announcement. But I am clear in my own mind that if the bank were to say that we need this in the statute, then I would be happy to see that happen.

Q530 Lord Lawson of Blaby: I am glad to hear that, and I hope that this will happen. May I just ask one further question on this area, which I think has been mentioned by one of my colleagues already? We were very concerned that the auditors were either given to understand by the previous Government, or assumed, that major banks could not be allowed to
fail, were too big to fail, and, therefore, they were rather too relaxed in the way that they audited these banks. What do you feel about that?

Mark Hoban: I read the evidence that my predecessor, Lord Myners, gave the Committee and I have seen the letters that I think he submitted to the Committee. I don’t wish to speak for him or the previous Government on that dialogue.

Lord Lawson of Blaby: No, speak for yourself.

Mark Hoban: I think that the judgement that both boards of directors and auditors make on going concerns is a matter for them. To be absolutely clear to the Committee, I have had no discussions—and nor has the Treasury—with auditors about the 2010 reporting season.

Q531 Lord Hollick: Minister, you used the word “scepticism”, which I think is something we have been in search of as we’ve talked to many of the witnesses. It seems to have been absent in a number of important ways. You just talked about “going concerns”. When we had the audit firms in, they emphasised that they were relying very much on what the board told them, what the directors told them and the executive told them, when they formed their judgement about the going concern of banks that they signed off on, which within a few months—in some cases weeks—were failing, in effect. I think it is difficult to see that scepticism was applied there. They seemed to be, dare I say it, somewhat spoon-fed by the directors and took it at face value, and I think—and we will perhaps come to this later—there is a concern in the profession that they are legally liable or have an increased legal liability if they apply judgement. I think that brings us to the point that a number of witnesses have made—it is also made in the BIS submission—which is the gap between what the auditors are offering and what the public, the users of accounts, are expecting. This is clearly a very difficult issue. In terms of having a financial system and financial institutions where the public, all of the users and lenders to those institutions, can have confidence in them, what measures do you think, given your experience before you were in Government as well, could actually be brought into play to try and help narrow this gap, to reintroduce scepticism and put that at the heart of the auditors’ judgement?

Mark Hoban: I certainly think that auditors and others need to be much more sceptical and much more challenging of management in forming conclusions on a whole range of judgemental areas for company accounts. I think some of the work that has been done around corporate governance since the financial crisis also speaks to that. But I think we also need to be very clear about what it is we are asking auditors to do, what they should be responsible and accountable for, and also what the role of prudential supervisors is. I see a set of accounts as not a substitute for prudential supervision but a starting point for it, and prudential supervisors who are publicly accountable for the safety and soundness of the financial system need to overlay on those accounts their judgements, whether it’s through Basel III and the capital rules there, or whether it is their own understanding of a firm’s business model. So I think we need to be very clear about what it is we expect from auditors and what it is we expect from prudential supervisors.

Q532 Lord Hollick: One of the suggestions is that the audit report might shed more light—and this is something that the shareholders were in favour of—on some of the key discussions that take place when forming their judgements. Do you think that that would be a good idea or do you feel that that would possibly destabilise the situation?

Mark Hoban: I am wary about treading on to the territory of my colleagues from BIS. I understand the appetite for more assurance, but that comes at a price and at a level of risk. How do you ensure that if that debate is made public that there is the right level of comfort in place for both the auditor and the company about that? I think that is a challenging area and I think it is an area that previous Governments have looked at as well, and it is an ongoing debate among institutional investors, auditors and companies. I think it is a challenging area to get right, to try to achieve that public understanding and acceptance, at the same time recognising some of the challenges that flow from those.

Edward Davey: If I may, I think where we’ve reached in our analysis and where we think we should push on this is—and I’m repeating myself, I’m afraid—the role of the audit committee’s report in trying to assist that dialogue and assist that understanding. I think you are absolutely right about the expectation gap, but in the review that we have undertaken of the academic literature, both the empirical evidence and the theory, it is quite clear that the expectation gap has been noted over the decades; that people think the audit can withstand a collusion between directors to defraud their investors, and often it is very difficult to be absolutely sure that it could do that. Equally, if there is a financial meltdown, it is not clear that audit can—in the theory of audit—give the reassurance in that sort of external environment when that is so challenging. So, the expectation gap is a real one; it’s there in audit theory, and the question is: how can we improve procedures so people understand that and maybe it can be closed a little bit. That is why we think the audit committee has a bigger role than in the past.

