Supplementary evidence submitted to the Committee on its inquiry into:

Auditors: market concentration and their role

Supplementary memorandum by Laurence Longe, National Managing Partner, Baker Tilly UK Audit LLP ................................................................. 2
Memorandum by Mr Cormac Butler .................................................................................................................. 3
Supplementary memorandum from Professor Stella Fearnley ........................................................................ 3
Further supplementary memorandum by Professor Stella Fearnley .............................................................. 7
Supplementary memorandum by Mr Timothy Bush .......................................................................................... 9
Further supplementary evidence from Mr Timothy Bush ................................................................................. 10
Further supplementary evidence from Mr Timothy Bush ............................................................................... 11
Supplementary memorandum by Mr John P Connolly, Deloitte ................................................................. 12
Supplementary memorandum by Ernst & Young ............................................................................................ 17
Supplementary memorandum by the Financial Reporting Council .............................................................. 23
Supplementary memorandum by the Financial Services Authority ............................................................. 31
Supplementary memorandum by Mr Steve Maslin, Grant Thornton ............................................................. 33
Supplementary memorandum by Mr Paul Lee, Hermes ................................................................................. 34
Supplementary memorandum by Mr Jonathan Hayward, Independent Audit Limited .................................... 36
Supplementary memorandum by The Institute of Chartered Accountants in England and Wales .......... 36
Further supplementary from Vernon Soare, Executive Director, Professional Standards, The Institute of Chartered Accountants in England and Wales ................................................................. 38
Memorandum by Professor Brenda Porter ...................................................................................................... 40
Supplementary letter from Mr Ian Powell, PricewaterhouseCoopers ............................................................. 42
Memorandum by The Rt Hon Lord Tebbit CH ................................................................................................. 50
Memorandum by Mr James Wood .................................................................................................................. 50
Supplementary memorandum by the Office of Fair Trading ................................................................. 51
Supplementary memorandum by Laurence Longe, National Managing Partner, Baker Tilly UK Audit LLP

Having followed the spoken evidence given to the Committee since the start of oral sessions, we are moved to make this further, short, submission, in supplement of one we made on 1 October to the Committee’s original Call for Evidence on the role of the statutory auditor and audit firm concentration.

In truth, the point we now wish to make is rather less supplementary in character than supportive of evidence given by Baroness Hogg, Chairman of the Financial Reporting Council (FRC), to the Committee on Tuesday, 9 November. In answer to an invitation from the Committee to offer the FRC’s recommendations for action by which audit market concentration could be loosened, Baroness Hogg mentioned a number of measures that the FRC believes will, singly and cumulatively, bring about increased competition.

Though we do not disagree with any of those recommendations (which included, for example, removal of restrictive covenants in banks’ articles of associations), what strikes us as potentially seminal for substantial increased competition was her, highly original and promising, belief in the value of participation in the Risk Committees of listed entities by audit firms which are not the entity’s own auditor.

As your Lordships may be aware, Risk Committees are quite a new addition to the overall corporate governance structure. In essence, their function is to exercise oversight of management’s execution of a listed organisation’s risk management policy. Oversight implies (a) assisting management to assess the different types of risk to which the organisation is exposed, (b) developing risk management policy and ensuring it is implemented by management, (c) interrogating, challenging, and validating the quality of implementation, and (d) being able to provide evidence for conclusions.

In our view, the independent judgement that auditors who are not instructed by management with discharging the statutory audit function can offer to Risk Committees:-

- complements the application of professional scepticism of statutory auditors by applying their own, and
- increases the degree of assurance that stakeholders of the broader and narrower kinds will benefit from.

Risk Committees’ capacity to fulfil the oversight function must inevitably turn on the objectivity they are capable of bringing to their work. In our submission (and we anticipate, the FRC’s judgement too), that objectivity will be underscored by taking the advice of third party audit firms. Should the largest companies be obliged to provide independent advice to their Risk Committees, it would, in our view, constitute sound public policy and likely be welcomed by Committees themselves.

The mid-tier firms are capable of fulfilling that independent role, given that the scope of their role will be well defined and targeted on an organisation’s specific chemistry of risk. As your Lordships may already have inferred from Baroness Hogg’s evidence, it is not those firms’ professional ability that has held them back in competition terms to date, but their size. Should your Lordships see fit to recommend that they should be given, by means of law or regulation, the right to service Risk Committee clients, it will follow that mid-tier firms would grow familiar with the larger audit client environment, and with that familiarity their capacity to take on the statutory audit role or the Risk Committee advice role, as suits their business models, will grow too.

11 November 2020
Memorandum by Mr Cormac Butler

Having worked as a banking expert on the International Financial Reporting Standards I am very encouraged on the progress you have made in exposing the role of the auditors in the banking crises. I have made some suggestions below of further areas of audit weaknesses which I feel you could address:

• Accounting profits on loss making transactions
  Many banks buy complicated high yielding structured products because they are able to record an accounting profits (and thus pay themselves bonuses) though the transaction is economically loss making. In effect traders exploit loopholes which allow them to record profits and delay recognition of substantial losses.

• Off balance sheet
  Entities continue to hide losses by recording liabilities and assets in hidden (often offshore) companies. This problem is well over 30 years old yet it is still practiced today by entities like Barclays. Other entities that have had off balance sheet problems include Citigroup, Lehmans, Rank Xerox, Dynergy, Elan, Americredit, Parmalot etc. You might like to examine Barclay’s recent transaction in September 2009 where $12 billion of toxic assets were hidden in another company allowing Barclays to hide potential losses through an entity called Protium Finance LP.

• New IFRS Developments
  The IFRS proposes to announce revamped accounting rules called the 'Partial Catch-up impairment rules' which will make it easier for banks to hide losses in the future, a potential backward step.

If you would like some background papers in readable English on the above I would be very happy to provide them or assist you in any way that I can. I can also offer you guidance on the role of Value at Risk (VaR) in reducing the risk that banks take on.

On 27th November you made reference to the audit of Allied Irish Bank and Bank of Ireland. I am currently examining the audit failure with these two institutions. If you have information/research on these institutions, or details of why you are particularly interested in them I would be very grateful if you could pass it on to me.

9 December 2010

Supplementary memorandum from Professor Stella Fearnley

How International Financial Reporting Standards (IFRS) changed accounting for mark to market and loan loss provisions in UK and Irish banks

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

• Be appropriately prudent;
• Justify asset values on the basis of the business being a demonstrable going concern;
• Observe substance over form.
Prudence is in the law to protect creditors and shareholders from abuse by directors by ensuring the maintenance of capital particularly in relation to paying out dividends (S. 837 CA 1986). Under UK law, all companies, including subsidiaries of groups, must prepare and file their accounts on public record. Subsidiaries can have their own creditors and some have external shareholders. The holding company may also have its own creditors and the holding company’s individual balance sheet is included in the group accounts as well as the consolidated balance sheet.

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

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

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

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

**The introduction of IFRS in the EU**

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

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

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

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

**IFRS and UK banks subsidiaries**

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

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

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

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

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

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

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

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

The impact of these accounting changes for auditors

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

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

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

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

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

The promotion of IFRS in the UK

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

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

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

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

2 November 2010

Further supplementary memorandum by Professor Stella Fearnley

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

1. Auditing as a profession

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

2. Economic dependence

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

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

3. IFRS and global barriers to entry to the listed company audit market

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

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

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

4. Number of small companies that do not have audits

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

5. Impact of fair value

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

* A speech and excellent slides presented by Lord Turner, the Chairman of the FSA in January 2010 in Chartered Accountant Hall about accounting and the economic crisis. ¹
* A paper issued by Ernst & Young in 2005 about fair values which highlights some of the problems before they actually happened and refers to the US influence on the standards. ²
What this highlights is that the problems were well recognised before it all went wrong.
* A very short letter from a US Fund manager to the US Financial Accounting Standards Board about his views of their proposals to extend the use of fair value accounting. ³

6. Governance of the International Accounting Standards Board

I attach some comments I sent to the IASB about their governance consultation last year which highlight my concerns about their governance.⁴

14 October 2010

¹ Not published here.
² Not published here.
³ Not published here.
⁴ Not published here.
Supplementary memorandum by Mr Timothy Bush

Supplementary memorandum by Mr Timothy Bush

Accounting issues at stake

1. Prudence (not overvaluing assets), loss visibility, no hidden gearing and being alert to contingent liabilities. These all underpin the creditor protection purpose of accounts and the audit. These things are also essential for directors and auditors to assess whether the business is a going concern, and for directors to understand where their businesses are at.

These things are required for the law to function (the capital maintenance clauses in the Companies Act) but are not delivered by IFRS (or the erroneously copied FRS 26 which directly clashes with Company Law). These things do form the foundation of “UK GAAP”.

Pervasive vested interests (“rule of standards” rather than the rule of law).

2. Since Johnson Matthey (UK, and earlier in the USA), auditing/accounting standard setters have been populated by people with professional expertise in auditor liability defence. The pendulum has therefore swung too far towards protecting auditors, at the expense of directors, creditors, shareholders and the wider public.

3. Auditors have benefited from complexity of accounting standards, not just their protective/ scope limiting characteristics. Bankers too benefited from the uptick in profits.

Britain cannot wait for the International Accounting Standards Board or the EU to fix problems

4. The timescale is slow. The EU is weak on this area, and not united, nor does it have same priorities. Other parts of EU have “dual boards” with non-IFRS accounts for director/ creditor assurance (e.g. Germany). The EU Commission seems to be a “soft touch” for Big 4 lobbying.

5. IASB in seeking to converge with the USA is up against the full force of the liability limitation tactics of the Big 4 USA and the pervasive power interests there. The biggest funders of the IASB were the Big 4 and the largest US investment banks. IAS 39 was written essentially in- house at Citigroup, the harmful bad debt provisioning model came from Big 4 USA.

6. Britain has got itself into position of “over adopting” IFRS (in companies and banking companies), caught between the worst aspects of the EU and the USA.

