



## Auditors: Market concentration and their role

### Written Evidence

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## Memorandum by the Association of British Insurers

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### 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 Group 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.

## **ANNEX**

### **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?*

Memorandum by the Association of British Insurers

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

## Memorandum from the Association of Chartered Certified Accountant

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### 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#top>

### 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, i.e. 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 covenants<sup>1</sup> 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 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

### **I. 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.

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<sup>1</sup>A restriction which prevents a company from using a firm other than one of the 'Big Four' to provide audit and other services

The Big Five became the Big Four following the collapse of Arthur Andersen in 2002/3 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. This is particularly true at the smaller end of the market.

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<sup>2</sup> 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

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<sup>2</sup> <http://www.fsa.gov.uk/pages/Library/Communication/PR/2010/108.shtml>

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 report<sup>3</sup> 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

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<sup>3</sup> Competition and Regulation in Auditing and Related Professions, <http://www.oecd.org/dataoecd/8/8/44762253.pdf>

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*<sup>4</sup>, 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 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

## Memorandum by Mr Duncan Alexander

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1. Following your Call for Evidence, I now enclose my thoughts on this matter and provide answers to the questions that you ask. My perspective comes from being a *working* investor creating and running small businesses and being a *passive* investor by investing in publicly quoted companies around the world. As a *working* investor I have direct, unfettered access to information on my ventures in trade. As a *passive* investor in quoted public companies my information is often restricted to publicly available sources. In view of this restriction, I would suggest that investors need to have verified accounts by auditors who are independent of those running the day-to-day activities of the firm.
2. I would like to confirm that I have made contributions to the DTI Company Law Review, the Auditing Practices Board on Aggressive Earnings Management, the Sandler's Review Team on medium & long term retail savings, the Treasury Committees' inquiry into the financial regulation of Public Limited Companies and the Review of Non-Executive Directors.

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<sup>4</sup> [http://www.accaglobal.com/pdfs/credit\\_crunch.pdf](http://www.accaglobal.com/pdfs/credit_crunch.pdf)

3. **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?** Business studies theory says that it is an inevitable reaction in the free market system that the over consolidation into a small number of players will occur as the prize for this is monopoly profits. Competition theory then goes on to say that it is the role of politicians to identify when this “*cornered market*” may have occurred and to arrange systems and processes to ensure free and fair markets. I believe that we have “*cornered markets*” in many services such as Auditing and Banking. I am convinced that our politicians and regulators have failed to meet their responsibilities in this matter.

4. **Question 2. Does a lack of competition mean clients are charged excessive fees?**

Yes – that is the prize of “*cornered market*” power!

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

Yes – excessive fees and very limited responsibility for negligent work [The House of Lords 1990 *Caparo -v- Dickman* case] no one should be surprised that this would lead to the present financial problems.

6. **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?**

This seems to be crazy logic! – but does highlight one of the central problems in auditing: Who is the auditors client? As a part owner in publicly quoted companies, I believe the owners/shareholders are the auditor’s primary client. Unfortunately, the auditor’s view the Board of Directors, who they are auditing, as their primary client. UK politicians need to now clarify who is right - Investors or Auditors.

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

Liz Hughes, head of the ACCA in Ireland said: “*Audit is a simple concept; an independent person, appointed by the investors, but paid for by the company, provides investors with an opinion on how well the financial statements reflect the underlying business performance.*” She then said “*However, what an audit does and doesn’t, cover is sometimes unclear. Auditors do not see themselves as “bloodhounds”, out to detect fraud, but rather as watchdogs, there to determine whether or not a company’s accounts are realistic representation of its business.*” This is the “*expectation gap*” problem. Investors want auditors to be “*bloodhounds*”, out to detect fraud; auditors don’t want to deliver that want. Politicians will now have to decide the countries position on this and the auditor’s primary client issue.

8. **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?** No – The auditors know they are in a “*cornered market*” situation; their main concerns will be to maximising their income while this persists. Scepticism is probably used only as a marketing tool to generate non-audit services. The present audit culture is aimed at revenue generation rather than protecting the interests of owners, creditors and other stakeholders.

9. More competition is the only way to break a “*cornered market*” situation. In an earlier response to audit reform, I suggested that the Regulator should dictate a minimum number of audit firms to service the needs of publicly quoted companies. We know that if the present Big 4 were reduced to 3; that they would be paralysed by conflict of interest problems. I suggested that 10 might be the minimum.
10. **Question 7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?**
11. It is not in the interests of auditors to change the present situation. However, the owners of Banks could have required their auditors to be “*bloodhounds*”, out to detect fraud. The Big 4 would probably refuse that requirement. Thus, political intervention is required to give owners the legal right to require that obligation.
12. **Question 8. How much information should bank auditors share with the supervisory authorities and vice versa.**  
Bank auditors should provide as much information as a supervisory authority needs for the execution of their responsibilities.
13. **Question 9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?**  
A legal requirement for auditors to be honest and objective towards owners would be helpful.
14. **Question 10. Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?**
15. There is a fundamental conflict of interest in trying to combine audit and consultancy roles. Auditing your own work in a quoted public company context **is wrong**. To maintain public confidence in the audit process, we should consider the answer may be that we should have audit only firms.
16. **Question 11. Should more competition be introduced into auditing? If so, how?**
17. Yes, we need more competition in an updated auditing market. Recognise that the present market lacks credibility following the financial crisis. Learn from basic business theory (Adam Smith – *Wealth of Nations*) that the capitalistic system has a tendency to monopoly. The Business Secretary, Dr Vince Cable MP has put it more colourfully as: “**Capitalism takes no prisoners and kills competition where it can.**” My solution would be to have audit only firms which recognise that the owners of companies are their primary responsibility. They should also recognise that the detection of fraud and unusual accounting practices is an essential part of their audit assignment. At the members AGM they must take a proactive role in explaining the risks that the firm is taking and the credibility of the Boards’ business plan. Overall, the audit market should have a minimum of say 10 firms for quoted public companies. As computerisation has taken away a lot of the mystery of accounting, it should be possible for other specialist labour only groups to adequately do this work.
18. **Question 12. Should the role of internal auditors be enhanced and how should they interact with external auditors?** I would wait until we see if the discredited audit system is reformed.

19. **Question 13. Should the role of audit committees be enhanced?** I would wait until we see if the discredited audit system is reformed – I don't see the point of going into this element of the process until the basic principles are established or changed.
20. **Question 14. Is the auditing profession well placed to promote improvement in corporate governance?** No – their reputation is discredited.

I would be glad to answer any questions you may have and if you have managed to absorb some of this *working* investors ideas, many thanks for your time.

23 September 2010

## Memorandum by BDO LLP

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### I. 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 4 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 4 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<sup>5</sup>.

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.

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<sup>5</sup> 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<sup>6</sup>, 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.<sup>7</sup>

**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.

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<sup>6</sup> K.P. McMeeking et al, The effect of audit firm mergers on audit pricing in the UK, 2005

<sup>7</sup> Kittsteiner and Selvaggi, Enterprise LSE, Research Report – Concentration, Auditor Switching & fees in the UK Audit Market, April 2008

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 scalable 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<sup>8</sup>. 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<sup>9</sup> 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

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<sup>8</sup> Financial Services Authority & Financial Reporting Council, Enhancing the auditor’s contribution to Prudential Regulation, 2010.

<sup>9</sup> House of Commons Treasury Committee, Ninth Report of Sessions 2008-09

evidence that is made available to them. Similarly, regulators 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")<sup>10</sup>, 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.

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<sup>10</sup> ICAEW, Financial Services Faculty, Audit of Banks: Lessons from the Crisis, June 2010

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.

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.<sup>11</sup> Domestic and international investors want more choice. Companies themselves want 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 7 included reference to the risks of auditor withdrawal from the market.<sup>12</sup> This failure to engage suggests to us that some more radical change is required.

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.

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<sup>11</sup> GAO, Audits of Public Companies, 2008

<sup>12</sup> FRC, Choice in the UK Audit Market, Fifth Progress Report, June 2010

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.

## Letter from Baker Tilly UK Audit LLP

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This response to the Committee's Call comes from Baker Tilly UK Audit LLP, one of the ten firms in the United Kingdom on which the Audit Inspection Unit of the Professional Oversight Board<sup>13</sup> publishes an individual firm report, the third-largest UK audit firm outside the 'Big 4', and having a significant number of listed and AIM audit clients.

Our principal submissions to the Committee relate to market-concentration, though we have responded to all of the questions set out in the Call. In summary, those submissions are that government should:-

- accept that competition can only be stimulated by direct intervention in the market
- discriminate positively in favour of potential competitors, in order to effect that intervention
- be mindful of addressing systemic risk when intervening, and of the need to support the owner-managed, SME-led recovery of the economy, and finally
- introduce effective statutory limitation of auditors' liabilities

Our answers to the questions are as follows:-

*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?* In our opinion, the modern audit-profession has been shaped by three factors, two of them brought about by government intervention, and the other market-led.

The first factor was government intervention, for the first time, in how the audit market operates, through the operation of the Companies Act 1989: the Act required audit firms to apply to their professional bodies, in order to be licensed for the conduct of audit. The new licensing régime saw a rush of firms lodging applications, though comparatively few actually carried out any real degree of audit work. Understandably, they were making 'protective registrations', wanting to preserve the right to audit even though in truth many firms were not well set up in an operational sense to carry it out. Over the ensuing 15 or so years, the activities of the audit registration committees of the professional bodies and their monitoring arms caused many firms to cede their registrations as the costs of registration or not having the capacity to put proper audit processes and procedures in place began to cause the numbers of registered firms to be rationalised. The numbers of registrations either lost or removed by regulatory action were quite considerable.