Q533 The Chairman: You have pretty well answered the question I was going to ask, but let me just ask it in case there is anything you want to add. In the context of a dialogue between the auditors and the regulator or the Bank of England, some information may flow...
back to the auditors that causes them concern which, basing their clearance of the accounts on the results of the year and, possibly even in terms of a going concern, they are not really able to express in their audit judgement. Yet, because of the knowledge that they may acquire that gives them concern, they may be misleading investors.

Mark Hoban: I think one would expect auditors, in trying to identify the risks attached to the audit and to a company’s accounts, to take into account the knowledge they gain from a regulator. If there is a particular concern about an area of business, I think the auditor would want to take that into account. Of course, one of the changes we are proposing, in terms of financial regulation, is a much more explicit dialogue about the risks that the macro financial regulator—the FPC— identify and what the appropriate response to that would be, in terms of a regulatory response. In a way, it is building on the work that the Financial Stability Report published by the Bank of England already does. So, you would already expect auditors to take that into account, but the judgement is theirs about how that then flows through to the financial statements and their opinion on the financial statements.

Q534 The Chairman: For example, if the regulator raised concerns about subprime mortgages, and the possible consequences of too much investment in subprime mortgages or CDOs, or whatever, would you expect the auditor to go back and challenge that in the bank before they made a judgement on the accounts?

Mark Hoban: I am not an auditor and it’s a long time since I’ve practised, but one would expect that auditors would take into account those sorts of issues and think about the valuation risks they attach to a book of mortgages in the subprime market. But, of course, I think one of the challenges is to provide the evidence to support a particular view.

Q535 Lord Lawson of Blaby: But they didn’t, did they?

Mark Hoban: There is a wider question about people’s understanding of some of the complex markets around financial instruments, where I suspect there is a large degree of ignorance about some of the future—

Q536 Lord Lawson of Blaby: The auditors are ignorant? Are you saying the auditors are ignorant?

Mark Hoban: No, I think there is a lot of concern, Lord Lawson, about the complexity of some of those instruments and how they were understood; how they were used and what the consequences were, and I think that is one of the strands that comes out from a number of reviews of the financial crisis. I don’t think it relates specifically to auditors.

The Chairman: We will be coming on to FRS and that sort of issue as well, which is relevant to this.

Q537 Lord Forsyth of Drumlean: There was nothing complicated or difficult about understanding balance sheets that had been stretched to beyond the point of commonsense, of 40 times and more. One of the things that I find very puzzling—I am not an accountant—is that I don’t really understand why an auditor could look at a balance sheet that was so overstretched and not express concern, and the cynical part of me thinks, “Well, perhaps the audit fees were not as important as the other fees that were being paid by some of these banks to the Big 4”. That is where I think there is an issue here about systemic risk. To take Lord Hollick’s analogy, all the incentives were to take the gap as being much narrower than what—looking with the benefit of hindsight—commonsense would tend to indicate, that the auditors should have been more on top of not the complex multiple derivatives, the exposures, and all the rest, but the bare facts that you had banks lending money on a scale relative to their assets that was obviously unsustainable.

Mark Hoban: But at the same time, Lord Forsyth, I think that there were a number of people in the same boat, not least of which were the management and directors of some of these banks, the regulators and credit rating agencies. There are a number of players in this financial crisis who could take some of the blame for this, and I think that needs to be recognised as well.

Q538 Lord Forsyth of Drumlean: But I am not seeking to apply blame, and for all these people I can make the same argument that it wasn’t in their financial interest to—in the face of the stampede—say to everybody, “Stop”, because they would have been run over. But, as a layman, I think the auditors would be the chaps who would press the alarm bell when the business model was clearly moving into a position that was unsustainable. Some people have given us evidence and they have said, “No, no, that is not the role of auditors”, and you have been very careful in saying what you think the role of the auditor should be. But I am asking you whether you think that, perhaps in those circumstances, it is not surprising that the auditors didn’t raise the alarm?