Solution and containment of problem

<table>
<thead>
<tr>
<th>i) UK must halt compulsory extension of IFRS as was proposed by (recently stepped down -12th October 2010) chair of UK Accounting Standards Board.</th>
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<tr>
<td>ii) The Department of Business must work with Accounting Standards Board to fix the clashes: between IFRS and the capital maintenance clauses of the Companies Act, and the problem of FRS 26, which clashes with both the capital maintenance clauses and the Companies Act accounting rules.</td>
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<td>iii) UK GAAP must be brought back to its pre-2005 condition. Each accounting and auditing standard should have a statement that it complies with the letter and spirit of the intent of Company Law, so as to avoid clandestine auditor liability limitation tactics (whether omissions or commissions).</td>
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27 October 2010
Further supplementary evidence from Mr Timothy Bush

**CATEGORISATION OF BANKING FAILURES BY ACCOUNTING ISSUE**

<table>
<thead>
<tr>
<th>Accounting Problem</th>
<th>Treasury Assets</th>
<th>Banking Books</th>
<th>Trading Books</th>
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<td>collapsing</td>
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<td><strong>Bad debt provisioning</strong></td>
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<td><strong>Fatalities (＞100% of capital lost)</strong></td>
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<td>insufficient to protect creditors and very growth expansionary</td>
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<td>Allied Irish Bank</td>
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<td>Bradford &amp; Bingley*</td>
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<td>Cattles (non bank lender)</td>
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<td>HBOS (Bank of Scotland)</td>
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<td>London Scottish Bank</td>
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<td>Northern Rock*</td>
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<td>* lack of contingent liability assessment (“make good” clauses in securitisations).</td>
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<td><strong>Mark to market gains covering up losses</strong> (Collateralised Debt Obligations), then met by <strong>mark to market downswing</strong></td>
<td>Most banks exposed. HSBC had MtM losses at one point approaching £20bn (these then substantially reversed).</td>
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<td><strong>Fatalities (＞100% of capital lost)</strong></td>
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<td><strong>Impact</strong></td>
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<td>Market rise and then panic. Regulatory forbearance needed. Tremendous market dislocation.</td>
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<td>Auditors of failed banks</td>
<td>PWC</td>
<td>E&amp;Y Netherlands</td>
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<td>Bank of Ireland, Cattles, Northern Rock</td>
<td>ABN AMRO</td>
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<td><strong>KPMG</strong></td>
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<td>Allied Irish, HBOS, London Scottish, Bradford &amp; Bingley</td>
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<td>Auditors of “victim” banks/survivors (victim meaning acquired collapsing banks)</td>
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Further supplementary evidence from Mr Timothy Bush

Technical addendum from Timothy Bush, to support evidence of 26th October 2010, given the evidence given 9th November by the FSA and FRC which is contradictory in two places.

1. Mr Haddrill stated that, prior to IFRS (2005), there was no UK standard on derivatives. That is incorrect. There is a UK standard, FRS 13 (1998) which is actually entitled "Derivatives and other financial instruments".

Also, UK standard FRS 5 (1994) deals with securitisations (as well as off balance sheet transactions), see the attached notes on both standards on the ASB website.

http://www.frc.org.uk/asb/technical/standards/pub0106.html
http://www.frc.org.uk/asb/technical/standards/pub0100.html

Further, and superior to that, are the Accounting Preparation Rules of the Companies Act itself. Part 2, Section A, 17-21 are the overarching accounting principles that must be adhered to.

http://www.legislation.gov.uk/uksi/2008/410/schedule/2/made

Para 19 (a) requires prudence (and no unrealised profits).
Para 77 (3) is a catch-all contingent liability clause.

All of this was then pulled together by the bank specific standard (SORP) from the British and Irish Bankers Association (attached) dated 1997 (and regularly revised). Page 51 et seq is the derivative section.

Mr Hadrill refers to prudence still being in the regulatory system, which seems to accept that it is no longer in the accounting system.

That does not work if, the company is not regulated (e.g. Cattles, which lent, but did not take deposits), nor does it work if the regulator is not alert, or themselves misled. The statutory purpose of Companies Act accounts is a stewardship function, irrespective of whether the company is regulated or not.

2. Further, on bad debt provisions, Mr Thorpe of the FSA stated correctly, that IFRS [by 2013 at the earliest] will move to an "expected loss" basis (forward looking) of bad debt provisioning.

However, he stated that the "incurred loss" model of IFRS was the same as had been in the UK for 30 years. That is in my opinion not correct.

IFRS has excised the general presumption of prudence (above) as a valuation method, and replaced the British and Irish Bankers’ Association SORP. Para 9 of page 5 of the BBA SORP deals with both specific and general bad debt provisions. It set an aspirational goal for the carrying value of loans set out as:

"Although specific and general provisions are computed separately, they are in effect components of the same provision. In total the specific and general components of a bank's provisions for bad and doubtful advances should represent the aggregate amount by which the bank considers it necessary to write down its impaired advances in order to state them at their expected ultimate net realisable value." (UK GAAP)

IFRS (IAS 39) requires provisioning on the basis of evidence of default (i.e. the customer is already not paying), rather than forward looking. It is highly qualified compared to UK GAAP. A PWC paper "joining the dots" which summarises this as: "IAS 39 specifically states that losses that are expected as a result of future events, 'no matter how likely', are not recognised."
The FSA's own discussion paper on the implementation of IFRS (04/17, October 2004) “Implications of a change of Accounting Framework”, para 2.42, says:

“General provisions under UK GAAP are provisions for losses that have been incurred but not yet individually identified. There is no equivalent concept under IAS 39, but the standard does permit companies to assess impairment "individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant" (IAS 39.64 as at 31 March 2004).”  

Although superficially, the FSA seems to have used similar language to UK GAAP, the word “incurred”, the FSA paper itself reveals that the definition that sits beneath is, both qualified and very different. The use of the term “permit” a provision, is clearly restrictive. The UK GAAP position is aspirational, requiring general provisions and for the total amount to be the expected realisable value.

From reviewing the accounts UK and Irish ordinary lending banks which collapsed, it can be seen that general provisions disclosed in the accounts either fall under IFRS, or disappear altogether.

The benefit of the audited statutory accounts of a company is for the body of members, to protect the capital, from hidden losses for the benefit of the members and hence the creditors. In my opinion, the accounting standard (IAS 39) does not meet that function in concept, or practice. Further to that, the FSA as a regulator seems to have assented to that deficiency.

The implication of this is that the regulatory interest in statutory audits – regulation has traditionally free-ridden off the contractually audited accounts for the benefit of the members - has intruded to the extent of being a part of a train of events that has then undermined the interest of the members, and then of the creditors.

11 November 2010

Supplementary memorandum by Mr John P Connolly, Deloitte

I am writing in response to your letter of 1 December 2010 following my appearance before the House of Lords Economic Affairs Committee on 23 November. I have set out below the answers to each of the questions set out in your letter. For the avoidance of doubt, my response is on behalf of Deloitte LLP and I am not speaking for the other firms who appeared at the same hearing.

Q283 - Going concern judgments as part of the audit of banks before and during the crisis

The Committee asked for details as to how going concern judgments were made for the years ended 31 December 2007 and 2008. Before explaining the judgments taken for these years, it is worth looking at the definition of going concern as set out in paragraph 25 (then paragraph 23) of International Accounting Standard 1 Presentation of Financial Statements:

"When preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. Financial statements shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity's ability to continue as a going concern, those uncertainties shall be disclosed. When financial statements are not prepared on a going concern basis, that fact shall be disclosed, together with the basis on which the financial statements are prepared and the reason why the entity is not regarded as a going concern."

The wording used in the equivalent UK GAAP standard, FRS 18, is slightly different but this has no effect in practice.
IAS 1 refers to liquidation and cessation of trade. It is frequently the case that the companies require access to finance that is not guaranteed for a year from the date of approval from the financial statements, e.g. a simple manufacturing company that is dependent on annual renewal of an overdraft. The job of directors in considering whether or not there is an uncertainty as to going concern, and of auditors in auditing going concern, is to consider whether such finance will, in all probability, be available if required. For banks, the same considerations apply - banks have always lent long but borrowed short (whether through wholesale funding or deposits by retail customers) - and the requirement is therefore to consider the availability of that finance to them. This includes the likely state of the wholesale markets, retail markets and other sources of funding which would include, for example, the Bank of England's liquidity scheme and the Treasury's credit guarantee scheme.

In forming our opinions on financial statements, we consider not only whether to draw attention to a significant uncertainty as to going concern, but also whether the disclosure within the financial statements is appropriate. For example, if we concluded that there was concern, but not significant concern, we would not be required by auditing standards to include an emphasis of matter in our opinion. Indeed, doing so might make a minor concern result in a run on the bank, thereby creating a self-fulfilling prophecy. We would, however, expect to see adequate disclosure of the facts and circumstances and assumptions made by directors, and to be able to see evidence to support these. If we were of the opinion that the disclosure was inadequate, or the disclosures were unreasonable, we would qualify our opinion. In considering the adequacy of disclosure, we have regard to the guidance issued by the Financial Reporting Council following consultation with all interested parties including companies, investors, auditors and the FSA. It is worth noting that the financial statements of banks for the years ended 31 December 2007 and 2008 have been subject to reviews by many organisations, including the FSA and the Financial Reporting Review Panel, and no material misstatements have been identified, nor have any been restated.

**Audits for the year ended 31 December 2007**

During the early months of 2008 we carried out our audits of the financial statements of our banking clients for the year ended 31 December 2007. At that time, audit teams on our banking clients considered going concern having regard to the above definition. We concluded that, based on conditions in the market at that point, we did not have significant concerns about going concern for the majority of our clients. This assessment was reached after considering both the state of the banking market and the actions of the Treasury, the Bank of England and others following the collapse of Northern Rock. In addition to auditing going concern, we audited the disclosures made by such clients and, for example, the financial statements of The Royal Bank of Scotland Group plc contained extensive disclosure to the shareholders around risks including the risk of steep falls in perceived or actual asset values accompanied by severe reduction in market liquidity, dislocated markets, recent market volatility and illiquidity and the further write downs that may adversely affect the group's future results, together with detailed numerical analysis of the liquidity position.

At this point in time, nobody (including the Bank of England, other central banks, governments, regulators, economists and analysts) had predicted the total market dislocation that would occur later in 2008; particularly the sudden and unexpected demise of Lehman Brothers on 15 September 2008 brought about within a few days a total meltdown in global liquidity for banking institutions.

We did, however, identify concerns around one of our "monoline" banking clients (those banks where the majority of their business was concentrated in narrow markets). We had discussions with the FSA as to the judgments being made by the directors and ourselves and managed to obtain sufficient evidence that the directors' assessment of going concern was reasonable in the circumstances, supported by judgments as to what was reasonably probable, and by disclosure as to the extent of the factors taken into account and the liquidity position of the entity. Subsequently this entity was the subject of a merger and in its merged form continued to be a going concern.
Reviews for the half year ended 30 June 2008

We continued to have regard to these risks in carrying out half-yearly reviews for the period ended June 2008. For example, the half yearly report on The Royal Bank of Scotland Group plc for the first half of 2008 on which we reported drew attention to significant losses and credit market write-downs, the difficult operating environment, unprecedented market conditions, the dislocated trading environment for credit markets and equities and the anticipation that the credit environment would become more challenging and that the difficult conditions in the financial markets look set to be compounded by a deteriorating economic outlook. The bank was nevertheless operating within its capital adequacy requirements.

