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Inquiry on

Auditors: market concentration and their role

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Witnesses: Mr Charles Tilley, Ms Helen Brand, Mr Robert Hodgkinson, Mr Iain McLaren

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Members present

Lord Best (Chairman)
Lord Lawson of Blaby
Lord Levene of Portsoken
Lord Lipsey
Lord Hollick
Lord Maclennan of Rogart
Lord Moonie
Lord Smith of Clifton
Lord Tugendhat

Examination of Witnesses

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

Q50 The Chairman: Welcome to you all. I am Richard Best. I am taking the chair because Lord MacGregor cannot be with us today. The interests of the different Members are in the Register and people will declare any special interest in today's proceedings. Two members of the Committee, Lord Currie and Baroness Kingsmill, are not taking part in this inquiry but the rest of us are. Let me get you in the right order. Ms Brand, Mr Tilley, Mr Hodgkinson and Mr McLaren, you are all extremely welcome. Thank you very much for joining us and thank you for the extensive written evidence that we have received from all of you. We would be grateful if you could speak in a loud clear voice for the transcript and for the webcast that will be made. When we come to the question time, please do not repeat what has already been said by one of your colleagues. We will take silence to mean you agree with what has already been said, since we have got all four of you behind us, but if you disagree with anything that has been said please do join in. Would any of you or all of you or

none of you like to make an opening statement, or can we go straight into the question time?

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

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

Q51 The Chairman: Thank you. Does anybody else wish to make an opening statement? Good. Well, perhaps we could go into the questions. I would like to begin with one about the professional bodies themselves, if I may. As an outsider, you seem a somewhat fragmented group in that there are, I think, six professional bodies representing accountants and indeed auditors. Do you think that this makes for the most efficient way of operating

and do you think possibly it means that today we will get some contrasting views, because some of you may have more of your membership and your income from the Big Four firms of auditors and some of you may not? Might there be something helpful to us today in getting some contrasting views or is there a major downside in having so many bodies all representing the profession?

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

The Chairman: Thank you very much.

Mr McLaren: I would take the point on efficiency but it has to be balanced with what we give the public interest and business, in terms of being diverse. There is no doubt that the reputation of all our professional bodies relies on the quality of the people that we manage to attract and I think it is accepted that a very good job has been done there. We get very high-quality graduates and non-graduates into the accounting professions. But it seems to me if we were to consolidate, one of the things that would be lost would be an element of competition. Certainly, in terms of audit training we compete vigorously, particularly with the English institute, and our customers tell us that they appreciate that. No one in this day and age likes to have a sole supplier. It is a very risky position for a business and I think there is quite a compelling argument to continue for that reason. I think the other thing that should be borne in mind—if there were great public interest drivers to achieve consolidation maybe they would take precedence—is that at the end of the day we are all member

organisations with long histories. My own is 156 years. Given that they are membership organisations, what we hear from our members currently is that they would not welcome any consolidation. In fact, contrary to perhaps public perception, Scots CAs pay £100 a year more than their English counterparts for that privilege.

The Chairman: Thank you very much. No more comments on that?

Q52 Lord Tugendhat: Do you think there is strong competition in the audit market for the audit of large entities? I am thinking not just of FTSE 100 but of the top echelon of FTSE 100, in particular the banks. Do you think there is strong competition? If so, can you tell me, please, how does it manifest itself?

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

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

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

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

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

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

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

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

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

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

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

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

because we don't feel we have a sufficient number of experts to handle this particular large client"?

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

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

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

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

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

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

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

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

Mr McLaren: The year before.

Ms Brand: The year before.

Mr Hodgkinson: Could I just talk about something as well that has been and is in progress to help with the issue that you identify? We produced a report on *Audit of banks: lessons from the crisis*, which was looking at things that could actually be done, and on 22 November there

will be, as we recommended in that report, a coming together of investors in financial services, financial institutions and their auditors to talk about concerns affecting the industry as a whole for the coming reporting season. It was a suggestion that we made in that report that we are acting on that there should be wider sharing. Whether it directly fits the medical analogy I do not know, but we are trying to make sure that concerns can be voiced and shared ahead of the reporting season.