Mark Hoban: I am not going to express a view on whether auditors, because they perceived a conflict of interest, didn’t sound the alarm bell. I just think there are a lot of people who didn’t sound that alarm bell; and ultimately the responsibility for running that business is down to directors and the management. We have a regulatory regime that is set in place to deal with the prudential supervision of these institutions and in a way, if you look outside the company, the people who then have the biggest responsibility for the safety and soundness of the financial system were the regulators, not the auditors.
Q539 Lord Forsyth of Drumlean: But what needs to be changed in your judgement?
Mark Hoban: In respect of the auditors or more widely? I think that more widely there needs to be a much better focus on prudential supervision than there has been, and that is part of the thrust behind the reforms that we announced last year that we're working through at the moment. In terms of audit, I think that Ed has outlined some of the areas where improvement needs to happen and I think that the area I would add on to—and acknowledging all the measures in the Banking Act 1987—is that improved dialogue.
Lord Forsyth of Drumlean: With the benefit of hindsight you don’t see any need for—
Mark Hoban: Clearly, we need to look at what they report, and I think we are going to come on to accounting standards shortly. There are a number of areas that we need to learn from on this where actually we can improve the rigour of the process. But I think there is a duty on all of us who engage in the financial services businesses to be much more sceptical than perhaps we were. A number of people believed we had suddenly moved to a new form of stability and events perhaps we were. A number of people believed we had a change in philosophy over a very lengthy period of time about how you look at accounts: you measure economic value much more than historic cost; present a more accurate snapshot of the value of a business at a particular time, and value the assets and liabilities it holds. There are merits in that approach, but I would say that I think the accounts are there to measure the assets and liabilities of the company, I don’t think they are a substitute for prudential returns. 
Edward Davey: I have to say, I am not a chartered accountant by training, but certainly, the advice I have had is that there are more similarities than are often given credit to between UK GAAP and IFRS, and that they do operate on the basis of “principles”. I think that has to be remembered when we are engaged in this debate. Whether the impact on IFRS, on audit, had a major change, the evidence in terms of the crisis does not appear to be there. We have been looking for it and we haven’t seen that.
Lord Tugendhat: Let me come at it in a different way. I can well believe that the two are more alike than unalike—to put it that way—but there are lots of these phrases like if somebody is not “a fit and proper person”, or “true and fair accounts”. It is quite difficult to describe precisely what they mean but, a bit like an elephant, you know it when you see it. Because we live in a more legalistic age—and I recognise the necessity for that—and because everything has more rules written down than it used to, and because we live in a global financial system and not a tight little city where everybody knew each other, we do have to operate on a much more formalised basis than was the case in the past. I totally recognise that. Nonetheless, it does seem to me that the idea of “true and fair” is something that is not just reflected in the absolute figures, it is reflected in the smell and the feel and all that sort of thing. I tend to feel that one of the things that has come out of this inquiry is that auditors have been doing it by the book and that the idea of “feel” and “sensibility” and, “Does it look quite right?” and, “Can you feel it?” has rather gone by the board. I see “person”, or “true and fair accounts”. It is quite difficult to describe precisely what they mean but, a bit like an elephant, you know it when you see it. Because we live in a more legalistic age—and I recognise the necessity for that—and because everything has more rules written down than it used to, and because we live in a global financial system and not a tight little city where everybody knew each other, we do have to operate on a much more formalised basis than was the case in the past. I totally recognise that. Nonetheless, it does seem to me that the idea of “true and fair” is something that is not just reflected in the absolute figures, it is reflected in the smell and the feel and all that sort of thing. I tend to feel that one of the things that has come out of this inquiry is that auditors have been doing it by the book and that the idea of “feel” and “sensibility” and, “Does it look quite right?” and, “Can you feel it?” has rather gone by the board. I see Lord Forsyth nodding. I wonder how you would react to that.
Edward Davey: There is a problem for an auditor in having to make a decision, isn’t there, because they really have a binary decision, haven't they? They either have to clear the accounts or not, and the question is: should we tinker with that approach or can we try to give the sort of sense that you are talking about in a different way?
Lord Tugendhat: Not different, but in addition to.
Edward Davey: Well, in addition to, so more information is out there so people can look at it and make judgements about it and respond to it. I have to say, that is why we keep stressing the role of the audit committee. I am sorry I keep coming back to that, but that is very much our position: that the role of the audit committee can be expanded to improve that communication. And the reports of the audit committee, if they can be expanded in the ways that we have talked about—I think, read alongside the audit—can begin to enable people to understand the underlying judgements, whether or not this company is quite aggressive in its approach to meeting accounting standards, and so on. So I think that is the way forward. I think asking auditors to change their traditional binary approach would create a lot of difficulties.