The next factor was competence-monitoring, which really got into swing when audit monitoring by the Institutes and then by the Audit Inspection Unit began. That phase has become well-embedded and sophisticated, mirroring the complexities of audit itself, and adding to the overall formula by which audit quality is secured.

The third factor, and the most decisive one, was the desire of the biggest audit firms to become even larger, to better serve their clients and to become more profitable, through merger. The last twenty years has seen a significant contraction of the numbers of those

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<sup>13</sup> The Professional Oversight Board is an operating arm of the Financial Reporting Council, the accountancy profession's principal regulator.

firms, and a correlative increase in the numbers of audit entities whose appointments as auditor they have been able to secure – over 98% of those entities are audited by the Big 4 firms. The conclusion we have drawn is that market-concentration will not change unless government chooses to intervene to effect it. Government and the Financial Reporting Council have already accepted that there are sound public policy justifications for greater competition<sup>14</sup> and a number of ‘mid-tier’ firms have responded, reaching the level of capability that they are able to service bigger clients. Their potential will always be fettered, though, so long as government assumes that change can be market-led.

Unless government concludes that it needs to intervene in the market again, the *status quo* will be self-perpetuating, for the reason that we have said: it was commercially-led market-mergers that caused the contraction and it will take positive discrimination in favour of potential competitors to now change it. We do not believe that economies of scale in themselves cause an impediment to competition but such is the degree to which the biggest firms have been able to use them to secure the numbers of audits they have, it is now incredibly difficult for market-led solutions to bring about change. We return to that theme below, in our answers to Question 10 and 11.

*Q2 Does a lack of competition mean clients are charged excessive fees?* There is, in our view, simply no evidence of over-charging, whether in the listed sector or otherwise.

*Q3 Does a narrow field of competition affect objectivity of advice provided?* Audit firms are subject to the Auditing Practices Board’s Ethical Standards for Auditors and the Codes of Conduct of the professional bodies, and firms’ compliance with the Standards and Codes are actively and regularly monitored. A narrow field of competition does, however, bring about the potential for the existence of conflicts of interest – the fewer the number of firms offering an audit service, the greater proportionally must be the numbers of situations in which conflicts of interest will present. Although the Standards and Codes provide mechanisms for managing conflicts and addressing them, it is a *sine qua non* of conflicts of interest that where they occur, poor or partial management of them might bear adversely on objectivity.

*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?* In our view, the mere fact that the numbers of audit firms at the top end of the scale are small neither increases nor diminishes the ease with which unwelcome advice can be delivered to audited entities. Our submission to your Lordships is that the training of auditors, the emphasis in both training and practice on professional ethics, and practitioners’ membership of the professional bodies who license their firms provide reliable assurances of sound professional behaviour.<sup>15</sup> The emphasis of audit training and audit practice is the preservation of sceptical objectivity and independence: firms’ (and audit practitioners’ own) reputations are simply too precious and fragile for them to conduct themselves below that standard. There is no evidence for the proposition, either that the bigger the size of the firm, the greater its capacity to provide objective advice, or the converse, that the smaller the firm, the greater the likelihood that it will compromise its objectivity in order to placate the client. On a pragmatic note, audited entities have a strong disincentive not to change their auditors when faced with unwelcome advice, as potential appointees are alerted (by law and by the requirements of professional conduct) to the reasons for the change in appointment.

*Q5 What is the role of auditors and should it be changed?* An audit has two essential features: a monitoring feature and an advisory one (which firms often refer to as adding value to the

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<sup>14</sup> See, for example, the conclusions in 2007 of the Market Participants Group set up by the Financial Reporting Council.

<sup>15</sup> For example, Beattie, Fearnley, and Brandt, “*Behind Closed Doors: What Company Audit is Really About*” (2001)

audit, perhaps in terms of benchmarking corporate performance against competitors or providing a risk analysis service). We have two principal submissions to make to your Lordships in answer to this Question.

The first is that, although a number of commentators have expressed disappointment that auditors did not anticipate the banking crisis, that was not a function of having failed in their duties. Audit is a statutory function and the scope of the obligation on the auditor has been largely unchanged since the first legislative expression of it in 1948: it requires audit firms to report on the financial statements produced by an entity's management; its scope is necessarily historical; and it is not a surrogate means of second-guessing the entity's strategy, business model, or vulnerability to risk. It may be that an expectation-gap has grown up over time but any change needed now is not a function of failure on the part of auditors hitherto.

Our second submission is that businesses, particularly those businesses that are owner-managed or in the SME sector (many of which companies are quite large, it should be pointed out too), need and want access to a suite of advice offered by their auditors because that is the most fruitful and trusted source available to them. Provided that the provision of that advice does not compromise the independence of the audit, other service-providers within the audit firm or affiliated to it ought to continue to be allowed to provide them.

The benefits to the audited entity, and the emergent economic recovery, are manifold. Our suggestion, therefore, is that the consideration of any change in the role of audit should take into account the consequences for the availability of that advice and its benefits to industry and commerce. If there is pressure for change in the role and scope of audit, then it is coming principally from some (perhaps a very few) institutional investors in relation solely to the biggest companies, not from the audited entity population as a whole, a factor which needs continually to be borne in mind by legislators trying to stimulate the SME sector.

We invite your Lordships to consider what the modern audit entails before becoming predisposed to a belief there is a need for change. There is, in any event, substantial current work being done at the hand of the Financial Reporting Council and the Financial Services Authority which might assist your Lordships and we imagine that the European Commission may be carrying out similar work in the near future.

*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?* We refer again to our answer to the previous Question; a number of examinations of the same ground has been entrained already and the results are expected in the near future.

*Q7 What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?* Aside from observing again that there is no evidence to suggest audits were deficient pre-crisis, we again refer to the work going on in this area.

*Q8 How much information should bank auditors share with the supervisory authorities and vice versa?* Again, this area of 'auditor communications' is under examination by other bodies and your Lordships may wish to await the conclusions of those studies.

*Q9 If need be, how could incentives to provide objective and, in some cases, unwelcome advice to clients be strengthened?* We said in our answer to Question 4 that the strength of an auditor's training is the emphasis on independence and objectivity, and on professional integrity. That emphasis is maintained not only by the 'tone at the top' of an audit firm (a feature recognised in the nascent Audit Firm Governance Code) but by audit practitioners' membership of the professional body that licenses his or her firm. The recognition of that professionalism and the means whereby it is underscored ought, in our respectful view, to be the focus of your Lordships' attention.

*Q10 Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated?* We strongly advocate to your Lordships that, far from there being a conflict between the audit and other advisory roles filled by auditors, there are, in the vast

majority of cases, sound public policy reasons supporting the entitlement of audit firms to provide Non-Audit Services to their clients, and we have already pointed out what those public policy reasons are: (i) in the market-sector below the systemically important listed audited entities, those charged with the care and stewardship of those entities wish and need to have access to the suite of advice that their auditors can provide; and (ii) the interests of the country are best served thereby.

We do not suggest that the provision of such services be unbridled, it should be noted, however – we have already pointed out the value of the Ethical Standards for Auditors and we strongly exhort your Lordships to accept our submission that the Standards constitute a sound system of checks and balances for the identification of conflicts of interest and their adequate management. There is, however, a significant proviso to this submission: in our view, where any classification of audit entity can be said to present a systemic risk to the capital markets, then the audit ought to be subject to more stringent professional prohibition so far as the supply of Non-Audit Services is concerned.

We have already pointed out (see our response to Question 3) that the narrower the choice from among which audited entities can choose their auditor, the greater is the likelihood of the occurrence of circumstances in which a conflict of interest can present. At the level of importance of systemic risk, the *appearance* of independence is as important as independence in fact and our strong representation to your Lordships is that audit firms' entitlement to provide Non-Audit Services should be significantly restricted where systemic risk presents. Plainly, the global banks, insurance and some other systemically important businesses will come into the category of presenting a risk of that kind but not the entire population of listed and AIM companies.

*Q11 Should more competition be introduced into auditing? If so, how?* Many audit firms have for a number of years been of the view that the absence of a viable means of limiting their liabilities to clients and to third parties must be addressed if they are at any stage to challenge the dominance of the four largest ones.

It is not possible for firms (indeed, even the largest) to obtain professional indemnity insurance that would adequately guard them from the effect of the joint & several liability principle of the common law, in terms of which plaintiffs are entitled to recover from one co-defendant all of the sums sued for when the other co-defendants are at least equally culpable. Auditors are seen as the source of the deepest pockets and are therefore peculiarly vulnerable to claims.

The 'limited liability agreement' régime<sup>16</sup> in the Companies Act presently is not a surrogate for a properly operating limitation mechanism. The absence of an effective means is a significant and unfair detriment to audit firms and a disincentive to competition. The limit of an audit firm's exposure should be the damage directly attributable to any fault on its part. This, *proportional*, liability is demonstrably fair from the standpoint of any stakeholder, including the investor-bodies, and our understanding is that at least one other, modern, English-law based jurisdiction (Australia) has introduced it. We respectfully ask your Lordships to support the principle of proportional liability, fulfilling as it does the necessary tests of all-round fairness and stimulating the public policy objective of competition in the audit market.

We add that we do not see this as the only means by which competition can be encouraged. Taking it as a given that government is already persuaded that having additional 'players' at the top end of the market is an important public policy objective in itself, we began our response with the proposition that change cannot be market-led and will instead need

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<sup>16</sup> Sections 532-538 of the Companies Act 2006 introduced a statutory entitlement, allowing audit firms to contract with their clients to limit their liability. The weakness in the LLA regime is in its name – it is purely voluntary and has had virtually no take-up on the part of audited entities as a result.

decisive intervention on the part of government. To lend more specification to that proposition, we say that the number of listed audits that any one firm is entitled to carry out should be limited. That will, it can readily be seen, oblige companies to seek their audits from a broader number of audit firms. They can have confidence in doing so: we observed in our answer to Question 1 that regulation is now so meaningful that it has become one of the determinants of audit quality, ensuring that the firms taking on the audit engagements ceded by the Big 4 are supplying services of the same quality.