Q62 Lord Lawson of Blaby: I would like to come in on the question of the banks, because that is what concerns me very greatly indeed. It is quite clear, and I think it is generally accepted, that the banking supervision in this country—not exclusively in this country, but let's focus on this country—failed badly. This was a combination of a flawed system and unsatisfactory performance by the supervisors. What concerns me in the context of our inquiry is that I know of no case where auditors caught catches which the supervisors dropped. I know of no case where bank auditors assisted the supervisors in catching the ball. Therefore it is in that context I would like to ask you what you think should be done. I shall make it a bit more specific. You will have read the document by the Financial Services Faculty where among their specific recommendations, if I may read them out, they said that auditors should “be proactive in setting up regular meetings with supervisors”. They should “be open in dialogue with supervisors; and raise concerns at a higher level within the regulator if they consider that the level of engagement from supervisors is inadequate”. Do you agree with that? What should be done about it? Do you feel inhibited? When I framed the 1987 Banking Act, which is concerned largely with this area, I had considerable resistance from the accountancy profession, who said that confidentiality prevented them from saying anything at all to the supervisors. Do you still hold that view? It does not seem to me that it is in the public interest.

Mr Hodgkinson: Can I respond in the first instance? There were a lot of points, so forgive me if I do not pick them all up. The Financial Services Faculty report I must agree with since it is ICAEW's Financial Services Faculty that raised that point and we have already started to take pragmatic proposals to carry forward that suggestion and establish the protocols for re-establishing better dialogue. I think there will be three meetings before Christmas of a group that we helped to convene, with the Bank of England, the FSA and the major audit firms, to look at how that dialogue works better. Maybe if I just go back to the point that you made about auditors catching things. It is one of the difficulties of the audit profession and the public trust in it that when auditors catch things or influence outcomes it is quite invisible. That is just because of the nature of the reporting that auditors do. I think some of the research from Professors Beattie and Fearnley, who I know you have spoken to, helps to show that a lot happens behind closed doors and that the audit process does change outcomes but it does it in a way that is not readily apparent. That leads to proposals for a longer, more informative form of audit reporting, which always hit problems because there are difficulties about having the auditors talking about what has happened behind closed doors. Our proposal in that Financial Services Faculty report, to try and bring some sunlight into this and break this logjam of audit reporting, is to say that audit committees do have the opportunity to report in a more freeform way that auditors do not have under auditing standards and that they should take the opportunity through the audit committee report to talk about the value that has been derived from the audit process and how they have looked at particular areas of significant judgement, and benefited from the audit process. I am trying to set up some practical ways of addressing that the real deep-seated problems are recognised.

Q64 Lord Lawson of Blaby: If I can come back and make it more precise, it is not the audit committees that I am concerned about, who are a group of amateurs; it is the

professionals. Let me make it specific. Supposing, as the auditor of a bank, you take the view either that the business model is a very hairy one, as was clearly the case of Northern Rock for example, or you take—and these overlap slightly—the view that this bank is taking excessive risks, or you take the view that they do not really understand fully the risks that they are taking. In the first instance, you would report back to the audit committee, and you might go higher in the company, but if they do not change would you then go to the supervisors to say, “Nothing specific, but I think you ought to take a look at bank X. We are somewhat concerned about it”? Would you say that? Did you say that?

Mr Hodgkinson: I am not an auditor. I cannot speak on whether people did, but we clearly want to make sure that the communication channels exist to do precisely that and that is why—

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

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

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

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

Mr Hodgkinson: I think it is worth acknowledging that professional scepticism is central to what auditors do—so central that it runs through the auditing standards; it is a golden thread through auditing standards. So you will find, if you look at the reports produced last month for the major firms that indeed there are some references on individual audits. Yes, there could have been more scepticism, but the suggestion that there is a pervasive issue, and it is not one in which there are points to pick up on in individual cases, I think is misconceived. I suppose that is why as a body, as a profession, we are ourselves a little bit sceptical about the broad-brush allegation that there has not been scepticism, because it is at the heart of what an audit is. The audits of the major firms and public interest entities are being looked at in great detail and there are, on public record, the reports of the results of those inspections. In the overwhelming majority of those reports, there is evidence that scepticism is being applied. We also need to bear in mind that scepticism is not something where the more of it you have the better. Professional scepticism is about striking a balance, because if people were to show unrestrained scepticism we would still be waiting for the first audit to be finished. It is about knowing when to question further and when to say, “We move on” because otherwise you get something that is unproductive. Striking that balance is an important activity and it is right at the heart of audit, so there is no problem here in focusing attention on it and saying, “We need to examine it”.