Q542 Lord Forsyth of Drumlean: I am sure, Minister, you spend a great deal of your time going around seeing companies. As an exercise, ask the finance director what they think about this issue of whether the accounting standards have moved towards a box ticking culture and away from getting a prudential, fair and accurate view of the accounts. I will be surprised if you don’t find, as I’ve found, that there is a pretty universal response. So it’s not so much about the auditors, it is about whether we have moved to a box ticking culture, and whether that was one of the ingredients that helped to create the crisis we had. It is that. The evidence we have had in Committee has been very striking. Some of it is controversial, but one person gave us evidence, which went through each of a number of examples and showed how the change to IFRS had made the position worse. It is that, I think, that Lord Tugendhat is talking about.

Edward Davey: As I understand it, the shift to the more rules-based approach has tended to be in the financial instruments zone of accounting, rather than in some of the accounting practices of the firms that you describe, Lord Forsyth. I’m sure that is an area you will want to explore, and I would encourage you to do that. But I think that is where the shift has been and where, perhaps, the focus of debate needs to be.

Q543 Lord Forsyth of Drumlean: What changes would you like to see in the area that you have identified?

Edward Davey: As I understand it, there are some proposals that are being evolved by the different accounting bodies to try to see whether or not they can take a better account of financial instruments. But I am going to turn to my colleague, who may have a better grip of the detail there.

Richard Carter: I think it is fair to say that one of the lessons to learn, from the last couple of years, is that the financial standards in relation to financial instruments do need revision; the IASB has that work well in hand. There will be tricky judgements because, on the one hand, one wants to make sure that one is producing enough clarity so that any auditor entering the same business would reach more or less the same conclusions. On the other hand, it has to be something that enables the auditor to say, “Hang on a moment, I don’t quite believe what I’m being told by the business. I need to make further inquiries. I need to be appropriately sceptical”. It also needs to be capable of producing information at the end of the day which is useful for investors in terms of deciding whether or not the directors are indeed discharging their responsibilities properly in terms of running the business.

Q544 The Chairman: You use the word “clarity”. One of the impressions we’re getting is that sometimes there has been a fudge in some of these areas of financial instruments. I was going to ask you what sounds like a very technical question, but I hope it draws attention to the point that we are all trying to raise with you. I don’t know if you have seen the evidence from Professor Fearnley and Tim Bush that we have received, but they have questioned—this is the technical bit, but there is something behind it—whether IFRS is in full conformity with the relevant provisions of the Companies Act 2006 and an associated statutory instrument. That statutory instrument requires prudence, no booking of unrealised profits, and recognition of contingent liabilities, among other things, and therefore that only profits realised at the balance sheet date are to be included in the profit and loss account. They have suggested that IFRS has submitted a neutral requirement for a prudent one and that, in so doing, IFRS is not in full conformity with UK law, and they go into areas like mark to market, which is different under the old SORP, the Statement of Recommended Practice that the bankers followed, and IFRS itself. So two questions: do you think that in fact IFRS may not be in full conformity with UK law in the Companies Act 2006; and, secondly, in the discussions with IASB that you have referred to, will you be pressing more for the old SORP kind of basis, which is the prudent basis, rather than the one which IFRS has at present?

Edward Davey: If I may, Chairman, I will start the answer and then hand over to Richard to complete it. But your very important point about whether IFRS is in conformity with UK law; I believe, in their evidence, the Financial Reporting Council said it was, and confirmed that. I’m not sure whether they gave you the references but, as I think you will know, the use of IFRS was expressly mandated under European law in 2002 for consolidated accounts of all listed groups. That proposal was consulted on in the UK in 2002 and the UK resolved to go ahead with that, and legal effect was given in 2004. So, as I understand it, there is no question about legal
conformity. It conforms. The argument that is put, that somehow IFRS has led to a loss of prudence, I think, to say the least, is contestable. As a matter of judgement, prudence is not a single point on a scale and I think it is simply not the case that IFRS has meant that prudence has been thrown out of the window. That is not how I understand it, but I wonder if Richard wants to add to that?