Audits for the year ended 31 December 2008

Following the global liquidity meltdown which occurred following the demise of Lehman Brothers, the state of the banking market had changed dramatically. We recognised that forming a conclusion on going concern, and the degree of uncertainty, would be hard for the directors of the banks when they approved the financial statements for the years ended 31 December 2008. We did not soften the standards that we applied in considering going concern, because the accounting and auditing standards remained unchanged. We were, naturally, concerned that if we modified or qualified our auditors’ report on going concern grounds that this would have brought about a banking collapse within a few hours as a result of the inevitable response of speculators and depositors, and therefore felt that it was important for the government to be aware of our concerns and of the need for the directors of the banks to be able to consider carefully the evidence of potential government support, given the virtual closure of the wholesale markets. The Big 4 firms approached the government in November 2008 and asked to meet Ministers to discuss the extent to which action was being taken to support the going concern position of UK banks. A meeting took place between the CEOs of the Big 4 and Lord Myners, the then City Minister, on 16 December 2008 at which the Minister provided evidence of the Government’s actions and the extent of their commitment which would support the management, directors and auditors in forming their view on going concern.

As auditors, we also considered the evidence obtained by the directors of our banking clients. This included an assessment of the recapitalisation scheme, the Bank of England’s Liquidity Scheme and the Treasury’s Credit Guarantee Scheme. Based on this evidence, the directors, and we as auditors, concluded on the majority of our clients that it was sufficiently likely that the support would be available to avoid uncertainty as to liquidation or cessation of trade, and hence, having regard to the definition in IAS 1, significant uncertainty as to going concern. Nevertheless, in doing so, we did audit the disclosures made by those banks in their financial statements around risk and liquidity. For example, the financial statements of RBS contained extensive disclosure of the liquidity provided by central banks in a number of jurisdictions and the support from UK Government on which the bank owed its continuing independence. The annual report also included a going concern statement which referred explicitly to the UK Government’s support for the group.

We had one client where there was concern as to the availability of support. In that case, we felt unable to give an unmodified opinion without an emphasis of matter as to a significant going concern uncertainty. We initiated a call to the FSA to meet our duty to report to them. When it became clear that support would not forthcoming, the directors concluded that there was significant going concern uncertainty and the tri-partite authorities instigated the special resolution regime. As a result of this, we were never required to issue an audit opinion on the entity in question.

Q287 - The impact on bank audits of IFRS accounting standards

We do not agree with the assertion that the loan loss impairment and fair value accounting (‘marking to market’) requirements in IFRS were a cause of the financial crisis. Both accounting conventions were well understood and were established ways of measuring financial assets, including those assets of banks, at a particular point in time. In the case of loan loss impairment requirements they illustrated at the balance sheet date how much losses have been incurred by the bank in lending
money. With respect to marking to market it showed clearly the value of a bank's trading positions and value of its more complex structured investments. Both conventions were transparent in the accounting policies of financial statements and their application consistently portrayed to investors the state of play at the balance sheet date. It is entirely right that emerging from the financial crisis questions have been asked by the G20 Countries and other constituents whether the accounting conventions could be improved in order to make the information at the balance sheet date more relevant.

The two key questions that have emerged that need answering by standard setters and all stakeholders, including investors, regulators, preparers and auditors are firstly, should all financial assets be measured at fair value, and if not, which financial assets should be measured at amortised cost (and therefore subject to impairment accounting), and secondly, can the impairment model be improved? We are entirely supportive of the IASB and the U.S. FASB working jointly to finalise their reforms by June 2011. Much progress has already been achieved. IFRS 9 Financial Instruments, issued in November 2009, simplifies and improves the distinction between what should be at fair value and what should not. Further, we support the IASB and FASB’s current work in proposing amendments to the impairment model so that it is more forward looking in capturing expected losses, not just currently incurred losses. It is right that accounting standards are subject to continuous improvement to ensure that the financial results that flow from applying these standards are more relevant. The completion of these reforms by June 2011 and, it is hoped, the speedy endorsement of IFRS 9 by the European Parliament will ensure UK banks and their investors can take advantage of these reforms as apply as early as is practicable.

Q290 - Other possible assurance services

In Q290, Lord Lawson asked us to provide a note of other areas which wider audit reports might address. We believe that it should be for regulators, banks and auditors to discuss which areas should be the subject of additional work by the auditor, bearing in mind that the risks may be different for different banks. Clearly some of the areas covered by the annual report are matters of subjective judgment for investors to take decisions based on whether they agree with management’s views. However, other areas are ones where there is objectively verifiable information on which auditors might report, given a suitable framework for management to prepare their reporting and for auditors to audit it. This could include the outcome of management’s stress testing exercises, accuracy of reporting of large exposures, accuracy of regulatory capital ratios and liquidity reporting and information on mortgage lending practices.

Questions not reached through lack of time

In recent years the share of non-audit fees in the Big Four’s total fees has fallen sharply, partly because fees for ‘audit-related work’ (including ‘extended audit services’) are reported as if they were fees for auditing. So that we can have a clearer picture of how much fee income you earn for work you do for audit clients which is not essential in order for you to provide your audit opinion, could we please have a breakdown of the proportion of total fees earned from:

(a) essential audit work
(b) ‘audit-related work’ excluding ‘extended audit services’
(c) so-called ‘extended audit services’, and
(d) consulting and other services?

We do not allow clients to report fees for "audit-related" work as fees for auditing. Whilst the existing disclosure rules are unhelpful (for example, by categorising fees for the audit of subsidiaries as fees for non-audit services), we believe there is an important distinction to be made between ‘audit-related fees’ and other non-audit services. This distinction is not made in the current law, although it has been recommended by the Auditing Practices Board (APB) in their recent consultation draft on non-audit services. We believe that it is important to distinguish between audit-
related services and non-audit related services. For example, audit-related services include the interim review of a listed company's half-yearly report, work on regulatory returns to the FSA and (for those entities with a listing in the US) auditing of internal control under Sarbanes-Oxley. These are services which can only be provided by law from the auditor or would normally be expected of the auditor. This is appropriate, as they are all independent assurance services and all require the same standard of independence as is required for the audit of the financial statements. In particular, the role of 'extended audit services' is minimal in driving the fall in non-audit fees. There are occasional requests from clients that fall into this category, but we do not actively target such opportunities and it is not part of our growth strategy which focuses on the sale of non-audit services to non-audit clients.

We do not separately collect data on 'extended audit services' as part of our financial reporting systems as there is not currently a requirement to separately disclose such amounts; our systems collect the information based on the categories required by law. However, we did carry out an exercise for the Audit Inspection Unit's review of this issue which formed part of their 2009/10 inspection cycle which provides information as to the scale of the issue. During the most recent year, our fees to the FTSE 100 were as follows:

<table>
<thead>
<tr>
<th></th>
<th>£m</th>
<th>% of audit fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Audit fees</td>
<td>90.587</td>
<td>100.0</td>
</tr>
<tr>
<td>Other services pursuant to legislation</td>
<td>13.830</td>
<td>15.3</td>
</tr>
<tr>
<td>Pension fund audits</td>
<td>1.779</td>
<td>2.0</td>
</tr>
<tr>
<td>Other non-audit services:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Extended assurance</td>
<td>0.075</td>
<td>0.1</td>
</tr>
<tr>
<td>- All other services</td>
<td>37.031</td>
<td>40.8</td>
</tr>
<tr>
<td>Total</td>
<td>143.302</td>
<td>158.2</td>
</tr>
</tbody>
</table>

We identified only £75,000 of "extended audit" services (less than 0.1% of audit fees) which comprised two engagements: independent assurance on sustainability disclosures for one client and independent assurance carried out for the audit committee (rather than management) of another client. Neither of these amounts was disclosed as audit fees. The remainder of other non-audit services were primarily tax and corporate finance services. We had no fees for internal audit, valuation or litigation work.

We attached a copy of our submission to the Auditing Practices Board's recent consultation on non-audit services to our original submission in response to the Committee's call for evidence. This submission contains more detail of our thinking in this area. In particular, we commend to the Committee our thoughts on reforming the disclosure regime for non-audit services (as we believe this to be an issue of perception, rather than reality); that restricting the choice of advisors that may be used when there is no independence threat may increase costs for British businesses, harming recovery and growth. It should be borne in mind that non-audit services supplied by auditors can be very much in the public interest. For instance, companies subject to hostile takeovers may be unable to issue timely defence circulars without the involvement of their auditors to provide independent verification of their contents; bringing in a new provider would take too long as that firm would not have the existing knowledge of the company. Similarly, companies in distress would be less likely to secure additional or continued finance without the rapid involvement of their auditors to challenge the assumptions underlying cash flow forecasts supplied to banks. Without such services, UK job losses could be much larger than would otherwise be the case.

Should audit firms be free to provide internal audit services to their audit clients? If they do, isn't it extremely unlikely the external auditor would ever tell the audit committee that the internal audit is rubbish?
We do not agree that audit firms should be free to provide internal audit services to their clients. The existing APB Ethical Standards for Auditors prohibit us from doing so when either we would place significant reliance on the work of internal audit as part of our external audit or we would undertake part of the role of management. We support these standards and believe they provide adequate safeguards such that it is very unlikely that as external auditors we would be commenting on the quality of our own internal audit work.

Please do not hesitate to contact me if you require any further clarification of the answers above.

17 December 2010

Supplementary memorandum by Ernst & Young

Thank you for your letter of 1 December 2010 addressed to Scott Halliday. Ernst & Young is pleased to submit further evidence to the Committee.

I attach an 8-page Appendix in which we set out our answers to the Committee’s specific questions. In so doing, we are mindful of the underlying issues in the Committee’s inquiry, notably the relevance and future role of audit. In that respect, we have sought, where appropriate, to highlight recommendations which we made in our original written submission and in oral evidence.

Appendix - responses to specific questions

“A note on how going concern judgments as part of audits of banks were reached before and during the financial crisis of 2007-09 (Q283). The Committee is particularly interested in how auditors reached unqualified going concern judgments on banks for the year ending December 2007 only for some of them to collapse in 2008. The Committee would also like to know what was the basis for going concern judgments on banks’ financial statements in December 2008, when some banks were already in trouble”.

1. Financial statements are prepared by companies and the accounting judgments are the responsibility of management and the directors. They are a snapshot of a company’s financial position at a particular point in time. A statutory audit is an examination of a company’s financial statements carried out in accordance with independently prescribed auditing standards. After the audit is completed, the auditor issues an audit opinion which is published as part of the financial statements. It states whether or not the financial statements give a true and fair view of the state of the company’s affairs and of its profit or loss for the period covered. It is designed to provide reasonable (not absolute) assurance that the company’s financial statements are free from material misstatement.