The Chairman: Let's hear from Ms Brand.

Ms Brand: I think while we would agree that within the scope of the audit, as it is currently constituted, scepticism was demonstrated or there has not been evidence that it was not, we feel that there may be need to evolve the technical scope of that audit moving forward and not to say, "This is the audit. This is how it will be forever", particularly looking at issues that maybe start to address Lord Lawson's point around internal controls, governance and, most importantly, the financial assumptions underpinning a business model of an institution. Those are the kinds of forward-looking aspects of an organisation that maybe the audit could start to move into in its technical scope. The unwelcome message that comes with that, though, is that then we do feel the liability issue would need to be looked at for auditors because they would be taking on a greater scope of work with more risks associated with it. Maybe that issue would need to be addressed again and looked at again with that widened scope of the audit.

Q67 Lord Tugendhat: Can I ask a very brief question? If a situation arises in which the auditors are sceptical about a point, the sort of point that Lord Hollick raised, and they are worried and they press the audit committee and the management on that point, do you think it would be helpful if the audit report stated that we were concerned about this particular issue but we were convinced by management that it was okay? I am not suggesting a question and answer but that the auditors would register that they had expressed a doubt on something and that they had been convinced by management.

Ms Brand: One interesting suggestion that has come up in the work we have been doing globally, and this was in an audit forum we held in Singapore, was that maybe the publishing of the management letter might be a useful form of exposure for those kinds of issues, because in that letter you would have the response of management. Of course, that would

have to mean that you do not then start holding back in the management letter, but that might be one mechanism to achieve that.

Q68 Lord Lipsey: Picking up on Ms Brand's point about the scope of audit, if you pick up an annual report now there is an awful lot in there that is not in the audited financial statements. The input of auditors into the rest of the report is somewhere between limited and negligible, if I am not misrepresenting it. Don't you want to see a bigger role for your members in approving more of the annual report so that investors really can have confidence in the thing as a whole and not just in the numbers you have put in the bag?

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

Q69 Lord Lipsey: If a company is doing a due diligence document, the whole thing is subject to due diligence and you usually have an accountancy firm as well as your solicitors over on your shoulder making sure it is all correct. Is it really so formidable a task to say you should audit the statements of an annual report in the same way?

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

Mr Tilley: I think this is a hugely important point. At the moment, we are getting to a point where we have annual accounts with 500, 600 pages and one questions who reads all of the pages that are there. We need to think about whether we can change the reporting model. For instance, do we have at the front of the report, set out very clearly, what the business

model is, how it works in the environment that the business is operating in—its marketplace, its competitors and so forth—and then how that business model is sustainable going forward into the future? The financial statements are hugely important and the foundation, if you like, of any business but reporting on the sustainability of the business model is crucial. How can auditors do that? I think that is a very challenging issue. Helen has already raised the issue of liability, for instance, but I think it is more about assurance over the processes of putting together the report that talks about the business model and what its ongoing sustainability is. One needs to be thinking about the future of the annual report and how the front end is structured, and ensuring that that report is balanced so that the views expressed in it cover both the positive and the negative issues. That is the real challenge. The assurance over the processes that go forward, with management and the board putting forward to their shareholders and other stakeholders how they have run the business, is a key area that should be looked at.

Mr McLaren: My own institute has a project under way just now on the future of assurance, drawing people in from academia and the profession and a large component from industry. There is a consensus emerging that, as Charles was saying, we need something to look at the front end, the prospective statements, including not just viability and going concern, but other statements that really are of interest to what investors and the community at large are looking for. The past is the past. Yes, you want to know its right, tick, and that's the statutory bit, but the bit about the future is of real interest when public companies are making announcements to the market. The thinking that has been touched on already—and this is not finished, but when it is we will be happy to pass a copy of our work to the Committee—is that the split should also have a slightly different form of report, so it would be assurance but not “true and fair”, in other words correct. It would be something like perhaps “balanced and reasonable”, because I think you have to be careful. The auditor

is one removed. To pick up something that was said earlier about exposing management letters and the discussion about whether you should extend the audit report, in my view you want to keep the nuclear option because people do not have a particular interest in that. I also think there are some issues about what you can say in private to an audit committee in a company that, if you try and expose it to the public, will get inevitably watered down because of litigation. Coming back to the fundamental point, we believe there is an interest in some form of assurance over that front end but that perhaps it cannot be done to the same standard as the historic numbers can be audited.