We do not believe that anything less than positive discrimination in favour of audit firms with the potential to compete with the biggest will make any difference to the *status quo*. Absent market-intervention, there is in our view no realistic possibility of stimulating competition. We believe too that the creation of competition would have the effect of diminishing the impact of one or more of the biggest firms suffering a cataclysmic event or just deciding to leave the market. The means we have set out above of increasing competition are proportionate to delivery of the public policy objectives we believe the Government is already persuaded of the need for.

*Q12 Should the role of internal auditors be enhanced and how should they interact with external auditors?* The role of the internal auditor is quite different from external audit, having a different focus and different obligations. We do not believe that the threat to loss of audit independence caused by manifest self-interest and self-review threats can be wished or finessed away. For these reasons having as a firm decided that we would not be willing to offer internal audit to any of our audit clients, we were then surprised to read in the Auditing Practices Board's recent consultation paper on non-audit services that much of what would formerly have been regarded as internal audit (and therefore impermissible in terms of the Ethical Standards for Auditors) can be re-classified as 'extended assurance' and therefore permissible. Plainly, we will have to take a view on the stance we had taken, in the light of how the applicable ethical guidance seems to be shaping but your Lordships will appreciate from our answer thus far that, however internal audit could be enhanced, our view is that auditors should have no part of it.

*Q13 Should the role of audit committees be enhanced?* This is another area in which a lot of work is going on in other quarters and your Lordships may care to await and consider developments in that regard.

*Q14 Is the auditing profession well placed to promote improvement in corporate governance?* The role that auditors play in overall corporate governance is substantial and we anticipate that governance norms applied in the conduct of audit will soon find their way into most boardrooms as an extension of good practice. Audit firms are able to highlight poor governance on the part of audited entities and their executives and this issue might usefully be picked up by the relevant regulator in terms of 'auditor communications'.

October 2010

**Memorandum by Professor Vivien Beattie: Glasgow University, Professor Stella Fearnley: Bournemouth University, and Tony Hines: Portsmouth University**

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## **I. Introduction**

I.1 We welcome the opportunity to submit evidence to the Committee on this very important subject.

I.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 I 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 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 2007-2008**

We carried out a major research study into the above areas in 2007-8. 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 2007-2008 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 5 related to the enhanced role of the audit committee including the top 2 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 (3.35)*.

#### **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 (e.g. 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<sup>17</sup> 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 than 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:**

### **I. 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*

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<sup>17</sup> 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.

*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.*

## **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, i.e. 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.*

October 2010

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3 October 2010

### **Appendix I: 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 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.

### **Letter from Mr A St John Brown**

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1. I claim no professional expertise on the subject, but have been the victim of investment losses where one can't but help feel that these might have been mitigated if the auditors had been more effective in doing their jobs.

2. I suspect there are three fundamental issues:

a. The auditors are appointed by the people they are supposed to be auditing. Does one really believe that the auditors are going to challenge aggressively the Finance

Director/Board of a company when they have many hundreds of thousands, or millions of pounds in audit fees riding on their reappointment (and probably even more valuable consultancy work – see 3 below) ? For the auditors to become genuinely independent they need to be responsible in a meaningful way directly to the shareholders.

b. It is clear that in some complex businesses – for example, trading operations – the auditors don't have a clue as to what the underlying risks really are. Enron was the clearest example of this. I suspect many of the derivative products/ operations in the investment banks are not understood at all by the auditors. (What is equally clear from the Banking Crisis is that the management in the banks themselves didn't understand the risks they are trading, and this was never made public.) In these circumstances the auditors should be forced to say "we have not been able to satisfy ourselves of the risks and potential profit opportunities in X, and are therefore unable to offer any opinion as to the accuracy of its statement in the accounts".

c. The Annual Reports provided by the companies/auditors are politically correct, largely meaningless nonsense. Most of the key information is in the Notes. The auditors should be made to provide a cogent summary of their view of the business, particularly around the risks they think the company is running. Is a company's viability vulnerable to a 5-10% drop in revenue, is it overly dependent on one customer, or one technology, or willingness of the banks to continue to make short term funding available, etc ?

3. From my own personal interaction with the Big 4 auditors they are mainly interested in selling other services – particularly management consulting, and regard the audit function as principally being a way of getting to the table and developing a relationship with management.

4. Clearly, if you are a multinational company it probably makes sense to use a multinational auditor, so large multinationals will naturally pick from the Big 4. Perhaps a compulsory change of auditors every 3 or 5 years should be enforced.

5. What is offensive with respect to the Banking crisis is that no auditors have been found legally culpable. How can they be allowed to get away with a number of their largest clients effectively going bust, and not suffer any consequences ? Auditors are in many ways like eunuchs in a harem – you think they have some value but ultimately they are not able to do the real business – and this needs to change.

September 2010

## Memorandum by Mr Timothy Bush

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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 [i.e. 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**

SI.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.

SI.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.

SI.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<sup>18</sup>, 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.

SI.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.

SI.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.**

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<sup>18</sup> Answer to Justine Greening MP from Margaret Hodge MP, Minister, July 2006.

SI.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.**

SI.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.

SI.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.

SI.9 The way that the law is still structured (Section 830-837) are still paramount objectives, complying with IFRS may well break the law, despite being the expected method of delivery. Instead of a health check of a business, the model gives false positives. Very dangerous indeed.

### **Background, the year 2008**

- EI.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.
- EI.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.
- EI.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<sup>19</sup>. 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.

EI.4 The official commented that speaking to long only investors (i.e. 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.

EI.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 (i.e. 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.

EI.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<sup>20</sup>. 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

EI.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.

EI.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.

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<sup>19</sup>Evening Standard, June 2008 <http://www.thisislondon.co.uk/standard-business/article-23498600-a-principle-we-must-save-at-bb.do>

<sup>20</sup>“Are banks different?” Lord Turner, January 2010. [http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0121\\_at.shtml](http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2010/0121_at.shtml)

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<sup>21</sup>). 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<sup>22</sup>) and give a “true and fair view” (i.e. a sufficient output). **Section 393 (and the auditor opinion thereon, Section 495(3)(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).**
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”, i.e. 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<sup>23</sup>. The terms of that agreement encountered problems<sup>24</sup> at the outset due to the problem set out below (E4.1).

### **Standards falling short of what the law demands after January 2005**

<sup>21</sup> House of Lords, Caparo vs Dickman, 1990.

<sup>22</sup> Also called “UK GAAP”. Though UK GAAP, is Companies Act formats and rules, and then Accounting Standards Board Standards.

<sup>23</sup> NAPF/Morley Fund Management, “Bringing Audit Back from the Brink” and “Undermining the Statutory Audit” 2004/5.

<sup>24</sup> Financial Times, Barney Jopson, 24 June 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<sup>25</sup>. 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 £1bn in value. So covering up losses within that package is a serious matter.

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<sup>25</sup> Companies Act, Schedule 2, Part 2, Clause 21. [http://www.opsi.gov.uk/si/si2008/ukSI\\_20080410\\_en\\_9#sch2-pt2](http://www.opsi.gov.uk/si/si2008/ukSI_20080410_en_9#sch2-pt2)

- 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, it was 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 2005-2007 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 its 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 (i.e. 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 (e.g. 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, i.e. may have been slightly higher than justified.***<sup>26</sup>

- 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 2005-2009.**
- E4.2 The IAS Statutory Instrument<sup>27</sup> (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 2005-2009.** 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.

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<sup>26</sup> Letter from Lord Turner to the Chancellor, Alastair Darling MP, [www.fsa.gov.uk/pubs/other/response\\_Dunfermline.pdf](http://www.fsa.gov.uk/pubs/other/response_Dunfermline.pdf)

<sup>27</sup> SI 2004/2947.

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<sup>28</sup>. The essence of investor concern was the following:

- 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.<sup>29</sup> 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<sup>30</sup>” 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.

Position	Pre-2005 accounts of all companies	Companies Act accounts 2005-2009	IFRS Accounts 2005-2009
True and fair view override	Yes	No, or at best unclear.	No, and no evidence of it being used in a UK bank, (it was used in France <sup>31</sup> ).
Prudence as an overriding accounting rule?	Yes	Accounting Rules are intact, but the ASB put IAS 39 into FRS 26 (see below)	No.  Imprudent provisioning was compulsory for banks (including banking subsidiaries), and this standard applied listed entities (their consolidated
IAS 39 (with its incompatibilities.)	N/A  The BBA-SORP required loans to be carried at “not more than their <u>ultimate realisable value below cost.</u> ”	IAS 39 was incorporated into UK FRS 26, despite being inconsistent with the Accounting Rules of the Companies Act, (incurred loss	compulsory for banks (including banking subsidiaries), and this standard applied listed entities (their consolidated

<sup>28</sup> Financial Times – John Plender. 10 July 2005, “Battle for truth in European Accounts”.

<sup>29</sup> IASB Conceptual Framework Project. IASB 2005.

<sup>30</sup> “Following the Money”, The Enron Failure and the State of Corporate Disclosure, Brookings Institution, USA, <http://reg-markets.org/admin/authorpdfs/redirect-safely.php?fname=../pdffiles/phpD9.pdf>

<sup>31</sup> 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.

Memorandum by Mr Timothy Bush

		provisioning, below).	accounts) and for the individual company accounts of bank holding companies.
		Incurred loss provisioning. Forbids adjusting loans for inherent credit risk.	

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.