2. Although preparation of the financial statements requires the directors to make certain assumptions about the future (indeed directors of listed companies are required to make an explicit statement that the company is a going concern), financial statements do not provide a forecast of future performance because they are a snapshot of a company’s financial position at a particular point in time.

3. In December 2010, the Financial Reporting Council made the following comments in its response to the European Commission’s Green Paper on Audit Policy. They provide a good explanation of what it means to prepare financial statements on a going concern basis.

“There is evidence of an expectation gap between the actual scope of an audit and public perception of the information an audit should reveal. Some stakeholders continue to believe that auditors provide an independent opinion on the financial health of a company when in fact they prepare an opinion on whether their accounts show a “true and fair” view. This particular expectation gap was evident in commentary following the financial crisis, with many people...”

http://tiny.cc/1s0mp at page 8
querying how a bank could have received an unqualified audit report, only to collapse a few months later. Specifically, it was questioned whether the risks and uncertainties facing the banks were adequately described and/or it was correct for the financial statements to be prepared on a going concern basis. In this context it is important to appreciate that a conclusion, based on reasonable assumptions about the company and the markets in which it operates, to prepare a company’s financial statements on a going concern basis is not the same as reaching a definitive conclusion that the company will in fact be a going concern some 12 to 15 months later.”

4. While Ernst & Young audits many banks outside the UK, we did not audit any of the major UK-headquartered banks during the relevant period. We do not therefore have sufficient knowledge to comment on how the directors and auditors of UK banks made judgments on going concern for the financial years ended 2007 and 2008.

5. That said, we believe that the following recommendations could help address the “expectation gap” to which the FRC refers:

a. expanding corporate reporting by developing standards that require companies to provide investors with information that goes beyond historical financial statements and management analysis to include improved and more relevant disclosures (e.g., business model, risks, controls, management estimates and judgments, and sustainability);

b. strengthening the role of audit committees to include issuing a report to investors providing greater transparency into discussions with management and the auditor on key financial statement risks and critical judgments and estimates;

c. requiring the auditor to provide some level of assurance or attestation – or have other involvement with – certain information outside of the financial statements, including a company’s narrative reporting, as well as any enhanced business reporting that may evolve; and

d. a greater role for auditors in prudential regulation including a regular two-way dialogue between bank auditors and prudential supervisors. Prudential supervisors could also make more and better use of auditors and other external experts using targeted risk based reporting.

“A note on the impact on bank audits of IFRS accounting standards (Q.288)”

Recommendation

6. The comments we make below reinforce the importance of global adoption of a single set of high quality accounting and auditing standards, namely IFRS and ISA.

Effect of switch to IFRS on financial reporting by banks

7. Like UK GAAP, IFRS is a principles-based set of accounting standards that require the application of judgment and professional experience by the directors when preparing the financial statements. Since IFRS has been applied, a body of supporting literature has been developed which seeks to ensure consistency of application globally and prevent abuse.

8. The relevant standards, guidance and accounting by banks for loan loss provisions and fair values were not significantly different under UK GAAP compared to IFRS. Pre-IFRS, UK banks were subject only to the Statements of Recommended Practice (SORPs) on loan provisioning, hedge accounting and securities measurement. These were developed by the British Bankers’ Association and ‘franked’ by the Accounting Standards Board. They were only recommended practice and less rigorous than IFRS.

a. Loan loss provisions - there is no major difference in the requirements of the SORP on Loans and Advances, which represented UK GAAP on the topic, and IAS 39 under IFRS: both are incurred loss models.

9. In relation to distributable profits, Mr Bush’s evidence is based on the assumption that solvency requirements for financial institutions are determined largely by reference to the financial statements. This has not been the case for some time, irrespective of whether UK GAAP or IFRS is used.

10. Distributable profits are (and were) based on retained earnings as shown in the financial statements, but are adjusted (typically downwards) to arrive at distributable profits using the guidance in Technical Releases issued by the main UK accountancy bodies. This recognises that not all profits recognised under IFRS (or UK GAAP) are sufficiently realised to be distributable.

11. Moreover, no well-managed organisation would seek to pay a dividend if the effect would be to reduce its capital below that which it needed to operate its business. This is where regulatory capital requirements for banks are relevant. In calculating regulatory capital under Basel 2 UK banks had to include amounts for expected losses beyond those recognised in the financial statements together with amounts for unexpected losses. This regulatory capital regime was also designed to cover the ‘stress test’ referred to by Mr Bush. In practice it meant that the profits available for distribution would always be less than those recorded for accounting purposes.

12. Regulatory capital requirements under Basel 2 are now recognised as having been set too low, but that was nothing to do with IFRS.

13. It is also worth pointing out that some countries which do not use IFRS have experienced difficulties in their banking sector (e.g. USA). Equally other countries which use IFRS have not experienced difficulties in their banking sector (e.g. Australia). This provides additional support for the view that there is no causal link between adoption of IFRS and problems in the banking sector.

14. However, we recognise that IFRS accounting standards are not perfect. Accounting standard setters are seeking to develop improved principles-based standards, especially for financial instruments, which respond to the criticisms made following the crisis. We also welcome the considerable progress made by banks in the quality of their disclosures on the financial instruments they hold and the risks they are exposed to.

**Effect of switch to IFRS on banks audits**

15. Like UK GAAP, IFRS are a principles-based set of accounting standards that require the application of judgment and professional experience by auditors when auditing financial statements prepared by directors.

16. The move from UK GAAP to IFRS should therefore have had limited impact on how audits of a bank’s financial statements are performed. Auditors have had to make similar sorts of judgments about the directors’ financial reporting of loan loss provisions, fair values and distributable profits, whether the financial statements were prepared under UK GAAP or IFRS.

“A note on the areas which wider audit reports might address (Q.290)”

17. In looking at what wider audit reports might address, it is important to distinguish between a company’s responsibility to report its annual results to the market and the responsibility of the auditor to provide assurance on that information.

**Recommendations**

18. We believe the following proposals should be considered for all public interest entities, not just banks:

   a. Strengthening the role of audit committees to include issuing a report to investors providing greater transparency into discussions with management and the auditor on key financial statement risks and critical judgments and estimates;

   b. Expanding corporate reporting by developing standards that require companies to provide investors with information that goes beyond historical financial statements and management
analysis to include improved and more relevant disclosures (e.g., business model, risks, controls, management estimates and judgments, and sustainability); and

c. Requiring the auditor to provide some level of assurance or attestation – or have other involvement with – certain information outside of the financial statements, including a company's narrative reporting, as well as any enhanced business reporting that may evolve.

19. For further information, please refer to our original written submission to the Committee dated 27 September 2010, and in particular our answer to the question “What is the role of auditors and should it be changed?”

20. The UK audit profession has done some detailed work on the future of bank audits. In June 2010, the ICAEW published its report on how bank audits might be enhanced6. In relation to auditor reporting, it identified that insufficient information is provided under the current framework about the work that underpins an audit. This makes it difficult for investors to assess the performance of bank auditors or to understand the key areas of challenge. To address this gap, banks should confirm that key areas of judgment discussed with auditors are set out in the critical accounting estimates and judgments disclosures in the financial statements. It also said that auditors should have more involvement in reporting on the front sections of annual reports.

21. The six largest UK audit firms are also part of a Bank of England-chaired working group comprising representatives from the FSA, FRC and ICAEW. The purpose of this working group is to consider how the relationship between auditors, firms and regulators can be more clearly defined to permit more useful and comparable disclosures about judgment issues and the sensitivities around material valuations. The working group is also defining ways in which the relationship between auditors and prudential regulators can be enhanced in practical terms. In respect of the latter workstream, a working protocol has largely been agreed.

22. On 29 June 2010 the FSA and FRC published a Discussion Paper looking at similar issues and asking, among other things, for views on bespoke reporting by auditors to prudential supervisors and whether auditors should audit Pillar 3 and prudential information in annual reports7. We enclose a copy of our response to that Discussion Paper and refer you in particular to our answers to Questions 10 to 15.

In recent years the share of non-audit fees in the Big Four’s total fees has fallen sharply, partly because fees for ‘audit-related work’ (including ‘extended audit services’) are reported as if they were fees for auditing. So that we can have a clearer picture of how much fee income you earn for work you do for audit clients which is not essential in order for you to provide your audit opinion, could we please have a breakdown of the proportion of total fees earned from:

(a) essential audit work
(b) ‘audit-related work’ excluding ‘extended audit services’
(c) so-called ‘extended audit services’, and
(d) consulting and other services?

Recommendations

23. The comments we make below reinforce the importance of:

a. strong active corporate governance including improved disclosures in company annual reports of an audit committee's policy on non-audit services and its reasons for approving significant non-audit engagements;

b. clearer information in company annual reports about how non-audit services are categorised; and

6 http://alturl.com/jgref
7 http://www.fsa.gov.uk/pubs/discussion/dp10_03.pdf
c. policy makers considering whether to require audit committees to pre-approve significant permissible non-audit services.

Comments

24. Transparent information about the nature and amount of non-audit services auditors provided to audit clients should help address any perceptions among stakeholders that objectivity and independence is impaired by their provision. We seek to achieve this through our transparency report which outlines revenues attributable to different segments of our firm. It also provides information about the relative size of our non-audit practice as compared to the audit practice.

25. We have sought to answer the Committee’s question as best we can by setting out figures taken from our transparency report for the year ended 2 July 2010\(^8\). Although we do not analyse fees centrally using the Committee’s categories, these numbers indicate the relevant financial significance of different types of services.

<table>
<thead>
<tr>
<th>Service</th>
<th>Amount (£m)</th>
<th>Percentage of total revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Statutory audit</td>
<td>303</td>
<td>22.3%</td>
</tr>
<tr>
<td>Other assurance services provided in respect of audit clients</td>
<td>23</td>
<td>1.7%</td>
</tr>
<tr>
<td>Other non-audit services provided to audit clients</td>
<td>183</td>
<td>13.5%</td>
</tr>
<tr>
<td>Services provided to non-audit clients</td>
<td>847</td>
<td>62.5%</td>
</tr>
<tr>
<td>TOTAL</td>
<td>1,356</td>
<td>100%</td>
</tr>
</tbody>
</table>

26. The Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008\(^9\) (“the Regulations”) also require companies to disclose a breakdown of fees paid to their auditors, albeit not in the same categories as those used by the Committee.

27. The Regulations provide a general picture of what a company asks its auditor to do but they could be improved. Accordingly, we support better disclosures in company annual reports about how non-audit services are categorised.

28. Under the Regulations, many services categorised as non-audit are services which are integral to the audit e.g. audits of subsidiaries or internal controls reporting required to be performed by the auditor under the US Sarbanes-Oxley Act. In 2010, we were therefore pleased to assist the Institute of Chartered Accountants of Scotland to develop recommendations\(^10\) for improvement to the FRC and the Department for Business on these issues. We are encouraged that, as part of a comprehensive review of the provision of non-audit services by auditors to audit clients over the past two years, the Auditing Practices Board (APB) and Department for Business are taking forward the principles underlying these recommendations. This includes amending the Regulations. We would very much welcome a recommendation from the Committee that this work be expedited by APB and BIS.