Mr Hodgkinson: I appreciate a lot of the comments that have been made and I agree with a lot of them. However, I think it is quite important that we do not just agree in principle and then say, "And it is a huge task". I think it is important to start making some progress here and getting some runs on the board. In the report that Lord Lawson referred to, we said that this is something that people can start experimenting on. We do not have to say that the whole 400 pages is going to be subject to an audit opinion, but we could start to see some innovation and market experimentation with audit committees on behalf of the board saying, "It would enhance the credibility of our annual report if we said we have asked the auditors to look at this particularly important table, these particularly important numerical disclosures or a high-level risk statement. Here's something specific that we've worked on". It would allow some differentiation and experimentation on which you could build to incorporate it into law.

The huge risk in just saying, "Let's make a legislative or regulatory change with no real experience" is you get the sort of problem that we saw in the United States after the Sarbanes-Oxley Act, where there was an extension of the audit that looked quite innocuous, it took a few words of legislation to say that auditors should report on the effectiveness of internal control over financial reporting. It has taken eight years to finally get a kind of truce

on which companies would be subject to that requirement, what the criteria would be for reporting and how auditors would do the work, and it cost American business a lot on the way. So I think we need to look, as we do in our report, at ways of getting real experimentation and innovation based upon what people think would be of value rather than grand sweeping regulatory gestures.

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

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

Q71 Lord Smith of Clifton: This is the low bowling question: isn't it time that the auditors simply agreed to stop doing non-audit work for their audit clients, rather than hiding behind ever more complex and refined rules to allow them to assert that there is no problem? This is the argument that there are Chinese walls. You bowl over the tender, then you say to them, "Ha ha, but then you need our consultancy services to get you up to scratch". What do you have to say about that?

Mr Hodgkinson: I think the short answer would be, "No, it isn't time to do that" but let me give a little bit of colour to that. We fully recognise that the fact that auditors provide non-audit services to audit clients raises a question and there is a clear need for the public to be reassured that auditors are being objective and they are standing up to the companies that they audit. That is the point of substance, that we want to know they are being objective and stand up to the companies they audit when they need to. This is something that has absorbed a huge amount of time, rightly, over the past 10 years, latterly with the Auditing

Practices Board at the instigation of the House of Commons Treasury Select Committee suggesting the sort of outright ban that you have alluded to. After quite an exhaustive process of public consultation, there is no substantial body of opinion that wants that outright ban. There are benefits in a market system of companies being able to engage their auditors, who are trusted and seen as having a degree of objectivity, to do non-audit services, subject to the sort of controls and safeguards that are needed to reassure the public and selective bans on things that are not appropriate.

So this is an area of acute concern that the outright ban solution is not appropriate. I think we need to keep the approach under review. We need better disclosure, because one thing which I think is now agreed out of the recent APB, Auditing Practices Board, discussion is that some non-audit services are very related to the audit and if we want to look at how the audit will develop in a marketplace, it would be through auditors providing some audit-related services which make the audit more valuable. So in the public disclosure, enabling people to see audit-related disclosure as different from perhaps more contentious non-audit services, will also be helpful.

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

Mr McLaren: The Scottish Institute carried out a survey at the beginning of the year into non-audit services and we had 150 responses. Only three people—an academic, a politician with well known views on this matter and one other—supported an outright ban. So the market response is certainly not there. Of course, at the end of the day, in my view, the

audit committee needs to step up to this plate. The auditors cannot force those other services on them. Okay, it is easy for management, but we have talked already about having audit committee reports individually signed as the auditor now signs, and having to articulate why they have gone to the auditor for services. Some are very self-evident: capital transactions, where you require a long form or a comfort letter and working capital letter. It is much more efficient to have that done by your auditor, but it needs to be challenged and the audit committee is the place to do that and to articulate to investors why they are comfortable and investors then can make up their minds.

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

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

entirely believe you, bearing in mind the size of the fees involved—would it not reassure the public if there were this separation?