Position	UK Auditing Standards to 2005	ISA from 2005#
An auditing <u>standard</u> dealing with the matters in the 1985 Act equivalent to the 2006 Act of 836 and 837?	No. In some supplemental guidance, on a form of words <u>when</u> an auditor qualifies his opinion.  But, this does not indicate the dividend test as a criteria <u>for</u> qualification, i.e. <b>it does not direct auditing in that direction. +</b>	
Materiality objective in auditing standards?	Accounting materiality [i.e. relevance for auditing purposes is: "Material in the context of the financial statements taken as a whole"*	
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<sup>32</sup>, 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<sup>33</sup>. 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:

- I) 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.

<sup>32</sup> HMRC manual - notes on Company Law aspects of dividends, <http://www.hmrc.gov.uk/manuals/ctmanual/ctm20095.htm>  
<sup>33</sup> 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.

- 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 expectation 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<sup>34</sup>. That has manifested in regulatory support for sheltering auditors from civil liability claims<sup>35</sup>. It is a classic manifestation of regulatory capture<sup>36</sup>.

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. I have yet to see any evidence that the UK's FRC uses information on successful auditor litigation (i.e. 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.

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<sup>34</sup> New York Times, <http://www.nytimes.com/2005/06/25/business/25nocera.html>

<sup>35</sup> FRC delegations to DTI in 2004/2005 to support a liability cap. Opposed by HM Treasury.

<sup>36</sup> “Regulatory Capture” Stigler, Chicago, Nobel Prize 1982.

**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**

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I have pleasure in submitting written evidence to the Committee supplementing that I submitted on 4<sup>th</sup> 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) & 2)

a memoranda relating to a standard setting committee to be held on 29<sup>th</sup> September 2010.

3) a maths based summary of what is not audited with IFRS (for a bank - its prime risk in fact).

27 September 2010

**Supplementary memorandum by Mr Timothy Bush**

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**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 (i.e. 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 ½-3 ¾ years).
8. There appears to have been inconsistent application of the law within the UK (not Ireland where essentially every bank failed). A mitigating factor in the UK may be the presence of ICAEW (Institute of Chartered Accountants in England and Wales) guidance on mitigating the effects of IFRS, published 2003).

9. This paper for the UITF, to minute, will form a proposal be taken to the full Accounting Standards Board for 12<sup>th</sup> October 2010.

**UITF (Urgent Issues Task Force of the Accounting Standards Board), memo for a minute, 29<sup>th</sup> September 2010.**

**Company law individual accounts and IAS (IFRS) individual accounts**

1.1 ICAEW/ICAS guidance on the law, under counsel opinion<sup>37</sup>, states that **prudence** applies as a fundamental valuation objective<sup>38</sup> 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 4<sup>th</sup> 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” (i.e. Companies Act accounts with FRS 26) does not require prudence<sup>39</sup>. 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 4<sup>th</sup> 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.

**Capital, and profits, the problem when IFRS is used in companies especially banks**

**Basic position (compliance with the accounting rules of Company Law – IV<sup>th</sup> Schedule)**

<sup>37</sup> ICAEW/ICAS TECH 07/03 and TECH 02/07 (the final form of TECH 21/05)

<sup>38</sup> TECH 07/03 para 6, 7 & 39, TECH 09 para 4.18

<sup>39</sup> A1.25.<http://www.frc.org.uk/images/uploaded/documents/FSA%20FRC%20Discussion%20paper1.pdf>

If a company is Net Assets N, Capital, C, and distributable profits D.

then,  $N = C + D$ , (i.e. 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.

**27 September 2010**

## Letter from CalPERS

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We are writing collectively on behalf of the California Public Employees Retirement System (CalPERS), the largest public pension plan in the U.S. with approximately \$210 billion in global assets and equity holdings in over 9,000 companies and the University of San Diego, School of Law, Center for Corporate and Securities Law.

Thank you for providing us with an opportunity to comment on your call for evidence on the concentration of auditors and the critical role they play in maintaining the integrity of financial reporting. We agree that audit is dominated globally by the Big Four accounting firms which does raise some concern about competition, the quality of audited accounts and about possible conflict of interests between audit and consulting. The following provides our perspective on the outlined questions:

- |   |
|---|
| I. 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? |
|---|

During the 1960's and 1970's, the eight largest auditing firms began to increase their international presence as the companies they audited increased their global operations. These auditing firms acquired or affiliated with other auditing firms in foreign countries, establishing international marketing arrangements under a common international brand name.

As discussed in pages 8 and 9 in the United States Government Accountability Office January 2008 Report, "Audits of Public Companies, Continued Concentration in Audit Market for Large Public Companies Does Not Call for Immediate Action," the largest U.S. accounting firms began merging with each other in the late 1980s. This reduced the number of major international accounting firms from eight down to five. Other large "second tier" firms, such as Main Hurdman, were also acquired. Further consolidation was pursued by the firms as E&Y and KPMG also asked for regulatory approval for a merger, but were declined. In 2002, the market dropped from five to four firms when Arthur Anderson ceased doing business. See also the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of Treasury, pages V: 4-V: 5, released on October 6, 2008 and available at <http://www.treas.gov>, for a more detailed history of U.S. audit firm mergers.

Today, accounting firms outside the "Big Four" are not competitive with the Big Four in terms of number of personnel, offices and a presence in foreign countries. In essence, much of the consolidation was the direct result of the large accounting firms responding to the need for a presence around the globe, in order to provide global audit coverage required by businesses operating globally. In addition, the consolidation gave the large auditing firms an advantageous economy of scale that makes it difficult for smaller firms to compete. The larger auditing firms have lower overhead costs, greater presence on college campuses allowing them to recruit new hires more effectively, the ability to provide audit resources in each major country around the globe, and national offices that can provide necessary resources for accounting, auditing, local and foreign taxes and business issues.

Prior to the GAO report, in 2007 the European Commission (DG Internal Market and Services) commissioned Oxera<sup>40</sup> to examine ownership and management rules related to audit firms, their corporate structures and their access to capital. The Oxera study showed that restrictions on access to capital were one of several potential barriers for smaller firms' entry into the market. Other barriers included reputation, the need for international coverage, international management structures and liability risk.

In addition, in the Highlights section of the GAO Report, it states the GAO found that the "small public company audit market is much less concentrated...[m]ost small public companies reported being satisfied with the auditor choices available to them. The GAO Report also acknowledged that "[s]maller accounting firms face various challenges in expanding to audit more public companies, although most are not interested in these clients." Despite this, "[s]ome have taken steps to increase their capacity by joining networks with other firms." The GAO Report concluded that "no compelling need for immediate action appears to exist."

We agree with the GAO Report findings. We are also supportive of increasing the number of high quality audit firms in the marketplace to increase companies' choice in selection and to benefit investors.

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

The Big Four compete very aggressively with one another on fees. According to a CFO.com article, "Auditing Your Auditor," April 1, 2010, "Audit fees have been dropping across the board since 2007...We have seen price competition return in 2007 and 2008...Not only have fees been falling, but they have fallen for companies of all sizes, including those not directly affected by 404. Companies with revenues between \$100 million and \$250 million saw an average 8% drop in fees from 2007 to 2008..."

However, the CFO.com article goes on to point out that unusually low fees can also signal trouble such as a weak audit. With the recent market downturn and fees decreasing, in some instances, this may also raise questions regarding whether audit quality is also subject to a corresponding decline. The potential correlation between reduced audit fees and poor quality audits is an issue that should be on the radar screen of regulators and warrants further examination via the audit inspection process.

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

A narrow field of competition does negatively impact the objectivity of advice when a firm is concerned that taking a "tough" stance could result in the loss of an audit as auditors may consider audit fees as a "loss leader" in anticipation of other consulting and advisory work in the future. This may provide additional pause on whether an auditor may be willing to hold to a bright line on issues. In addition, this concern is elevated when a company operates in a jurisdiction where it can "shop" among auditors for a specific opinion, and the regulators do not mandate transparency to investors regarding such actions.

We do feel where the audit firm receives significant fees for services other than an independent audit, and the information is not properly disclosed to investors, the lack of

<sup>40</sup> "Ownership rules of audit firms and their consequences for audit market concentration", <http://www.oxera.com/main.aspx?id=6588>, October 2007,

auditor independence negatively impacts the auditors' objectivity. We feel that some services are in fact, inconsistent with an auditor maintaining their objectivity, such as services that might result in the auditor having a common financial interest, in auditing their own work, or engaging in management activities.

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 don't necessarily believe that limited competition makes it easier for auditors to provide unwelcome advice to clients.

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

The number one objective and priority of an independent auditor is, and should be, to provide investors with an independent opinion as to whether the financial statements and disclosures therein, are materially accurate and complete. If this objective is not achieved, the value of an audit is lost.

As aptly noted on page 10 of the ICAEW Financial Services Faculty June 2010 Report, "Audit of Banks: Lessons From The Crisis, ..."the audit process is highly valued by investors...and seen as essential in providing discipline to directors in their presentation of information, and to the control environment around their financial processes." However, as noted on page 11 of the Report, investors want less boilerplate language and more commentary from auditors with better risk disclosures.

An auditor can, but does not currently, provide useful information to investors with respect to the financial statements, financial information, and the audit. Such information should include for example:

- Key business and audit risks the auditor believes exist, and which the auditor has considered when conducting the audit,
- The auditor's perspective on what are the key assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low, most likely, or high end of the range of possible outcomes,
- Key audit issues and their resolution which the audit partner documents in a final, summary audit memo,
- Changes to accounting policies that have a significant impact,
- Unusual transactions,
- Accounting applications and practices that are unique to the industry, and
- Change of auditor and background thereof.