29. Over the last ten years there has been a robust debate about the range of non-audit services an audit firm may provide to an audit client. Countries like the UK have adopted detailed regulations in this regard. In our view, delivering the most complete range of permissible services increases an audit firm’s knowledge of the audited company, its risks and processes, all of which contribute to audit quality. An “audit-only” firm could be detrimental to audit quality as such firms would encounter difficulty in hiring high quality specialists (e.g., in tax and valuations) that are fundamental for a quality audit. Existing professional standards and regulations set appropriate parameters for the scope of permitted non-audit services to audit clients.

30. The decision about which permissible non-audit services are obtained from a company’s auditor should remain with the audit committee. In many countries, including the UK, the audit committee already plays a key role in this regard.


31. We support enhanced disclosures by audit committees about their policy on non-audit services and their reasons for giving approval for significant non-audit engagements. Policy makers might also consider requiring audit committees to pre-approve significant permissible non-audit services. By enhancing pre-approval and disclosures, such as the nature and amount of permissible non-audit services provided by the auditor and the fees, audit committees can best select the most appropriate firms and permitted services for their companies.

**Should audit firms be free to provide internal audit services to their audit clients? If they do, isn’t it extremely unlikely the external auditor would ever tell the audit committee that the internal audit is rubbish?**

**Recommendations**

32. The comments we make below reinforce the importance of:

a. strong active corporate governance including improved disclosures in company annual reports of an audit committee's policy on non-audit services and its reasons for approving significant non-audit engagements;

b. clearer information in company annual reports about how non-audit services are categorised; and

c. policy makers considering whether to require audit committees to pre-approve significant permissible non-audit services.

**Comments**

33. It is not Ernst & Young’s policy to perform an outsourced internal audit function for our audit clients. That said, certain limited services are permissible provided that a number of detailed conditions are met. Our policy is in line with the relevant auditor independence standards which guard against the threats of self-review and/or acting as management. These restrictions are entirely appropriate.

34. Active corporate governance also plays a very important role. Listed companies generally have audit committee policies covering the type of services auditors may or may not perform. An audit committee would have to authorise the auditor to provide any internal audit-type services. Accordingly, the scenario envisaged by the Committee’s question is unlikely to arise.

35. It is also important to distinguish internal audit from what might be described as “extended [external] audit services”. The Auditing Practices Board has looked at this very issue in its current review of its Ethical Standards. As a result it has sought to clarify the position by amending its Ethical Standards in the following ways:

a. Improving the guidance as to what work should be treated as [external] audit work rather than non-audit services;

b. Including extended audit services within ‘audit-related services’; and

c. Giving greater guidance on what internal audit services comprise including making a distinction between ‘assurance activities’ designed to assess the design and operating effectiveness of existing or proposed systems or controls (auditor permitted to perform) and ‘advisory activities’ where the auditor is involved in advising an entity on the design and implementation of its risk management, control and governance processes (auditor not permitted to perform).

36. We support this move by APB which is consistent with international ethical standards in this area. It is important that an auditor does not perform internal audit-type services where it might threaten his or her independence. However, audit quality must not be threatened by restricting the external auditor to only those procedures set out in auditing standards. This would not be in

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11 IESBA Code of Ethics paragraph 290.200
Supplementary memorandum by the Financial Reporting Council

the public interest. An auditor must continue to be free to perform all necessary procedures for the external audit in order to make the requisite judgments underpinning an audit opinion.

22 December 2010

Supplementary memorandum by the Financial Reporting Council

Auditors: market concentration and their role

We are pleased to provide the Committee with this further letter following up on the issues that were raised in the course of our oral evidence on 9 November. This letter also responds to the Committee’s request for further information on contingency planning on how to respond to the withdrawal from the audit market of one of the Big Four and issues concerning IFRS and the Companies Act 2006.

1. FRC structure and powers

The regulation of accounting and audit has evolved from a self-regulatory system and today it is the Financial Reporting Council (FRC) which provides oversight of the auditing, accounting and actuarial professions. We believe that further steps are necessary to strengthen the FRC’s position as an effective, independent regulator.

In order to facilitate this transition, the FRC needs increased powers to:

- Gather information on failed companies to establish whether governance or audit failures were contributory factors;
- License auditors of public interest entities; and
- Investigate and discipline misconduct by auditors.

Legislative change is also needed to enable the FRC to rationalize its current structure and ensure that information can be freely exchanged internally.

In future we believe the FRC should have a greater capacity to be proactive in identifying and responding quickly to problems in capital markets. We currently have powers to monitor the quality of audit, and we review 300 sets of accounts each year. We also conduct investigations into potential misconduct by members of the accountancy and actuarial professions. However, we have limited powers to inquire into the accounting judgements of companies that have failed; our investigations into misconduct cannot compel evidence from, e.g., directors who are not accountants and are very time consuming; and our audit inspections are established for the purpose of annual monitoring, and have insufficient powers for exploring urgent issues that fall outside our routine monitoring. This means that we are dependent upon the goodwill of the firms in helping us to understand whether there are any lessons to be learned in other areas, for example from the collapse of a number of companies supplying the public sector.

We believe that additional measures could be taken to strengthen our independence and enhance audit quality:

Information sharing
The FRC believes that better information sharing across our organisation and with fellow regulators, would benefit the market and help to spot and manage risks.

There are currently restrictions on information sharing between some of the FRC’s operating boards. For example, under current legislation the Financial Reporting Review Panel (FRRP) is unable to share information on companies whose accounts it may be investigating with the Audit Inspection Unit (AIU). We would ask the Committee to support legislation which will enable effective information sharing across the organisation.

Licensing

The increasing complexity of global business practice and enhanced investor expectations of the auditors of public interest entities require auditors to have a greater degree of expertise and experience to manage adequately the risks involved.

We therefore propose an additional licensing regime for auditors of public interest entities. The need for this is shown by the evidence of the AIU’s 2010 Annual Report, published in July 2010, which concluded that “the number of audits assessed as requiring significant improvement at major firms is too high” and among other firms a higher proportion of audits conducted required significant improvement. We believe a new regime for auditors of public interest entities should be provided by the FRC while the professional accountancy bodies should retain responsibility for the oversight of smaller firms.

The ICAEW, in their letter to the Committee of 23 November about the audit inspection and monitoring regime, suggested that the existing regime could achieve our goals. It is correct that the Audit Registration Committee (ARC) has responded to individual reports made by the Audit Inspection Unit (AIU). However, the regime currently operates within very tight parameters. The AIU is restricted in the action it can request the ARC to take; its efforts to broaden the definition of what is a public interest entity have been challenged; as has its wish to undertake non-routine inspection work without seeking the ARC’s permission.

Discipline

The current professional disciplinary regime is complicated and is not as independent or effective as it should be. At present the Accountancy and Actuarial Discipline Board (AADB) is required to consult with the relevant professional body before it can begin a disciplinary investigation. It has no statutory powers to obtain evidence.

We believe that the independence of the process is compromised by the requirement placed upon the AADB to consult and seek the agreement of the professional bodies – this is the product of the previous self-regulatory system that we believe should now come to an end.

To address this issue we therefore propose the clarification and streamlining of the AADB’s discipline scheme. All disciplinary cases relating to public interest audits should fall to the AADB in the first instance.

Where the market has been misled deliberately it is important that a robust sanctions regime is in place to deal with such behaviour. We are concerned that this does not exist at present and that the sanctions available to the FRC are limited, meaning that the most appropriate remedy is sometimes not available to us. We would therefore like a more tiered sanctions regime to be put in place which, accompanied by other changes outlined in this letter, would strengthen the FRC’s independence and contribute to the better operation of the market.
Taken together we believe these measures would significantly improve the accountability of the audit profession, strengthen the FRC’s independence and put in place a robust sanctions and company investigations regime in the public interest.

2. FRC governance

The governance structure of the Financial Reporting Council was significantly strengthened three years ago, reducing a large representational council to a Board of 16 members (currently consisting of a non-executive Chairman, the Chief Executive, 6 chairmen of the operating bodies and 8 independent non-executive directors). However, further changes under consideration for the coming year are intended to have the effect of increasing the majority of independent directors on the Board. These are selected to provide a wide range of skills and experience in business, investment institutions, the professions and policy-makers, including those affected by the work of the FRC. However, as the table below shows, there are no practising auditors on the Board, nor on the boards of the bodies responsible for auditor discipline.

Breakdown of FRC board membership

<table>
<thead>
<tr>
<th>Board</th>
<th>No of members</th>
<th>Current Big Four accountants or auditors</th>
<th>Ex-Big Four accountants or auditors</th>
</tr>
</thead>
<tbody>
<tr>
<td>FRC Board</td>
<td>16</td>
<td>0</td>
<td>3</td>
</tr>
<tr>
<td>Accountancy and Actuarial Discipline Board (AADB)</td>
<td>10</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Professional Oversight Board (POB)</td>
<td>11</td>
<td>0</td>
<td>2</td>
</tr>
<tr>
<td>Board for Actuarial Standards (BAS)</td>
<td>16</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Accounting Standards Board (ASB)</td>
<td>10</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Auditing Practices Board (APB)</td>
<td>15</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Financial Reporting Review Panel (FRRP)</td>
<td>29</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td><strong>TOTALS</strong></td>
<td><strong>107</strong></td>
<td><strong>12</strong></td>
<td><strong>17</strong></td>
</tr>
</tbody>
</table>

There are specific rules in the FRC constitution pertaining to the AADB, which must always contain a lay majority, and the POB, where no board member can be a practising auditor and a majority of members must have been out of practice for at least five years.

3. Withdrawal from the audit market of one of the Big Four firms

The FRC has been concerned for some time that the failure of one of the Big Four audit firms would have serious implications for the stability of the capital markets. The disorderly
movement of partners and audit teams to other firms could result in companies not being able to produce audited reports and accounts on the timescales expected by the markets.

The FRC has therefore put forward proposals aimed at addressing this issue and we have discussed our recommendations with both the Government and prudential regulators.

The key issues that the FRC believes need to be addressed are:

- The need for a clear statement that the government/competition authorities would break up a ‘Big Three’;
- A resolution regime and internationally agreed mechanism to ensure the orderly wind-up of a failing firm;
- A system for ring-fencing healthy parts of the network;
- An early warning system of significant threats to operations; and
- Living wills for accountancy firms.

Tackling this issue will require action and agreement both internationally and across a range of UK regulatory bodies and competition authorities. The FRC has written to the Financial Stability Board (FSB) and recommends that the UK Government takes up the issue with the FSB with a view to it being discussed at G20 level in due course.