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

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

the external auditor as head of the internal audit function. It needs to be owned within the company.

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

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

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

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

Chairman: Before Ms Brand comes in, Lord Tugendhat.

Q74 Lord Tugendhat: In the written evidence which was given to us before we started, one of the Big Four, I think it was Deloitte—there may even have been two—said that

auditing FTSE 100 companies was one of their less profitable lines of business and almost gave the impression that they were doing it as a public service. If this is a less profitable line of business for them, it suggests to me that perhaps the non-audit services are a more profitable line of business for them, and that there is a danger therefore in their principal function being perhaps relatively underpriced and their subsidiary function being the one where the money is. I think that comes back to the conflict of interest point that Lord Lawson made.

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

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

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

Mr Hodgkinson: Could I just make one other point there? The disclosure of margins by area of business is something that came out of the Financial Reporting Council's study on the

Market Participants Group into competition and choice, and was meant to be a disclosure that would provoke the sort of challenge and inquiry that you have embarked upon. It is good to have that into the public domain. I do not think that the differences in margins are that stark as to raise fundamental issues, but the fact that that information is being disclosed on the basis of guidance that ICAEW prepared is a helpful contribution to the debate.

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

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

Q76 Lord Lawson of Blaby: If I can pick up on something that Mr Hodgkinson said, which is slightly relevant; I am not persuaded that it wouldn't be both in the public interest and in the interests of the corporate sector—and possibly even in the interests of diversity, as it were, within the accountancy profession—if there were a necessary separation between the

company that did the auditing and the company that did the consulting, the tax advice or whatever it happens to be. But in your defence of the status quo, you explained that auditing—I was not quite sure of the connection, but it is an important point all the same—was not just a matter of box ticking, and that in the United States they did need to make this separation because in the United States auditing is much more a matter of box ticking. The evidence that we were given last week was that in fact auditing in this country has become very much a matter of box ticking. I do not know whether you read the evidence that was given to us, but that was clearly what came out of these very expert academics in the subject.

Mr McLaren: Could I kick off on that? I am obviously three or three and a half years out of date, and maybe it has changed, but I doubt it, fundamentally. I did understand the point that the academics were making and, in part, the balance of our audit inspection, which I think is a good thing, inevitably focuses—as has been discussed here earlier—on what you can see out of an audit, and you can't see the inherent quality, unfortunately. You can see a file that is full of points. So I think there is a real issue about that sort of review driving box ticking. The big firms will now be more and more putting checklists together so that when you are AIU inspected, you will have the perfect file, so you do not get adverse comment. I understand that there can be a rather large jump to say that auditors have thrown their scepticism and their professional training out of the window. I think that is a jump too far.

Personally—we talked about it earlier—this scepticism project I think is a good one. There was one thing that I saw as an elapsed auditor; one of the statements was that there has been far too much focus on corroboration rather than challenge. That struck a chord with me because I realised that post the AIU requirements for absolute documentation there probably had been a drift that way. I am not suggesting for a moment that all scepticism on key issues has gone out of the window, but the fact that this has been raised and will perhaps

be embedded in the training in a formal way—it was a sort of by-product before throughout the training—I think will be healthy. If there is an expectation here, and if there is any issue in reality, I think it will help address that.

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

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

Mr McLaren: I have been involved only once in a joint audit. They were reasonably popular in the 1970s and prior to that, and in part, I think the French started doing this in the 1960s. You did not have the global reach, but businesses started going global and getting bigger. You have to remember the Big Four only came into existence from 1987 through to 1998; there was a Big Eight or Big Ten prior to that. So I think that joint audits arose out of that. I was

involved in one, as I say, many years ago. It was not a very satisfactory arrangement for either party because, as I have explained earlier, there is a dynamic nature to audit, which is the actual tone of the questions and so on. The file of the conclusions cannot give any truth about that. So you only have part of that sight of the audit that you have to jointly sign up, so you are relying wholly on the quality of the other firm, and inevitably there is going to be, at the very best, inefficiency while you assure yourself that that is up to your standards.

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

The Chairman: Any other comments?