Moreover, on page 1 of the July 29, 2009, Report of the Financial Crisis Advisory Group, it identified "Effective Financial Reporting" as one of four key principles and stated as follows:

"Financial reporting plays an integral role in the financial system by striving to provide unbiased, transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards as well as the consistent and faithful application and rigorous independent audit and enforcement of those standards. Financial reporting is of great importance to

investors and other financial market participants in their resource allocation decisions and to regulators and other users. The confidence of all these users in the transparency and integrity of financial reporting is critically important to global financial stability and sound economic growth.”

In our opinion, we should adhere to a continuous improvement audit profession model to ensure independent, high quality audits by audit firms. Auditors should serve as independent gatekeepers that instill public confidence via high quality audits in public companies seeking capital from investors. In addition, regulators should consider requiring an Auditors Discussion and Analysis (AD&A) as part of the filing to provide investors with the auditor’s perspective on key risks. Such a requirement would help ensure that auditors are not missing anything significant and it would incent auditors to perform better audits.

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?

Questions need to be asked about the scepticism by auditors when auditing banks in the run-up to the financial crisis of 2008. Business is increasingly complex and global in nature, which in turn affects the skills and staffing requirements needed to conduct a high quality audit. Today, the majority of audit work is still being performed by staff that on average has less than six years of experience. Increased training of auditors, from junior members to partners and mid-career professionals will give auditors the up-to-date technical skills they need to help avoid material audit “misses.” In addition, creating professional schools of accountancy at universities to provide better, more targeted coursework for auditors than the present requirement, for example in the U.S. of 150 hours of training, would also be a step in the right direction to ensure high quality audits and fewer audit “misses.”

The importance of professional scepticism is highlighted in the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury released on October 6, 2008 and available at <http://www.treas.gov>. The Committee notes in V. Background, page V:I that “Auditors’ professional conduct requires an attitude of healthy scepticism in performing their work and their assurance is critical to investor confidence and, ultimately, the flow of capital. The auditor’s role in the effective functioning of the capital markets cannot be underestimated.” In Section VI. Human Capital, Recommendation 4 (b), page VIII:19, states, “Develop training materials to help foster and maintain the application of healthy professional scepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals.”

As also noted by the Auditing Practices Board on page 3 of its August 2010 Discussion Paper, “Auditor Scepticism: Raising the Bar,” “Audit is essential to public and investor confidence in companies...The application of an appropriate degree of professional scepticism is a crucial skill for auditors. Unless auditors are prepared to challenge management’s assertions they will not act as a deterrence to fraud nor be able to confirm, with confidence, that a company’s financial statements give a true and fair view. On page 4 of the Report, it states the Auditing Standards define professional scepticism 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. It is widely acknowledged that a sceptical attitude of mind is essential if an audit is to be rigorous and performed with professional due care.”

Professors Tina Carpenter and Jane Reimers found in their academic study, “Professional Scepticism: The Effects of a Partner’s Influence and the Presence of Fraud on Auditors’ Fraud Judgments and Actions,” published in September 2009, that fraud risk assessments are higher with a partner who emphasizes an attitude of professional scepticism than with a partner who places less emphasis on professional scepticism. They further find that auditors’ choice of appropriate fraud audit procedures is responsive to their fraud risk assessments when fraud is present, but only with a partner who emphasizes professional scepticism (as opposed to efficiency).

There was insufficient auditor scepticism as demonstrated by PricewaterhouseCoopers declaring Northern Rock a “going concern.” (See page 114, House of Commons Treasury Committee Report, The run on the Rock, Fifth Report of Session 2007-08). Furthermore, the House of Commons Treasury Committee Report, Banking Crisis: reforming corporate governance and pay in the City, Ninth Report of Session 2008-09, refers to ‘tunnel vision’ on page 78 and states...”the big picture that shareholders want to see is lost in a sea of detail and regulatory disclosures.” (See also pages 80-81 of the Banking Crisis Report for ICAEW suggestions on where the role of auditors might be strengthened in the audit of banks). In page 87, the Banking Crisis Report states, “We believe the complexity and length of financial reports represent a missed opportunity to improve the understanding that users of accounts possess of the financial health of firms and recommend that the FSA consult on ways in which financial reporting can be improved to provide information in a more accessible way.”

7. What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?
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As noted on page 115 of the House of Commons Treasury Committee January 24, 2008 Report, “The run on the Rock,” states as follows:

“299. A lesson to be learnt from this crisis is that the auditor can only provide an assurance of a snapshot of the past state of the company. We recommend that the accounting bodies consider what further assurance auditors should give to shareholders in respect to risk management processes of a company, particularly where a company is regarded as an outlier. We are also concerned that there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution. For example, PricewaterhouseCoopers received £700,000 in non-audit fees largely comprised of fees related to assurance services in connection with Northern Rock’s actions in raising finance.”

Every major banking crisis has been primarily the result of banks making bad loans which were not repaid. Auditors can make a significant positive contribution to mitigate such risks again by:

- I. Recommending financial institutions disclose in a separate section of their reports to investors significant business risks, including risks existing in their lending, securitization and investing activities.

2. Requiring auditors to provide assurance on the risk section report, including the completeness of the report.
3. Reviewing and recommending better disclosures with respect to loans, including:
  - a. Risks in lending activities such as underwriting controls and standards, concentrations, credit risks, etc.
  - b. A disclosure of key assumptions used when assessing loan quality and losses.
  - c. Loan performance (or non-performance) including breakdowns by loan types of nonperforming loans, extent of non-performance, such as how old delinquencies are, extent of loan restructurings etc.
  - d. A comparison of actual and historical loan provisions, charge-offs, and allowances for loan losses, for each material class or type of loans.
  - e. Having the auditor opine on the additional or supplemental loan information.

We believe that audit firms should consider an auditor's discussion and analysis which would provide at a summary level audit risks, deficiencies and how these were resolved, similar to the business risk section of 10-K filings, which are widely read by investment professionals. Moreover, with respect to recognition of securitizations in the audit process, we support better disclosure of the following:

- Valuation. Current audit standards do not disclose risks when quoted market prices are not available. Assumptions involved in value estimates should be disclosed.
- Non-Performing Assets. Increase transparency through more stringent non-performing asset auditing standards at the securitization level and creditor level to assist investors.
- Special Purpose Vehicles. Improve disclosure and audit procedures to provide full transparency regarding special purpose vehicles to disclose ownership, capital structure, size of issue, terms of offer, details of the underlying asset pool and its performance history, transaction structure, and service arrangements.
- Sensitivity Analysis. Require stress-testing for securitizations with scenario ratings to take into consideration adverse events such as changes in default rates, decreases in underlying asset valuations, higher prepayment and discount rates, changes in the timing of cash flows, and early amortization triggers.

8. How much information should bank auditors share with the supervisory authorities and vice versa?
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An external auditor brings an independent and objective view to an institution's financial reporting process which provides useful information to investors, management, audit committees and other stakeholders. Supervisory or regulatory authorities focus on key aspects that would also be helpful to the external auditor. In this context, we agree that cooperation between external auditors and supervisory authorities should be deepened and considered so that the authorities have an opportunity to learn and obtain some assurances from the auditor through for example:

- periodically requiring financial returns to be audited – some of the information does not form part of the accounts, for example, regulatory capital ratios;
- greater use of powers by regulators in order to gain more information on the operation and application of controls in compliance with regulatory requirements;

- review the 'Pillar 3' disclosures introduced by Basel II; and
- more regular meetings between the authorities and the auditors.

If there has been a supervisory examination in the most recent period under audit, the independent auditor should be required to inquire of the supervisory authority, as to significant matters and risks that came to the attention of the examiner, and document how those items will be addressed in the course of the audit. The supervisory authority should also make available to the auditor any and all agreements the regulator has entered into with the institution.

Conversely, the independent auditor should make available to the supervisory authorities their audit workpapers, audit reports, and management letters. They should be receptive to inquiries by the authorities regarding audit scope, significant audit risks and issues, and significant audit findings, including with respect to deficiencies in internal controls, governance or management.

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

A "carrot and stick" approach may be considered. On one hand, if the auditor provides such advice, they should be rewarded with continuation as the independent auditor. However, if the supervisory authority finds the auditor did not provide objective advice, including in the case of where it would likely not be welcomed, the supervisory authority should be given the authority to require a change in the auditors.

Periodic rotation of the audit firm (rather than just the audit partner) would also provide an incentive to provide objective advice, especially when such advice may come under scrutiny by the subsequent auditor. When an audit firm takes over an audit from another firm, it does an exceptional job of checking, reporting and due diligence in order to prevent assuming liabilities for the previous audit. This is a compelling argument for rotation every seven to ten years.

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

We agree with page 110 of the June 2010 ICAEW Financial Services Faculty Report, "Audit of Banks: Lessons from the Crisis," "We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. 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." As noted on page 82 of the House of Commons Treasury Committee May 12, 2009 Report, "Banking Crisis: reforming corporate governance and pay in the City," Ninth Report of Session 2008-2009, "other commercial interests can compromise auditors in their ability to confront directors on difficult issues."

We strongly support this view of auditor independence and not permitting auditors to provide non-audit services to audit clients, including but not limited to the prohibition of the following non-audit services: internal audit, information technology, valuation,

actuarial valuation, tax, litigation support, legal, recruitment and remuneration, corporate finance, transaction related, and accounting (See The Auditing Practices Board Ethical Standards, “Consultation on Audit Firms Providing Non-Audit Services to Listed Companies they Audit,” October 6 2009, pages 28-31). In addition, a November 15, 2009 Study, “Auditor Independence and the Cost of Capital Before and After Sarbanes-Oxley: The Case of Newly Issued Public Debt,” by Eli Amir of the London Business School found that the Sarbanes-Oxley Act of 2002, by enhancing auditor independence, has resulted in a lower cost of borrowing. Investor confidence in financial statements will be enhanced through greater auditor independence, expertise, and effective risk management.