The FRC does not believe that any of the Big Four should be seen as too big to fail. In particular, the taxpayer should not be expected to subsidise losses and regulators should not hold back from disciplinary action against misconduct. The value of audit depends wholly on confidence in its quality. Firms must not be disincentivised from the pursuit of quality by expectations of state protection.

The Big Four are now global networks. This gives them resilience against the collapse of one part of the network. Resources can be transferred and loss of business need not be catastrophic. However, as audit business is dependent on client and investor confidence, the networks’ strength can also be a source of vulnerability, as such loss of confidence in one country becomes contagious. The FRC believes that the networks are strong enough to survive a failure in most markets, but not in the US or probably the UK. The adequacy of response to a crisis is therefore of particular importance in both countries.

Governments and regulators have liaised closely in the past if a network has been threatened to ensure any necessary action is co-ordinated and consistent. The international nature of the firms and of market confidence requires this. Such action has been specific to the cause of the problem.

The success of such action depends on the authorities having enough time before failure becomes catastrophic. To that end, the FRC has agreed with the firms a protocol providing for the early warning of any significant threat to UK operations, including – to the extent known - from overseas.

Such measures are valuable, but are not capable of ensuring against failure. Audit failure may have been so serious that the firm needs to close. Early warning depends on failing parts of the firm not keeping their problems secret from the network. News that damages confidence can have a very rapid impact, as seen in the wake of Enron.
Governments and regulators do, therefore, need to be clear what their policy and plans will be if a network collapses. This needs to cover two major issues: how is audit work to be conducted in the short term and what long term structure is proposed for the audit market?

More work needs to be done on devising a vision for a longer term structure ahead of a crisis. The audit market would face major challenges if it was shared between just three firms. Depending on which firm failed, there could be no competition for the business of large companies in some sectors, such as energy and insurance. In all sectors, conflicts of interest would arise between audit and non-audit business as the remaining three sought to pick up clients of the failed firm. We therefore believe that a market dominated by three firms is not desirable. However, in a crisis it could come about by default as the partners and teams of the failed firm would be rapidly recruited by the other large firms. To reduce the risk of this, we propose that the competition authorities, in the EC, UK and US in particular, should indicate in advance of failure how they would be likely to respond. A statement in advance that they would act to break up a Big Three would help to prevent this being created. We believe collaboration between Governments, competition bodies and audit regulators to consider market structure in the event of a major failure should be initiated.

At the point of crisis, the authorities need to act to preserve market confidence consistent with their longer term vision. If, as we believe, that vision should not foresee the creation of a Big Three, the failing firm will need to be kept as a viable operational entity until new arrangements for handling its work are put in place. Under current legislation, this is not easy to achieve. Partners and employees cannot be forced to stay with the firm, nor can clients.

Finally, whilst public authorities need to plan their actions, we believe the firms’ own plans also need to be developed fully. The concept of living wills could be borrowed from the financial services sector. These would set out how a firm would segregate, under regulatory supervision, how good and failing parts of the business will be separated and funded.

It is vital that cross-border contingency plans are put in place and to achieve this we recommend that the Government engages first with the Financial Stability Board and then at G20 level to coordinate action that will lead to a plan being put in place.

4. IFRS and the Companies Act 2006

The FRC has studied carefully the issues raised in your letter and we hope that the following response will help to clarify the Committee’s understanding of the issues relating to IFRS and the Companies Act 2006.

The FRC has consulted BIS and shares its view that the adoption of IFRS was in conformity with the Companies Act 2006 because:

- The use of IFRS for the consolidated accounts of all groups listed in the EC was expressly mandated by the EC in 2002\(^2\).
- In addition, the EU gave individual Member States the right to decide whether to require the use of IFRS for the preparation of individual accounts of listed companies

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and their subsidiaries, and for any other companies. Following a consultation in 2002\textsuperscript{13}, the UK Government resolved to permit the use of IFRS by such companies.

- The necessary changes to the legislation to reflect these, and other, changes to the UK legislation came into effect on 12 November 2004\textsuperscript{14}.

We would also like to address the underlying concern that IFRS resulted in financial statements that showed a higher profit (or smaller loss) than would have been the case under UK GAAP.

Whilst it is right that the introduction of IFRS led to certain situations where profits could differ from those under UK GAAP, it is not the case that IFRS would always result in a higher profit than UK GAAP. So, for example, while the UK GAAP requirement to amortise goodwill would result in a reduction in profit as compared to IFRS, in contrast the effect of discounting financial assets carried at amortised cost when there is evidence that there has been an impairment loss under IFRS would result in a lower profit than under UK GAAP.

The FRC has consulted with BIS and shares its view that the introduction of IFRS did not give rise to breaches of sections 830 and/or 831, Companies Act 2006.

Those sections prescribe the manner in which a company must determine the profits that it has available for distribution. They provide that the profits as shown by a company's financial statements should be the starting point for determining the profits available for distribution. They then provide for various adjustments to be made to take account of a number of factors. Once those adjustments have been made, it is for the directors of the company to decide the amount of any dividend to be paid to shareholders.

Directors make such decisions:

- in the light of the company's 'realised profits' as defined by section 853(4), Companies Act 2006. The method of calculating profits regarded as realised 'in accordance with principles generally accepted at the time when the accounts are prepared' is set out in 'Guidance on the Determination of Realised Profits and Losses in the context of Distributions under the Companies Act 2010\textsuperscript{15}; and

- having regard to their fiduciary duty to act in the best interests of the company.

In summary, whilst the accounting framework determines the calculation of the profits shown in the financial statements, the decision as to the amount of any distributable profits to be paid to shareholders by way of dividend is determined by reference to the company's realised profits (as defined in accordance with section 853(4), Companies Act 2006).

\textsuperscript{13} International Accounting Standards 'A Consultation Document on the possible extension of the European Regulation on International Accounting Standards', DTI, dated 30 August 2002.

\textsuperscript{14} SI 2004 No 2947 The Companies Act 1985 (International Accounting Standards and Other Accounting Amendments) Regulations 2004


This guidance is issued following public exposure and independent legal review.
Supplementary memorandum by the Financial Reporting Council

The FRC shares BIS’ view that, for these reasons, changes are not required to either IFRS or to the Companies Act 2006 in order to reduce any possibility of illegality.

The FRC has urged the IASB to learn lessons from the financial crisis and a number of changes have been made as a result, for example to standards on the accounting for financial instruments. Other standards that have been reviewed, and where the FRC has been active in influencing proposals, include insurance accounting and leasing.

I understand that the Committee has invited Roger Marshall, interim chairman of the ASB, to give evidence to the inquiry on 18 January on the effect of changes to accounting standards and he would be delighted to expound further on these points.

5. Increasing choice in the audit market

In our oral evidence to the Committee on 9 November we set out several specific proposals to expand choice in the audit market which we feel it would be helpful to expand upon.

Audit Commission

We believe that the abolition of the Audit Commission provides an opportunity for one or more non-Big Four firms to expand into that market and grow significantly. This could be the catalyst to encourage a fifth big player in the audit market. If the existing Audit Commission was kept together as a standalone entity, it would be the fifth largest audit firm in the UK. A strategic alliance with another mid-tier firm would enable it to access the corporate market as well as the public sector.

Our objective in making a recommendation in this area is to ensure that the audit market does not become concentrated still further as a result of the Government’s decision to abolish the Audit Commission. We recognise the practical difficulties that may need to be overcome to ensure the UK complies with European law relating to the procurement of public contracts but believe the prize of greater competition in the market makes this proposal worthy of further consideration.

Banking covenants

The FRC echoes concerns that have been raised by auditors from mid-tier accountancy firms that restrictive bank covenants could contribute to audit market concentration and restrict choice. We recognise that in essence the issue is a commercial one although we believe there is sufficient anecdotal evidence to require a further investigation in to this issue.

The Lending Standards Board (which replaced the Banking Code Standards Board) is currently consulting on the Lending Code. However, the Code applies only to private individuals and micro-entities and so is not an appropriate vehicle for addressing the bank covenant issue. In the absence of a similar Code for larger entities, we would urge a greater level of dialogue between the British Bankers’ Association, lending institutions, audit firms and regulators to address the issue as soon as possible.

Risk committees

The FRC would encourage banks and other systemic institutions to use non-Big Four firms as a source of advice to their risk committees. This would give such firms an exposure to
large companies they might not otherwise have access to and may in time provide them with the opportunity to tender for the audits of some of these entities.

Ownership rules

The FRC believes that serious consideration should be given to amending the current rules on audit firm ownership which would allow audit firms to access external capital.

In principle we believe that it should be possible to change the current rules governing the ownership of audit firms without risking audit quality. Alternative ownership structures, including the possibility of raising capital from external sources, have the potential to make it easier for firms to invest to allow them to expand into the market for the audits of the largest companies. Research carried out by Oxera has indicated that the cost of capital in a partnership was considerably higher than in an ownership model which allowed for external investment.

6. Going concern

The FRC meets with market participants regularly to discuss their concerns and identify issues that need to be addressed. This engagement intensified following the collapse of Lehman Brothers in September 2008. During 2008 the FRC held two meetings with market participants, and a further two meetings were held in 2009. Typically, these meetings involved: companies, corporate treasurers, auditors, investors and business organisations. These formal meetings are held in addition to ad hoc meetings held throughout the year.

The FRC issued guidance to the market in 2008 in response to concerns in the market that auditors would find it difficult to sign off the accounts of a large number of companies as going concerns because of the state of the credit markets.

7. Early warning signals

In our oral evidence we suggested that the audit process should be capable of providing an early warning signal to the market – something that was not delivered in either 2006/07 or 2007/08. We believe that the market is capable of providing more signals and the creation of a Market Participants’ Group comprising regulators, auditors, finance directors and investors would enable warnings to be identified and discussed by the market. These issues could be addressed through market information, guidance or regulatory action. The FRC would be well placed to convene such a group and we would welcome the Committee’s support for such a proposal.

8. Scepticism

The FRC believes that company boards have a responsibility to encourage a culture of professional scepticism by auditors. The Committee requested further details on the work the FRC has undertaken to encourage auditors to demonstrate appropriate professional scepticism. We attach as an Appendix a discussion paper which we published in August 2010, along with another paper published jointly with the FSA and which deals with the financial sector specifically. We are currently analysing the responses to these consultations and will announce the outcomes in 2011.

The Audit Inspection Unit’s 2010 annual report also called on auditors to exercise greater professional scepticism particularly when reviewing management’s judgements relating to
fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.

We hope this supplementary submission is helpful to the Committee. As we say in our written evidence, we stand ready to play our part in implementing policies that will both enhance competition and quality in the audit market. We look forward to the Committee’s analysis and recommendations.