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

Mr Hodgkinson: Could I just add a couple of reflections? You are right to refer to French practice, and I do not think we should out of hand suggest that the French might not have good ideas which work in their environment, but as Iain said, that practice is quite long-established. I think it is the sort of thing that people should actively consider. Let's just

be clear, what we have at the moment is a permission to do joint audits. An audit committee could appoint all the Big Four, if you wanted to, to be joint auditors. There is no market prohibition on this, and if people saw an advantage in doing it, they could experiment with it. I think the issue is that if nobody is doing it and they have the choice, then you would need to be pretty certain before mandating that they should make the choice. It might be for the reasons of cost and potential ambiguity that colleagues have referred to that people do not do it. But companies can experiment with this if they want to, and who is to say that there might not be ways of it working, but to mandate it as a way of improving quality or addressing the concentration issue is something that you need caution on before going that way.

The Chairman: A blind alley. Ms Brand.

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

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

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

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

Mr McLaren: Indeed. Well, speaking from an institute point of view, do they influence the profession? Our governance is surprisingly underweight. We have a council of 32 in Scotland, and including myself and one other retired, there are only two other active Big Four partners out of 32, and three of those are public interest members. So in a sense, they are under-represented there. Looking at presidents, I looked back the last 15 years. There

have only been five that have come from Big Four backgrounds. So, certainly on the governance side there is not an issue.

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

Mr Hodgkinson: May I just make a couple of additional points? I would echo the points about representation in our governance structure. When you look at current Big Four partners or recently retired, that's one of our three office holders from that background, but only three out of 16 board members and only 11 out of our council of 101. The constituencies are very broad in which our members are represented. As a very tangible proof that we can do things which on the face of it you might not think the firms would welcome, I was project director on a recently completed project to draft an audit firm governance code, which will apply to the eight largest firms with effect from 1st June this year. That is something which we were entrusted with by the Financial Reporting Council,

which I think evidences a degree of confidence that we would establish something which was demanding and perhaps not immediately popular. That, for example, will call upon the major audit firms to have independent non-executives in their governance structure. So, I think that is very tangible evidence of independence.

Can I just make one final point about the perception of the dominance of the Big Four? We need to be very careful here. There is a dominance at the top end of the market, but across the broad swathe of British business there is competition. Even if you look at the AIM market, which is where a lot of IPOs—initial public offerings—happen, there's far more dispersion and there is a lot of capability outside the Big Four. So, I would not want any impression left with this Committee that there were four firms and nobody else. There is a very broadly based profession of 15,000-plus firms who are dealing with their specific markets doing audits, and what we are talking about is a concentration at the very top end of the market, which is around capability to do those sorts of audits. But I would not want the idea that somehow there are four audit firms only. There are very capable firms elsewhere.

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

Mr Hodgkinson: Well, if I gave that impression that would be wrong. The firms are very important in the underlying technical work that we do and their contribution is very important. I was saying in the governance structures there is a fair reflection of our underlying membership, which is predominantly not in practice, predominantly not in the Big

Four and predominantly not auditors within the Big Four. It is something which we monitor very zealously to make sure that our structures are reflecting the underlying membership, and that is an appropriate balance. There is certainly no feeling that the major firms absent themselves from the professional bodies.

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

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

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

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

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

Lord Maclennan of Rogart: Then I have a supplementary.

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

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

Mr Hodgkinson: Oblige regulators to consider how regulation affects availability of choice. Make it a criterion for regulatory action because it is clearly of public interest.

Q81 Lord Maclennan of Rogart: May I just ask whether any of these three issues have been considered by the CCAB and, if so, where did the balance of opinion lie with respect to them? I recognise that it is a consultative not a legislative body, but it would be interesting if you could give us any evidence from that source.

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

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

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

The final thing I would say, because I sit on a number of audit committees and I am chair of a FTSE 100 audit committee, I really do think there is more mileage in putting audit committee chairs, as I said, under the spotlight to account to the shareholders why there has not been an audit tender. We now have the default position, of course, of nine years for directors or then you are not independent. Perhaps we could have 10 or 12 years and, if not, you would

have to explain. That would mirror what is happening in other governance areas. I think more can be done through the audit committee to perhaps have some effect on this. I think we have to realise that changing this concentration issue may not be possible because of the gap, and if it is to be achieved, it is probably going to be quite a long haul.

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

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

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

Mr Hodgkinson: Thank you.

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

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

The Chairman: And we are not doing so well here. Thank you all very much for joining us. It has been very helpful.