In addition, all the fees the independent auditor charges a company should be disclosed annually in a transparent manner to investors.

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

Yes. This issue warrants further study and consideration. These firms and the independent audits they perform are very important for establishing trust and confidence on the part of investors in the global capital markets. However, at the same time, they should not be considered “Too Big to Fail.” In the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury released on October 6, 2008 and available at <http://www.treas.gov>. The Committee made seven recommendations that, at a minimum, should be considered for implementation, such as greater transparency for, or elimination of, contractual provisions limiting the choice of public company auditors. Audit firms could, as major banks have been required to do, develop a plan for orderly and legal hand over of audit clients should a firm be in terminal difficulties.

Section VIII. of the Final Report, Concentration and Competition, page VIII:4, states more specifically as follows:

“Recommendation I. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. To address these issues, the Committee recommends that policy makers press for the reduction of barriers, to the extent consistent with audit quality and other public interest factors, to the growth of smaller auditing firms. For smaller firms, this includes encouraging and promoting development of technical resources in such areas as international financial reporting standards (IFRS) and fair value accounting, and development of specialized or “niche” practices or industry “verticles” where they are in the best interests of investors and can lead to more effective competition. Pressure also should be applied against-nonjustifiable resistance to using smaller firms on the part of a variety of market participants.”

Awareness may also assist in the removal of “stigmatism” of not using one of the big four auditors. For example there are many U.S. Public Pension funds, such as CalPERS which utilize an auditor outside of the big four network.

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

The role of the internal auditor can be enhanced through steps that include:

- I. Having the internal auditor report directly to the audit committee, enhancing the independence of the function.

2. Having the audit committee evaluate and set the compensation levels for the internal auditor.
3. Requiring the internal auditor to establish its own charter, including compliance with applicable professional and educational standards.
4. Giving the audit committee oversight responsibility for the internal audit function, including the oversight of the annual internal audit plan.
5. Periodically have an independent evaluation and/or peer review of the internal audit group and its work product.

With proper management, vision and oversight, internal audit can be used to examine and strengthen internal controls, financial reporting and transparency, risk management and operations.

13. Should the role of audit committees be enhanced?
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Consistent with the Enhanced Disclosure Working Group, Guidelines for Enhanced Disclosure to Assist Directors, Audit Committees, Shareowners, and Investors dated April 2009 and available at <http://pdf.standardlifeinvestments.com>, the role of the audit committee should be enhanced through:

1. Standards for serving on an audit committee;
2. Education of the audit committee;
3. Audit committee charters setting forth the objectives of, and work carried out by the audit committee; and
4. Transparency of the work of the audit committee.

Audit committees should be comprised of diverse members who are:

1. Knowledgeable of the industry and business in which the company operates;
2. Knowledgeable of the financial statements and disclosures;
3. Informed with respect to external and internal audit practices; and
4. Informed of their responsibilities to investors.

In essence, there should be requirements that set forth and ensure audit committee members know what they are doing when overseeing the financial reporting and auditing process, including with respect to internal controls, of the financial institution or company. There should also be broad education requirements that require board members to obtain continuing education on relevant topics on a periodic basis.

A charter should be required for each audit committee that sets forth its obligation to investors, principle responsibilities, and how those objectives will be met or responsibilities will be carried out. The charter should be disclosed to investors and periodically updated. The audit committee should have to make an annual report to investors with respect to the work they performed in carrying out their obligations and responsibilities. Such a report should avoid boilerplate language and be written in Plain English. The report should discuss matters such as:

- From the perspective of an investor, were there any independence issues with respect to the independent auditor?
- Significant matters that were discussed with the auditor including audit scope, significant risks, internal control weaknesses, audit staffing, etc.

- Whether the auditor would make any changes to the financial statements?
- Whether the auditor would make any changes in internal controls?
- Did the auditor receive sufficient cooperation and information?
- Are there accounting practices that the company or institution uses that are acceptable, but not the preferred method of accounting?

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

Currently no, as audit firms around the globe have themselves often times lacked transparency and have not adopted preferred governance practices. This is not the case in some model countries such as the U.K. where the largest audit firms have provided greater levels of transparency with the recommended Audit Firm Governance Code<sup>41</sup>. We believe that globally, audit firms should first proactively address their own governance structures and practices before advising clients on such matters by agreeing as an international firm to do the following:

1. Publish an annual report that includes their financial statements prepared in accordance with applicable accounting standards (preferably audited), along with a discussion of their governance, operations, risks, and key audit quality indicators;
2. Create independent oversight of the governance of the audit firm through independent board members, or advisory boards, that report to investors on their activities. The independent board members should be accountable to the public, given the public role legislated for the firms; and
3. Audit firms should improve their own firm governance and transparency by requiring the engagement partner to sign the audit report along with the name of the firm (as opposed to the current practice in some jurisdictions of signing only the name of the audit firm).

As an independent gatekeeper, the audit profession, among others, should most certainly be involved in improving corporate governance for the benefit of investors and the global capital markets generally. However, the firms should first demonstrate their commitment to excellence in the governance and transparency of their own firms.

24 September 2010

## Letter from CIMA

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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.

<sup>41</sup> The Audit Firm Governance Code, A project for the Financial Reporting Council, January 2010.

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 through 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 being 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 October 19.

## Memorandum by CIMA

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### **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?**

12. 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
13. 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.
14. 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.

15. 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' i.e. '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.
16. As a result of the need to offer a global solution, the infrastructure requirements of a Big Four audit firm are significantly 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?**

17. 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.
18. 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.
19. 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?**

20. 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.
21. 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.

22. 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.

**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?**

23. 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?**

24. 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.
25. 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>)
26. 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
27. 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.
28. 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.
29. 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> )
30. 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.
31. 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 re-double efforts to act upon all 15 recommendations in as timely a manner as possible.

32. 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 is, undoubtedly, an important building block for an efficient allocation of capital but is only one element of the system.
33. 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.
34. 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.
35. 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.
36. 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.
37. 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.

38. 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.
39. 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?**

40. 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 September 15 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'
41. 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?**

42. 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?**

43. 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?**

44. 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?**

45. 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?**

46. 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.
47. 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?**

48. 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.

49. 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?**

50. 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.
51. 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?**

52. 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 Corporate Value Associates**

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Introduction

i. Corporate Value Associates (CVA) is a global strategy consultancy firm that specialises in designing and supporting the implementation of business strategies that add value over the longer term. CVA works with boards and chief executives, using proprietary approaches and models which encompass the value provided by a business organisation to all its major stakeholder groups. This enables CVA to advise its clients on the strategic architecture to optimise the value provided to customers, shareholders and other stakeholders. This focus provides CVA with a distinctive positioning in the sector.

ii. In responding to the call for evidence, CVA has selected questions that raise the issue of how strategic value is addressed in board rooms, and the role therein of auditors and other providers of professional services. CVA does not, on this occasion, directly address questions relating to the competitiveness of the market for audit services.

Response to questions

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

iii. The principal role of an external auditor, in the generally accepted definition of the term, is to ensure that the published accounts of a business organisation are “true and fair” and correctly and consistently reflect its profit and loss and its assets and liabilities, using applicable accounting rules and practices. Whilst the valuation of assets and liabilities and the profit and loss account will to some extent reflect future probabilities, the published accounts are predominantly a historical reflection of performance to date. Financial auditors look at book value, not at future value. Audited accounts do not embrace actions taken today or planned to be taken in future, whereas corporate success and reward is as much to do with future expectations as it is with historic performance. There is generally a significant mismatch between the accounting or book value of an organisation and its value under other definitions such as liquidation value, sale value, going concern value and quoted market value.

iv. Whilst auditors can and should do a better job of incorporating the reality and probability of the impact of changes and external shocks in published accounts, there will never be a way that accounting values can substitute for other forms of valuation. Understanding the viability of current and future business is around business risk assessment and market dynamics, which are outside the remit and core competence of financial audit and auditors. It is important that boards, the accounting profession, investors, financial experts and other interested parties accept the limitation of the role and scope of financial accounting and financial audit, lest the risk materialise that financial audit and financial auditors are seen as the sole or main piece of external governance quality assurance. Financial audit does not have the breadth or depth of scope to report on the total health of an organisation.

v. One solution is for the UK Corporate Governance Code (June 2010) to make more specific reference to the duties of boards to challenge and assess strategy and strategic value, and the need for external strategy audit by appropriate competent independent service providers. Properly advised, boards should challenge and take ownership not only of their company’s strategy but also of the strategic future valuation of the firm – sometimes referred to as the “warranted equity value” – including the underlying assumptions and forecasts. This is currently in many cases an area of significant weakness, with boards relying excessively on the executive and being insufficiently knowledgeable and probing.

vi. The UK Corporate Governance Code does state that the directors should include in the annual report an explanation of the basis on which the company generates or preserves value over the longer term (the business model) and the strategy for delivering the objectives of the company. This is not an area where external financial auditors have a core competence, and reliance on reassurance from that quarter would be misplaced.

vii. The proposals in v. above would also help to tackle what CVA understands is one of the two most material and consistent failures of boards discovered in professionally facilitated board evaluations, namely lack of time and focus for discussion on strategy. (The other is succession planning.)

viii. In general, boards should recognise the various elements that make up good governance and ensure that in every one they have expert external as well as internal professional advice and scrutiny.