22 December 2010

**Supplementary memorandum by the Financial Services Authority**

1. This memorandum is submitted by the FSA as a follow-up to the oral evidence given by Sally Dewar, Managing Director of Risk, and Richard Thorpe, Head of Accounting and Audit, on 9 November.

2. The memorandum provides further information in response to two questions that the Committee asked on:
   a) the frequency of auditor-supervisor meetings in the period 2006-2008; and
   b) when and why the practice of auditor-supervisor meetings fell away.

3. As the FSA has acknowledged on a number of occasions over the last two and a half years (including in our evidence to this Committee), in the run-up to the financial crisis the regulatory framework in the UK and globally and our supervision of major firms were inadequate in important respects. This was also true of our engagement with the auditors of individual large firms and with the audit profession as a whole.

4. In April 2008, in response to the shortcomings we had identified in our report on our supervision of Northern Rock, we launched our Supervisory Enhancement Programme. As a result, we have overhauled both our supervisory philosophy and our capability to deliver it. The FSA is now a radically different organisation from that which existed prior to the summer of 2007. We have invested substantially in creating the capacity and capability needed to deliver this new intensive approach. For example, since April 2008 we have added 537 staff to our supervisory and specialist support areas, including accounting and auditing specialists. We have increased our engagement with auditors and investors to emphasise their role in the oversight of firms, and we now meet at least annually with the external auditors of high impact firms, and have regular high level meetings with the firms on key thematic issues.

A. Frequency of FSA meetings with external auditors of individual firms

5. The Committee asked how frequently we met with the external auditors of Northern Rock, Halifax Bank of Scotland (HBOS), Royal Bank of Scotland (RBS), and Bradford & Bingley, in the years 2006, 2007, and 2008. We had the following contacts:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Auditor</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Rock</td>
<td>PWC</td>
<td>-</td>
<td>1 meeting and 1 phone call.</td>
<td>2 meetings and 4 phone calls.</td>
</tr>
<tr>
<td>HBOS</td>
<td>KPMG</td>
<td>1 phone call.</td>
<td>1 meeting.</td>
<td>2 meetings.</td>
</tr>
<tr>
<td>RBS</td>
<td>Deloittes</td>
<td>1 meeting.</td>
<td>I meeting.</td>
<td>-</td>
</tr>
<tr>
<td>Bradford &amp; Bingley</td>
<td>KPMG</td>
<td>-</td>
<td>1 meeting.</td>
<td>1 meeting.</td>
</tr>
</tbody>
</table>
6. In line with our improved arrangements outlined in paragraph 4 above, in 2009 and 2010, we have met these banks’ auditors with the following frequency:

<table>
<thead>
<tr>
<th>Bank</th>
<th>Auditor</th>
<th>2009</th>
<th>2010 to date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northern Rock</td>
<td>PWC</td>
<td>3 meetings and 1 phone call.</td>
<td>1 meeting.</td>
</tr>
<tr>
<td>Lloyds Banking Group (which includes HBOS)</td>
<td>PWC</td>
<td>2 meetings.</td>
<td>3 meetings.</td>
</tr>
<tr>
<td>RBS</td>
<td>Deloittes</td>
<td>1 meeting.</td>
<td>2 meetings.</td>
</tr>
<tr>
<td>Bradford &amp; Bingley</td>
<td>KPMG</td>
<td>3 meetings.</td>
<td>1 meeting.</td>
</tr>
</tbody>
</table>

B. When the regular practice of auditor-supervisor meetings fell away

7. The regular practice of auditor-supervisor meetings fell away gradually following the transition from the Bank of England to the FSA as banking supervisor.

8. Until 1998, banks were supervised by the Bank of England and auditor-supervisor interactions were governed by the Banking Act 1987. One element of the Bank’s supervisory model was to rely on the work of external auditors to a greater extent than has been the case under our model. For example, the Bank commissioned auditors to undertake additional work to examine a firm’s systems and controls, or to address thematic concerns. The Bank then held bilateral meetings with the auditor or trilateral meetings with both the auditor and the bank to discuss the results of this work.

9. In June 1998, the Banking Act 1998 transferred banking supervision from the Bank of England to the FSA. The Financial Services and Markets Act 2000 (FSMA) superseded the Banking Act as our legislative framework for banking supervision from 1 December 2001. FSMA established a wider, more comprehensive ‘regulatory toolbox’ for our responsibilities, including our supervisory responsibilities over banks. Section 165 of FSMA gives us the power to require information from firms. Section 166 allows us to require firms to commission reports by skilled persons (including, but not limited to, auditors) on areas of concern.

10. With the transition to a new regulatory framework in 2001, we also adopted a different supervisory approach. For example, we established supervisory specialists in-house, supported by further in-house specialists in policy, risk and sector-specific areas. This in-house expertise was designed to reduce the need for regular reporting by auditors on supervisory matters relating to individual firms. One consequence was that, over time, meetings between supervisors and auditors also became less frequent. There were still cases where FSA supervisors continued to meet with the auditors at least once a year, but this happened on a less structured basis. In line with our supervisory philosophy of that time, we made less use of third parties (i.e. use of section 166 reports) and placed more reliance on what firms told us. As noted above, we now recognise that this approach was wrong.

11. Following the crisis, we have committed to making greater use of our powers under section 166. We now form our own judgements on firms’ judgements. The table below shows our increasing use of section 166 powers, and we expect this trend to continue in the coming year.

<table>
<thead>
<tr>
<th>Number of s166 reports commissioned</th>
<th>2006/7</th>
<th>2007/8</th>
<th>2008/9</th>
<th>2009/10 to date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total</td>
<td>18</td>
<td>30</td>
<td>56</td>
<td>88</td>
</tr>
<tr>
<td>Banks or firms within banking groups</td>
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12. We have used our section 166 powers to commission reports from a variety of skilled persons, in addition to the 'big four' accounting and audit firms, ranging from mid-tier accounting firms to compliance consultants and lawyers. The reports examine regulatory concerns, such as review of past business and quality of advice, adequacy of systems and controls, corporate governance, capital requirements, and treating customers fairly.

13. Our specialist Accounting and Auditing Sector Team, established in 2005, co-ordinates our work with the national and international bodies that represent the profession and strengthens our relationship with the major auditing firms. This cross-sector and cross-firm engagement with auditors has also intensified in response to the crisis. It now includes high-level bilateral meetings with audit firm partners, technical bilateral meetings with audit firm directors and roundtable meetings with the largest firms to discuss key financial reporting and audit issues across sectors on a regular basis. In addition, last year we established an Accounting Review Team. This group of experienced accountants undertakes detailed analysis of the published accounts and the reports from auditors to management for high impact firms. Their primary role is to support supervisors on accounting and audit-related matters.

14. We are strongly committed to engaging more effectively with external auditors, in particular in our supervision of high-impact firms. We would expect this approach to continue under the proposed Prudential Regulation Authority (PRA). We are working closely with the Bank of England to plan this and other aspects of the PRA’s supervisory philosophy and practice.

14 December 2010

Supplementary memorandum by Mr Steve Maslin, Grant Thornton

Having viewed a number of the oral sessions and read some of the written submissions to the Committee, I am moved to write to you to reinforce two points I made at the oral session, as I am very concerned that the Committee could be misled by aspects of the evidence supplied by some other parties. If protocols permit, I should be grateful if you would bring this note to the attention of the Committee and I would be happy for its contents to be put on the public record. As ever, I would happily take your advice on how best to deal with this matter.

The first point concerns audit quality, a matter my firm views as a priority. I expressed the view at the hearing that the FRC had missed an opportunity in publishing the results of the 2009 findings of the AIU on the large audit firms to make a positive comment on the audit quality of some firms outside the four largest. While I am not complacent about Grant Thornton’s ability to deliver high quality audits on a consistent basis, and acknowledged that the firm would be likely at some future point to have audits that the AIU believe were less than satisfactory, those 2009 AIU findings highlighted that while each of the four largest firms had audits graded “requires significant improvement” neither Grant Thornton nor BDO had any such negative findings in the audits examined by the AIU. (I have provided a summary of the 2009 AIU findings in the attached memorandum.) Not only did the FRC miss this opportunity to correct some false perceptions about relative audit quality at firms such as Grant Thornton and BDO, in publishing the 2010 AIU audit findings it allowed some commentators to perpetrate further the myth that the four largest firms have a monopoly on audit quality (for example in response to the 2010 report of AIU findings the Times ran a piece on 21 July which stated "Regulators have been concerned for years that the audits of big companies are concentrated among a handful of top accountants — but if the smaller firms are not up to the job, what choice do those companies have?” despite the fact that the AIU report did not contain criticisms of Grant Thornton or BDO). While in its own written submission to the Committee the FRC does seek to redress this balance, I continue to believe it could do much more when publicising the AIU findings to make a positive comment (where merited) about respective levels of audit quality.

I am keen to reinforce this point now, i.e. that the evidence of the AIU findings is that firms such as Grant Thornton and BDO are capable of providing high quality audits at least as well as the four
largest firms (and arguably on a more consistent basis), as I see that one of the largest audit firms in its written evidence has sought to make a link between size of audit firm and levels of audit quality. I believe that it would easily be possible for a reader of that submission to draw the false conclusion that the AIU's findings support the audit quality of the four largest firms over firms such as Grant Thornton and BDO. While in its 2010 report the FRC did criticise the audit work of some small firms, this criticism was clearly directed at certain firms very much smaller than the four largest and indeed much smaller than Grant Thornton or BDO.

The second point concerns the levels of investment required, inter alia in global "audit approaches", for firms such as Grant Thornton to provide high quality audits to large corporates which operate on a global scale. I expressed the view at the hearing that Grant Thornton already has the capability to deliver high quality audits to possibly all of the FTSE 250 and indeed much of the FTSE 100 and that we have the cash resources already in place to acquire the people necessary to audit at least 20% of the FTSE 250 without diluting partner capital.

I am keen to reinforce this point now, as I see that one of the CEOs of the four largest firms is reported to have told the Committee that his UK firm had spent approximately £40m to roll out the firm's revised audit approach project in response to the changing needs of its clients and that the "overhaul" cost the network globally around $400m. However, Grant Thornton (both in the UK and throughout all of the Grant Thornton International member firms which operate in approximately 100 countries) has already invested in and successfully rolled out its own modern audit approach which is enables us to meet the industry international quality kite mark (ISQC 1) and all modern audit standards and regulations. Moreover, the results of the AIU inspections, coupled with the various audit awards Grant Thornton received in 2009 (which include:

- the CBI/Real Director Auditor of the Year (Large 6) Award (voted by the FDs if 1,000 of the UK’s largest entities);
- the Aim Auditor of the Year Award; and
- the Accountancy Age Global Audit Firm of the Year Award

suggest to me that we have successfully implemented this modern audit approach in a way which enables Grant Thornton to continue to provide high quality audits in a way which meets the needs of its large corporate audit clients.