Richard Carter: Shall I start with the difficult word, “prudence”. It is difficult, partly because you will not find it defined in companies’ legislation, but I take it to mean that gains and assets aren’t overstated and that losses and liabilities aren’t understated. I am supported in that view by looking at some of the wording in the Financial Reporting Standards, and I can find almost identical wording in the framework that the International Accounting Standards Board uses. So I think, as a concept, it’s something that you can see running through both of them. I certainly agree there are questions as to whether or not that concept was something that the standards in force at particular times, with the benefit of hindsight, sufficiently developed and sufficiently included. If you want the history of the accounting rules, it is worth bearing in mind that up to 2004, if you wanted any guidance at all on any of this area, you wouldn’t have found it in company law and you wouldn’t have found it in the UK’s own accounting standards. You would have had to go to the Statement of Recommended Practice issued by the British Bankers’ Association and approved by the Accounting Standards Board in order to be able to fill in some of the key lacunae as to how to treat the general standards and standards when doing the specific audits of banks. This was a fairly standard approach where if you had specific areas of the economy that needed specific guidance about how the general standards applied, then an appropriate body would draw up a Statement of Recommended Practice, and the Accounting Standards Board would then decide whether or not it was prepared to agree to that. That was the process it followed in relation to banks. In 2005, when the ASB approved a new standard in relation to financial instruments, which was very similar—essentially the same—as the one being used internationally, the British Bankers’ Association people decided that there was no longer any need for the Statement of Recommended Practice, because they thought that the effect of what was being introduced mirrored what the Statement of Recommended Practice had said, so it was therefore unnecessary. With the benefit of hindsight, were the arrangements in place ideal? No. Would you have got a better answer under the Statement of Recommended Practice? I have my doubts. You might have got a slightly different one. But if we look at the scale of changes that were going on—I think a lot of the debates about: was banking accounting prudent or not?—effectively what was going on in the real economy meant that we risked focusing almost on the wrong question, as it were.

Q545 The Chairman: I was going to say that some of the points in the SORP would have been better followed than the strict IFRS definitions. Therefore, I’m wondering what changes you’re seeking in IFRS in the current review?

Richard Carter: I’m not, as it were, sitting here with a package of 25 changes, which I want to see made in terms of, “Change this sentence to say that sentence”, or whatever. What I’m saying is: what I think we would like to see emerge from this review is a standard that people can understand; a standard that people can apply, a standard that people have confidence in, and will avoid—in so far as any standard can—the sort of issues we’ve had over the last couple of years. For instance, if you want a particular area, quite a technical area around loss provisions, historically we’ve been in a situation where the banks’ accounts would only take account of those losses that they already knew had been incurred. But there is the suggestion, which I think is probably quite a good one, that going forward they should also take account of those losses that they expect are going to be incurred because of something which is going to happen in the future. That is quite a significant change. At one level it sounds technical—and I apologise if I haven’t explained it as well as I think, to say the least, is contestable. As a matter of fact, it was going through both of them. I certainly agree there are questions as to whether or not that concept was something that the standards in force at particular times, with the benefit of hindsight, sufficiently developed and sufficiently included. If you want the history of the accounting rules, it is worth bearing in mind that up to 2004, if you wanted any guidance at all on any of this area, you wouldn’t have found it in company law and you wouldn’t have found it in the UK’s own accounting standards. You would have had to go to the Statement of Recommended Practice issued by the British Bankers’ Association and approved by the Accounting Standards Board in order to be able to fill in some of the key lacunae as to how to treat the general standards and standards when doing the specific audits of banks. This was a fairly standard approach where if you had specific areas of the economy that needed specific guidance about how the general standards applied, then an appropriate body would draw up a Statement of Recommended Practice, and the Accounting Standards Board would then decide whether or not it was prepared to agree to that. That was the process it followed in relation to banks. In 2005, when the ASB approved a new standard in relation to financial instruments, which was very similar—essentially the same—as the one being used internationally, the British Bankers’ Association people decided that there was no longer any need for the Statement of Recommended Practice, because they thought that the effect of what was being introduced mirrored what the Statement of Recommended Practice had said, so it was therefore unnecessary. With the benefit of hindsight, were the arrangements in place ideal? No. Would you have got a better answer under the Statement of Recommended Practice? I have my doubts. You might have got a slightly different one. But if we look at the scale of changes that were going on—I think a lot of the debates about: was banking accounting prudent or not?—effectively what was going on in the real economy meant that we risked focusing almost on the wrong question, as it were.