**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?**

ix. External auditors are appointed by vote at the shareholders' annual general meeting, on recommendation from the board. Audit tendering takes place every few years but, in the main, companies – especially in the executive line, particularly finance - and their auditors enjoy lengthy relationships. There are many reasons for this, but there is little doubt that as a result “scepticism”, particularly what might be termed systemic scepticism, can on critical occasions suffer where material judgement calls are required by auditors.

x. Lack of competition can be a factor in the award of audits, but the more important factor in the award of audits is the relationship one. Perhaps the factor that might most help create a climate where the auditors are sufficiently challenging of the executive is a board which itself does just that and which takes effective ownership of, and evaluates, the relationship with the auditors. A possible additional way to approach the issue would be “tenure” for audit firm relationships balancing the cost of change with the risk of relationship familiarity. Finally, if there is lack of board challenge, or if the board is complicit in trying to persuade the auditors to reach judgements they may not be comfortable with, then more reliance than should be placed on auditors knowing they can be held to account by regulators and the courts.

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

xi. There is relatively little that auditors could have done. As stated above, the more important factor is that boards, regulators, investors and other interested parties should not place too much weight of assurance on external financial audit. The limitations of financial audit should be recognised and the governance and oversight architecture which is needed should be designed accordingly.

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

xii. As already stated, there is an acute agency problem here. Auditors rely on companies for their appointment. Auditors and companies enjoy long and very close relationships. The primary source of reassurance about objectivity is a skilled, well functioning and properly challenging board, which takes ownership of audit, and where the NEDs act as representatives of the external stakeholders. The secondary and underlying source of reassurance is an audit system where poor practice is subject to discovery, criticism and the rigours of regulators and the law.

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

xiii. We believe there are significant conflicts of interest between audit and consultancy roles when carried out for one client by the same organisation and that this situation should not be permitted or should be subject to very stringent controls. We believe there are legitimate questions about the efficacy of “jacks of all trades” in professional services. We recognise audit relationships can influence the award of consultancy business.

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

xiv. Board audit committees relate primarily to the audited accounts and the relationship with the external auditors. The Walker Review of corporate governance in the UK banking industry called for the additional establishment of board risk committees.

xv. In CVA's view, as described in the response to question 5, boards should pay far more attention to strategic matters and to the valuation of strategy, supported by board strategy audits. It would be a mistake to conduct this through the board audit committee, since their focus is primarily on the financial accounts, or through the board risk committee, whose focus is primarily on financial risk. In CVA's view, the discussion and valuation of strategy should be central to the business of the board as a whole. It should therefore be dealt with at the board and the proposed independent audit of strategy should be in support of the board as a whole.

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

xvi. It would be unwise to place excessive reliance in the field of governance on external financial audit and those who conduct it. In the first place, as stated above, we believe that financial audit is an important but circumscribed activity, with its own rules and skills etc. In the second place, asking auditors to provide further elements of reassurance – whether in areas of strategic valuation, organisational or risk architecture, governance practices, and so on – would be asking them to stretch the scope of their activities into areas where they are not competent. They would then be giving a fundamentally false level of reassurance to those who sought it. There is also the consideration that combining the various facets of governance audit largely within the remit of the professional financial auditors would lead to too much scrutiny in the hands of one body, potential conflict of interest and increased complexity.

24 September 2010

#### **Letter from Deloitte**

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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 4 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 I, attached.

## **Appendix I: Responses to questions raised in the Call for Evidence**

### **I 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?**

I.1 Auditing large companies requires global reach, a robust approach, the highest quality, and a pristine reputation. The audits of multi national 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<sup>42</sup> 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.

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

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<sup>42</sup> <http://www.frc.org.uk/about/auditchoice.cfm>

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<sup>43</sup>. 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

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[http://www.icaew.com/index.cfm/route/172482/icaew\\_ga/en/Technical\\_and\\_Business\\_Topics/Thought\\_leadership/Inspiring\\_Confidence\\_in\\_Financial\\_Services/Audit\\_of\\_banks\\_lessons\\_from\\_the\\_crisis](http://www.icaew.com/index.cfm/route/172482/icaew_ga/en/Technical_and_Business_Topics/Thought_leadership/Inspiring_Confidence_in_Financial_Services/Audit_of_banks_lessons_from_the_crisis)

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<sup>44</sup>. 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.

24 September 2010

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<sup>44</sup> [http://www.frc.org.uk/documents/pagemanager/apb/Responses\\_to\\_consultation\\_October\\_2009/Deloitte%20LLP.pdf](http://www.frc.org.uk/documents/pagemanager/apb/Responses_to_consultation_October_2009/Deloitte%20LLP.pdf)

## Memorandum by the Department for Business Innovation and Skills

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### 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;
  - 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<sup>45</sup>. 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

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<sup>45</sup> 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).

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.

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 £2billion in 2009 in audit fees<sup>46</sup>.

### **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,

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<sup>46</sup> 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>

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 rationale<sup>47</sup> for audit is that it is demanded under two conditions:

- a. accountability, whereby an agent gives an account of his actions to a principal;
- 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;
- 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.

13. In voluntary audit environments<sup>48</sup>:

- 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<sup>49</sup>,
- the bigger the company the more likely it is to have a voluntary audit<sup>50</sup>.

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<sup>51</sup>.

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 audit<sup>52</sup> enables companies to regain some of the effect. This research also demonstrates that bigger companies gain disproportionately more from higher quality audits than smaller

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<sup>47</sup> Power M (1999) *The Audit Society: Rituals of Verification*, Oxford University Press, Oxford

<sup>48</sup> Pittman, J. and Fortin, S. *Auditor choice and the cost of debt capital for newly public firms*, Journal of Accounting and Economics, Vol 37, Issue 1, February 2004, pp. 113-136

<sup>49</sup> Ahmed, Rasmussen, Tse *Audit Quality, Alternative Monitoring Mechanisms and Cost of Capital: An Empirical Analysis*, Texas A&M University August 2008; Melnick A. and Plaut S. (1995) *Disclosure costs, regulation, and the expansion of the private placement market; professional adaptation*. Journal of Accounting, Audit & Finance (Winter) 23-42.

<sup>50</sup> Collis, Jill *Directors' views on accounting and auditing requirements for SMEs* April 2008  
<http://www.bis.gov.uk/files/file50491.pdf> p.55;

Rennie M, Senkow D. Rennie R. & Wong J (2003) *Deregulation of the private corporate audit in Canada: Justification, lobbying and outcomes* Research in Accounting Regulation 16 227-241, referred to in Wallace W. (2004) *The economic role of the audit in free and regulated markets: a look back and a look forward* Research in Accounting Regulation Volume 17, 267-298

<sup>51</sup> Hail L., Leuz C., International differences in the cost of equity capital: do legal institutions and securities regulation matter? Journal of Accounting Research Vol 44 No. 3 June 2006

<sup>52</sup> Tsai H. and Hua M. (2009) The effects of Audit Quality on Loan Interest Rates for Small and Medium-Sized Enterprises in Taiwan, International Journal of Business. 14(3), 265-281;

companies do. Bigger audit firms are perceived to offer higher quality audits<sup>53</sup> partly because of their increased expenditure on training, systems and branding, partly because they have more to lose in reputation<sup>54</sup> and partly because they have more to lose via litigation<sup>55</sup> (auditor liability). It is difficult to split these effects<sup>56</sup>. 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 (e.g. banking) because regulation acts as another substitute<sup>57</sup>. Financial directors and investors do however find audit valuable in checking company compliance with accounting standards and other regulatory requirements<sup>58</sup>, while they do not find value in the very limited (and often boiler-plate) qualitative assessment currently provided<sup>59</sup>.

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<sup>60</sup>, internal auditors, credit ratings, insurance markets, investment 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

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<sup>53</sup> Teoh S. and Wong T. 1993 Perceived Auditor Quality and the Earnings Response Coefficient, *The Accounting Review* 68 (April) 346-366, Becker C., DeFond J. Jiambalvo J. and Subramanyam K.P. 1998 The effect of Audit Quality on Earnings Management *Contemporary Accounting Research* 15, 1-24; Seetharam, A. Gul, F.a. and Lynn, S.G. Litigation Risk and Audit Fees: Evidence from U.K. Firms Cross-Listed on U.S. Market *Journal of Accounting and Economics* 33(1), 91-115; Abbott, L.J., Parker, S., and Peter, G.F. 2006 Earnings Management, Litigation Risk and Asymmetric Audit Fee Responses *Auditing: A Journal of Practice and Theory*, 25(1) 85-98

<sup>54</sup> Chaney P. and Philipich K. 2002 *Shredded reputation: the cost of audit failure* *Journal of Accounting Research* 40 (Fall): 1221-1245;

Teoh S. and Wong T. (1993) *Perceived auditor quality and the earnings response coefficient* *The Accounting Review* 68 (April): 346-366

<sup>55</sup> Khurana I.K. and Raman K.K. 2004 *Litigation risk and the financial reporting credibility of Big 4 versus non-Big 4 audits: Evidence from Anglo-American countries* *The Accounting Review* 79 (2) 473-495;

Lennox, C. *Audit quality and auditor size: an evaluation of reputation and deep pockets hypotheses* *Journal of Business Finance & Accounting*, 26(7) & (8), Sept/Oct 1999

<sup>56</sup> Skinner, D. and Srinivasan, S. 2010, *Audit quality and auditor reputation: evidence from Japan*, Working paper 10-088 <http://ssrn.com/abstract=1557231>;

Weber J., Willenborg, M. and Zhang J. 2008 *Does auditor reputation matter? The case of KPMG and ComROAD AG*, *Journal of Accounting Research* 46: 941-972

<sup>57</sup> Dunn K., Mayhew B., 2004 *Audit firm industry specialization and client disclosure quality*, *Review of Accounting Studies* 9, 35-38.

<sup>58</sup> Penny Sukhraj *Priceless or worthless*: p12 *Accountancy Magazine* April 2010

ICAEW Financial Services Faculty: *Audit of Banks: Lessons from the Crisis*, (part of the Inspiring confidence in financial services programme) April 2010

Deumes, R. Meuwissen, R et al *The Value of Audit*, Maastricht Accounting Research Center (MARC), 1 March 2010 <http://www.maastrichtuniversity.nl/web/file?uuid=5a6429c8-58e4-4ea2-92e3-9a9da025fc67&owner=dfd82a02-50b4-432d-a051-3e12cf75af95>

Hodgdon, C., Tondkar, R. et al (2009) *Compliance with International Financial Reporting Standards and auditor choice: new evidence on the importance of the statutory audit*, *The International Journal of Accounting* 44 (2009) 33-35

Bank for International Settlements 2008, *Fair value measurement and modelling: an assessment of challenges and lessons learned from the market stress*, Basel.

<sup>59</sup> ICAEW Financial Services Faculty: *Audit of Banks: Lessons from the Crisis*, (part of the Inspiring confidence in financial services programme) April 2010;

Ipsos MORI – Global Investors Summary – Global Executive Summary, August 2009, p3.

<sup>60</sup> Carcello J. and Neal T., *Audit committee characteristics and auditor dismissals following “new” going-concern reports*, *The Accounting Review* Vol 78, No.1, January 2003 pp 95-117

importance of audit is as one element in a multi-faceted regime of corporate governance and regulation<sup>61</sup>.

17. Mautz and Sharaf, in their seminal work on auditing (1961)<sup>62</sup>, 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<sup>63</sup>. 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<sup>64</sup>. This has the potential to make it hard for auditors, who are in reality selected by management<sup>65</sup>, and who are commercial organisations, to stand up to management, particularly when financial results are poor<sup>66</sup>. Lennox (2000) shows that

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<sup>61</sup> Leuz, Nanda and Wysocki (2003) *Earnings management and investor protection: an international comparison* Journal of Financial Economics 69 505-527;

Ashbaugh-Skaife H., Collins D., LaFond R. 2006, *The effects of corporate governance on firms' credit ratings*, Journal of Accounting and Economics 42, 203-243;

Power, M. Memorandum to the House of Commons Treasury Committee on the banking crisis. Written evidence (Vol. II, HC 144-II) The Stationery Office Ltd, EV. Pp173-176

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144w156.htm>

<sup>62</sup> Mautz, R and Sharaf, H. (1961) *Philosophy of Auditing* (American Accounting Association); Power, M. Memorandum to the House of Commons Treasury Committee on the banking crisis. Written evidence (Vol. II, HC 144-II) The Stationery Office Ltd, EV. Pp173-176

<http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/144/144w156.htm>

<sup>63</sup> Humphrey C., Loft A., Woods M. *The global audit profession and the international financial architecture: understanding regulatory relationships at a time of financial crisis*, Accounting, Organizations and Society 34 (2009) 810-825

<sup>64</sup> Ball, Ray *Market and political/regulatory perspectives on the recent accounting scandals* Journal of Accounting Research Vol 47 No 2 May 2009

<sup>65</sup> Sikka, Filling and Liew *The audit crunch: reforming auditing* in Managerial Auditing Journal Vol. 24 No 2, 2009 p.135-155

<sup>66</sup>Power, M. Memorandum to the House of Commons Treasury Committee on the banking crisis. Written evidence (Vol. II, HC 144-II)

companies are able to engage in opinion shopping<sup>67</sup> 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 Raghundan (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<sup>68</sup>. 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<sup>69</sup>.

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.

### **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"<sup>70</sup>. There would need to be clear evidence that the information benefit exceeded the cost either in fees or liability capping before Government would act.

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<sup>67</sup> Lennox, Clive (2000) *Do companies successfully engage in opinion-shopping? Evidence from the UK*. Journal of Accounting & Economics Jun 2000, Vol 29 Issue 3, p 321-337

Ghosh, A., Moon, D. *Auditor Tenure and Perceptions of Audit Quality*, The Accounting Review, Vol. 80, No. 2, 2005 pp585-612,

Mansi S., Maxwell W., Miller D. (2004) *Does auditor quality and tenure matter to investors? Evidence from the bond market*. Journal of Accounting Research Vol 42 No. 4 September 2004.

<sup>68</sup> American Institute of Certified Public Accountants 1992 Statement of position regarding mandatory rotation of audit firms of publicly held companies

Geiger and Radhundan 2002 *Auditor tenure and audit reporting failures* Auditing: a journal of practice and theory 21 67-68

<sup>69</sup> Chaney P. and Philipich K. 2002 *Shredded reputation: the cost of audit failure* Journal of Accounting Research 40 (Fall): 1221-1245

<sup>70</sup> Financial Times 7 June 2010 PWC boss seeks an open debate on regulation by Rachel Sanderson

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.<sup>71</sup>

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%.

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<sup>72</sup>.

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<sup>71</sup> Accounting Standards Board, *Rising to the challenge: a review of narrative reporting by UK listed companies*, Financial Reporting Council 2009 p17.

<sup>72</sup> Professional Oversight Board *Key Facts and Trends in the Accountancy Profession* June 2010 p.20  
<http://www.frc.org.uk/images/uploaded/documents/Final%20Key%20Facts%20and%20Trends%202.pdf>

30. The Government has been concerned about competition for FTSE 350 audits for some time. BIS and the FRC jointly commissioned an independent analysis<sup>73</sup> 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<sup>74</sup> have now been implemented and the FRC recently published their fifth progress report<sup>75</sup>. 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.

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<sup>73</sup> Oxera *Competition and choice in the UK audit market* (April 2006) <http://www.bis.gov.uk/files/file28529.pdf>

<sup>74</sup> Financial Reporting Council *Choice in the UK Audit Market: Interim Report of the Market Participants Group* (April 2007) <http://www.frc.org.uk/documents/pagemanager/frc/Visio-Choice%20MPG%20Interim%20Report%20web.pdf>

<sup>75</sup> Financial Reporting Council *Choice in the UK Audit Market: Fifth Progress Report* (June 2010) <http://www.frc.org.uk/publications/pub2289.html>

10 September 2010

## **Letter from Ernst and Young**

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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.

## **Memorandum by Ernst & Young**

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### ***Competition and choice***

- I. 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<sup>1</sup> 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.

September 2010

## **Appendix - responses to specific questions**

For more information about our organisation, please refer to our UK transparency report<sup>1</sup>. 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<sup>1</sup> 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.

**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<sup>1</sup>.

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.
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)<sup>1</sup> 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<sup>1</sup>.
19. Concerns about professional scepticism in the audit of banks have been raised by the FSA in its joint Discussion Paper with the FRC<sup>1</sup> 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.

**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 2<sup>nd</sup> 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"*<sup>1</sup>.

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<sup>1</sup>. 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<sup>1</sup>. 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.
31. Responses to a recent APB consultation indicate that there continues to be widespread stakeholder confidence in this approach<sup>1</sup>.
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<sup>1</sup> 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.

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

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 (e.g. 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<sup>1</sup>. 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.

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

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<sup>1</sup>. 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 the Financial Reporting Council

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### I. Introduction and main points

I.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*.

I.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.

I.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.

I.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.

I.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.

I.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.

I.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<sup>1</sup>. 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<sup>1</sup> to promote debate on these issues within the profession.

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<sup>1</sup> 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;
- 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<sup>1</sup>. 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.

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<sup>1</sup> 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<sup>1</sup> 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.

## **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<sup>1</sup> 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.
- 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<sup>1</sup>”; 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<sup>1</sup> 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<sup>1</sup> 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.*

**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<sup>1</sup>, 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.*

*In its most recent Annual Report<sup>1</sup> 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** 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** 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** 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** 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**

	Good with minor improvements required		Acceptable but with improvements required		Significant improvements required		TOTAL	
	No.	%	No.	%	No.	%	No.	%
<b>Firm type</b>								
Big 4	60	55.5	38	35.2	10	9.3	108	100.0
Other major firms	8	25.0	18	56.2	6	18.8	32	100.0
Smaller firms	4	18.2	7	31.8	11	50.0	22	100.0
<b>Overall total</b>	72		63		27		162	

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

Memorandum from the Financial Services Authority (FSA)

- “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**

<b>AUDITOR</b>	<b>FTSE 100</b>	<b>FTSE 250</b>	<b>FLEDGLING / SMALL CAP</b>	<b>AIM</b>
<b>NUMBER OF COMPANIES</b>	100	250	413	1012
	%	%	%	%
<b>PRICEWATERHOUSECOOPERS</b>	40	27.3	22	11.6
<b>KPMG</b>	23	22.2	22	15
<b>DELOITTE</b>	20	26.6	19.1	10.8
<b>ERNST &amp; YOUNG</b>	16	18.7	17.9	7.8
<b>BDO</b>	1	2.4	3.9	13.7
<b>GRANT THORNTON</b>	0	1.6	9.2	18.4
<b>PKF</b>	0	0	1	4
<b>BAKER TILLY</b>	0	0	1	7.3
<b>HORWATH CLARK WHITEHILL</b>	0	0	0	1
<b>OTHERS</b>	0	0.2	4.1	10.4
<b>NON BIG FOUR SHARE</b>	1%	4.4%	19.2%	54.7%

*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 from the Financial Services Authority (FSA)

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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.

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).

### Competition in auditing

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

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.

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.<sup>76</sup>

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

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<sup>76</sup> In this response, the term 'firms' means FSA regulated firms.

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.

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.<sup>77</sup>

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.

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 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.

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.

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.

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.

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<sup>77</sup> *Auditor scepticism: Raising the bar*, Auditing Practices Board, August 2010

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**

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.

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.

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 (i.e. '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).

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.

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.

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.

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**

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).

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).

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.

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.

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<sup>78</sup> could be one alternative.

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.

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)**

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.

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.

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<sup>78</sup> 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.

## Memorandum from the Financial Services Authority (FSA)

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.

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.

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.

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.

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