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Q546 Lord Lawson of Blaby: Clearly, we know from what has happened that this accounting was not prudent. It may have been legal, and—I am not a lawyer—I am prepared to accept that it was legal, unless it has been demonstrated otherwise. But it clearly wasn’t prudent. Unrealised profits on financial instruments, under the mark to market or fair value accounting, or whatever you like to call it, could not possibly have been realised in practice if everybody had wanted to realise it, or even if a large number had wanted to realise it. Because there would have been a sell-off of these instruments; no way could these profits have been realised. Therefore, it was completely imprudent. Yet, as we know—I understand that the Government is concerned about bank bonuses—bonuses were paid out—real bonuses, realised bonuses, if you like—were paid out of these unrealised and mythical profits. That surely must give rise to some concern. That surely must make you feel that there is something amiss?

Edward Davey: Lord Lawson, I think no one who has lived through that period and seen the damage done to our banks, and to the global economy, would be complacent in any of these areas. As I said right at the
start of my remarks, one of the reasons why we welcome your inquiry is that we want to expose some of these very significant issues. The question I think you’re driving at is whether or not the move to IFRS created the approach that you have described, and whether or not, if we’d had UK GAAP, it would have been avoided. I have to say I’m not sure. I don’t think the evidence is clear on that at all.

Q547 Lord Lawson of Blaby: What are we going to do about it? That is the real question.

Edward Davey: As Richard was saying, there is an awful lot of work being done on all aspects of the crisis to see whether or not different aspects of the regulations need to change. Richard mentioned the change to how we look at bank losses and see whether ones that are expected to happen should be taken account of in terms of provisions. I think it is right that all those types of regulations, around these particular financial instruments—the more exotic ones—are considered.

Richard Carter: If I may, I think it entirely right that there needs to be debate about the role of fair value. If one is looking at valuing a building, does one assume one is selling it in a fire sale, when everybody else is looking to sell their property in the adjoining streets, in which case you get a very low value, or do you assume that you are going to sell it in an ordinary market? I think there are similar issues when one looks at some of the treatments of financial instruments. I agree that there clearly were significant issues about how they were treated. I think we need to try to make sure that we end up in a better, happier place, which doesn’t involve everything automatically having to be marked fairly to market when it’s not appropriate. Under one set of potential American proposals, for instance, there would have been a need for a lot more fair value accounting, but I think that is something that it’s pretty clear that neither the UK nor indeed Europe would be happy with. But equally, if one has something where one has absolutely no involvement in looking at the real, realisable value of the assets, then one has to answer the question of: do you have a set of accounts that tells you enough about what is going on in the company? That is why these things all become so complicated. One other point I would just make in passing is that whilst none of us really needs to pause on the scale of what happened in the last couple of years, the losses were immensely greater than all the bonuses and dividends that the banks had paid out over the financial cycle.

Q548 Lord Tugendhat: I would like to make an observation, and you may or may not wish to comment or agree with it. One of the problems about the excessively rule-based approach on the one hand, and the too small number of auditors on the other, is that in practice an auditor is not going to give up a client because it doesn’t smell right. I have a long memory, like other people here, and I remember a time—not with an auditor—when Cazenove decided that they could no longer do business with Conrad Black. It wasn’t that Conrad Black had done something illegal. He hadn’t. It was just that Cazenove, who were very shrewd people, took the view that it didn’t smell right and they would be better off—and their reputation would be better off—if they dropped him as a client and he could find another advisor, which of course he did without any difficulty. Now, they could do that because there were lots of other financial advisors he could go to; it was done very quietly; it was done very discreetly. But the combination of this excessively rule-based approach means, first of all, that smell does not feature much in the way in which people approach it; and, secondly, it is inconceivable that an auditor could give up a client, because that would be such a major crisis. If one of the Big 4 gave up a FTSE 100—let alone a bank—the heavens would fall. So the people are trapped into relationships, and I think that is a point that perhaps contributes to some of the difficulties that we’ve been inquiring into.

Edward Davey: I think a lot of what you say has strong value. What we should note, though, and this is from the ethical standards of the professional bodies in this area, is that no auditor should be dependent on one single client so that they can’t walk away. That is a very important ethical standard, and auditors are expected to adhere to it.

Q549 Lord Tugendhat: It is not that they are dependent. It is just that the scandal that would arise would be so great because they wouldn’t be able to go to anybody else. There is no choice in the audit market, in effect, if you have three people dealing with the banks. Whereas, when you had eight big auditors, if somebody felt discreetly that they would prefer not to have a relationship, it was possible for a relationship to change. But in practice, I don’t think it is now.

Edward Davey: I don’t want to rehearse all the arguments we had at the beginning of the session. Chairman, about the importance of increasing competition and choice in the audit market. I think that there is agreement there, and I just think that it would be wrong for me to say that there are auditors who failed to walk away from particular clients, because I don’t have that information. But it is important that the ethical standards are held to, and the professional bodies look at that very seriously.

The Chairman: Finally, then, to competition and choice—and fairly briefly—there are a couple of questions more I think we need to ask you to finish.
Q550 Lord Lawson of Blaby: I would like to follow on from Lord Tugendhat, who made a number of points. One of them was, in effect, audit timidity, or you might call it something else, but they don’t want to lose the business and therefore that makes them a little more timid in what they say and do than is ideally desirable. There is another way in which timidity comes in that is connected, and that is their liability. We have been advised—and I assume correctly so—that whereas the Companies Act does allow a cap to be put on liability of auditors, in practice that doesn’t happen. Do you think it might be desirable, to counter auditors being unduly timid, if the idea of a cap on the auditor’s liability were to be a practical reality more often than a purely theoretical possibility?

Edward Davey: We have looked at this—obviously, it’s a very important issue of policy—and our conclusion is that we shouldn’t put a cap on. We have no plans to do so. We went about this by looking at the academic evidence, because if there had been evidence that the benefits of doing this would exceed the cost, then obviously we would have considered it carefully. But the liability does drive quality of audit, and there is quite strong evidence from the academics in this regard.

Q551 Lord Lawson of Blaby: I am not suggesting for a moment there should be zero liability.

Edward Davey: No, but as soon as you put a cap on it, then the question is: is that going to reduce quality? And that is a concern that we have. So that’s not the road we want to go down. I would also make this observation, because in the department we have been evaluating the Companies Act 2006, in which the option of a company agreeing a cap with its auditor was put in. So it wasn’t the Government putting in a cap, but enabling a company with its auditor to agree that they would have a cap. We found that something approaching 17% of medium, large, public and quoted firms have taken steps to adopt or actually adopted auditor liability agreements, and about 9% have actually signed such agreements with their auditor. So there has been some take up of that option within the Companies Act 2006. Therefore, companies can negotiate that cap if they think it’s appropriate. They trade that off—in their view, in an open way—with how they think the auditor will respond.

Q552 Lord Lawson of Blaby: Of these 9%—I don’t know the answer to this question, it is always dangerous to ask a question if you don’t know the answer—how many involved the Big 4?

Edward Davey: I don’t know the answer to that, but I am very happy to get you that answer. I have just magically remembered the answer—I think you will know the feeling, although you probably never had to have inspiration the way that some of us do—and the answer is zero.

Lord Lawson of Blaby: I thought so, yes.

Q553 The Chairman: Finally, you will have seen that Lord Myners suggested last week that this question of the audit market should be referred by the OFT to the Competition Commission. You may not have a view on that, but can I ask you if you have?

Edward Davey: I am the Minister for Competition, so obviously I have a lot of views on a lot of issues around competition. On this particular one I might want to give a pass, if I may. I think I have made it clear that we have huge concerns about competition in this area. I have laid out a whole set of actions that I think should be taken, particularly on the demand side, and I think in the first instance we should be cracking on with those types of measures before we have any referral.

The Chairman: Thank you very much indeed. All three of you have given us a great deal of response, information and help. It has been a very interesting session for us. I’m not sure we have the answer yet as to how you deal with the question of the Big 4 becoming the Big 3, but we will do our best to find some answers too. It has been a very helpful session, very interesting responses, and we are very grateful to you. Thank you all.

\[1\] Note by Witness: It might be useful for the Committee to know that when an auditor ceases to hold office, under s519-521 of Companies Act 2006, he must deposit a statement (which is sent to the company, the shareholders and Companies House) which sets out the circumstances connected with his ceasing to hold office.