I am sorry to introduce a further piece of written evidence, as I am sure that the Committee is already faced with a large amount of material. However, Simon Michaels of BDO and I have both referred to the danger in the audit competition and choice debate of false perceptions being allowed to circulate and I am very keen to reinforce Grant Thornton's record of and commitment to delivering high quality audits to large corporates on a consistent basis (without in any way being complacent about that record) and its commitment and capability to invest in securing a significantly higher proportion of FTSE 250 audits (and over time FTSE 100 audits) and indeed similar investments on an international basis.

That increase in market penetration can only come about with a change in the buying patterns of these companies. We believe that regulatory action is necessary to provide a stimulus to change those buying patterns and we believe that the package of proposals we submitted to the Committee are a practical start point.

December 2010

Supplementary memorandum by Mr Paul Lee, Hermes

A comment on International Standards for Auditing (ISAs)

As I was the sole investor representative member of the Auditing Practices Board (APB) over the period when we took the bulk of the decisions on adopting ISAs in the UK, I thought it might be
helpful to the committee to make a brief comment on ISAs, given that I am aware that they have received some criticism in some evidence to the committee.

The committee's adviser, Andrew Chambers, was also a member of the APB throughout this period and as I recall supported adoption. I am sure he will have some reflections on this note.

Auditing standards in the UK long predate the ISAs. They were first created in 1980 and have been bolstered, both in terms of substance and in the framework surrounding them, over the years since (notably in 1991 when the APB as is was created, following Maxwell, Polly Peck and BCCI; and in 2003/4 after Enron, Worldcom and Parmalat).

So we have had standards which establish processes to be followed in auditing for some considerable period of time in the UK. This is not something which has changed through the adoption of ISAs – indeed UK auditing standards provided the backbone for the original ISAs. If process is the crime, ISAs are not the criminal.

Adopting ISAs brings positives

I have my own concerns about ISAs – not least the annoying tendency to attempt in standards on auditing to try to impose obligations on the management and boards of audited companies, and the markedly poor audit report standard – there is much of substance which is good. Notably, ISAs are marked improvements on prior UK standards in such areas as group audits and related parties, both vital issues.

UK endorsement of ISAs supports international acceptance of them, which should raise auditing standards in other markets, vital given the highly international nature of UK companies. The EU has declared its intention of adopting ISAs and UK endorsement gives us a stronger basis for helping the EU adopt in the most appropriate way.

The source of ISAs

ISAs are produced by the IAASB, one arm of IFAC, the audit firms' global representative body. While the apparent independence of the IAASB has improved of late, with the insertion of a monitoring board, Hermes has repeatedly called for a more structural change such that the IAASB is no longer part of an auditor-led organisation. We believe this is needed in order to address the biggest failings in ISAs, which all appear to be aimed at liability limitation for the firms (certainly that seems to be the thinking behind the two particular problems noted above).

Levels of detail

Through the process of agreeing to adopt ISAs, I read each of them in considerable depth. They are certainly not principle-based standards, they are rule-based standards. But importantly, they do not exclude the exercise of professional judgement. The rules set out minimum expected procedures but they leave a great deal of space for firms to go further and certainly do not remove their responsibility to fulfil the obligations of the profession to exercise thought and judgement.

It is a failing of the profession to the extent that they fall into the trap of following a set of procedures blindly and do not ensure that the necessary time and space is kept available for exercises of judgement, not a failing of the ISAs themselves.

13 January 2011
Supplementary memorandum by Mr Jonathan Hayward, Independent Audit Limited

Following the Committee session at which I gave evidence, I would like to make one point regarding financial statements insurance.

While this is at first sight an interesting and potentially attractive idea, I am not convinced that it would work in this country. What follows is expressed somewhat tentatively, since I am not a lawyer, but if the Committee were to consider pursuing the idea of financial statements insurance then I would suggest that you first obtain proper legal advice on this point.

The idea of financial statements originates from the USA where the system of law and regulation is directed and maintaining an orderly secondary market. The purpose of financial statements in that jurisdiction is primarily to enable secondary market transactions to take place at well-informed prices, which facilitates litigation against companies whose accounts are misstated since litigants need only show that they suffered loss through dealing at a price which was based on incorrect information. In this country, the legal framework for corporate reporting is based on the idea of accountability to shareholders, and as a general rule legal action by shareholders against directors and auditors arises when the company itself has suffered loss.

Claims against companies in the UK because unsatisfactory information has affected dealing prices in the secondary market are extremely rare. I understand, however, that it is such claims that underpin the idea of financial statements insurance. So if financial statements insurance were to be introduced into this country, making it effective would necessitate a change in the legal framework to enable investors to bring claims much more easily against companies whose accounts were misstated.

This would be a significant change which would be viewed by many as a severely retrograde step.

29 October 2010

Supplementary memorandum by The Institute of Chartered Accountant in England and Wales

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

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

The proposal and its practical application

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

My proposal is that audit regulators should include the issue of choice in their regulatory principles. Where relevant, they would consider choice in each aspect of their work such as framing new or revised regulations and standards, or reporting on monitoring and enforcement activities.
In so far as practical application is concerned, I suggest that at the outset of a piece of work the regulator would formally determine whether the output might affect the availability of choice in the audit market because of its impact on potential providers and purchasers of audit services. If it might do so, then the regulator’s internal processes would require the regulator to confirm that in deciding on a course of action it had given full consideration to the impact on choice in the audit market. There would also be reference to choice in the impact assessments that accompany the regulator’s output.

One benefit of this suggestion is that future inquiries into choice in the audit market would be better informed about practical experience of trade-offs between choice and other public interest issues, including audit quality.

It may help the Committee if I provide a little background to this proposal.

**Background information**

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

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

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

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

However, in addition to these specific initiatives to help widen choice, the FRC and its subsidiary boards undertake many on-going, broader activities such as framing new or revised financial reporting, auditing and ethical standards and reporting on monitoring and enforcement activities. In my opinion, the outputs of these broader activities are very likely to influence the perceptions of, and the choices made by, audit committees and shareholders as well as audit firms. My proposal seeks to address this matter. Audit regulators need to consider the consequences of all their relevant actions on perceptions of key participants in the audit market.

Currently the words ‘choice’, ‘concentration’ and ‘competition’ do not feature in the FRC’s document *Regulatory Strategy: Our Role and Approach* (Version 4) dated April 2009. By way of contrast, the Financial Services Authority (FSA), in pursing its functions under the Financial Services and Markets Act, is required to have regard to additional matters that it refers to as ‘principles of good regulation’.
Further supplementary from Vernon Soare, Executive Director, Professional Standards, The Institute of Chartered Accountants in England and Wales

There is a competition principle which states 'The need to minimise the adverse effects on competition that may arise from our activities and the desirability of facilitating competition between the firms we regulate.' The FSA states that one of the aims of its principles is to avoid unnecessary regulatory barriers to market entry or business expansion. It goes on to note that competition and innovation considerations play a key role in its cost-benefit analysis.

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

Follow-up actions to ICAEW report on the audit of banks

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

- have established the Financial Services Faculty Auditor-Investor Forum to highlight and discuss key risks across the financial services sector. The Forum will meet for the first time on 22 November 2010 with the aim of promoting wider understanding of the key areas of focus of auditors of financial institutions in the upcoming reporting season and potential difficult issues in preparing annual reports, including any systemic risk concerns. This should promote greater confidence that auditors will be considering and addressing these issues;
- have established a working party to develop good practice guidance for communication between auditors and audit committees in financial institutions. The objective of this initiative is to provide better information to audit committees and to encourage better disclosure by audit committees about their dialogue with auditors. We aim to publish draft guidance before the end of 2010 and final guidance after the next reporting season; and
- have assisted the Bank of England and the FSA in establishing a working group to examine and revise protocols for dialogue between auditors and supervisors. This will look at both the information that auditors should share with supervisors and the information that supervisors should share with auditors.

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

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

28 October 2010

Further supplementary from Vernon Soare, Executive Director, Professional Standards, The Institute of Chartered Accountants in England and Wales

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

Background
Further supplementary from Vernon Soare, Executive Director, Professional Standards, The Institute of Chartered Accountants in England and Wales

As the Committee may be aware the current arrangements for audit supervision in the UK arose out of a 2002/03 Government Review commissioned by the then Secretary of State for Trade and Industry (Review of the Regulatory Regime of the Accountancy Profession). This Review concluded that the arrangements established under the Companies Act 1989 were fundamentally sound but that the system could be strengthened.

This led to the introduction of a revised supervisory framework (now part of the Companies Act 2006) whereby Recognised Supervisory Bodies (RSBs) such as ICAEW are subject to the oversight of the Professional Oversight Board (POB) and are also required to participate in independent arrangements for the monitoring of public interest audits and the investigation, for disciplinary purposes, of public interest cases. The latter arrangements are operated with ICAEW’s agreement via the Accountancy and Actuarial Discipline Board (AADB), the former via the Audit Inspection Unit (AIU), who along with POB are part of the FRC.

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

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

9 November evidence session

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

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

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

As we have stressed to the Committee in our previous submissions, it is important that recommendations on the future of audit regulation are evidence based. The AIU and POB are made aware of the ARC’s decisions that are based on AIU reports and they have never commented adversely on the decisions or the process used to reach them.
As far as the ICAEW is concerned, nothing presented by the FRC to date suggests that the Companies Act 2006 provisions are not working effectively. However, we recognise that the continuing success of the regime depends on clear lines of reporting between the AIU and the ARC.

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

During their evidence session the FRC also commented that it needed a wider range of sanctions against RSBs. Again we would advocate an evidence based approach here. The POB undertakes annual reviews of each RSB. Inevitably matters are discussed and recommendations made. As far as we are aware, all matters raised have been resolved to the satisfaction of the POB as evidenced by successive annual reports by the POB to the Secretary of State.

As the Committee is aware the European Commission is currently consulting on a number of these issues at a pan-European level including the possibility of an EU-wide audit licence, which would have a major impact on current licensing arrangements for audit firms carrying out audits of public interest entities. This has been a global crisis and reform proposals must be capable of implementation across international markets.

I would be happy to brief you further on any or all of these matters.

23 November 2010

Memorandum by Professor Brenda Porter

First I will establish my credentials — I am a retired Professor of Accounting of many years standing. Since my retirement in February 2009 (from Victoria University of Wellington, New Zealand) I have been a Visiting Professor of Accounting at Exeter University (UK) during the Spring semester and at Chulalongkorn University, Bangkok, during the Autumn semester. Prior to returning to NZ in 2003, I taught at Cranfield Warwick Universities in the UK for five and two years, respectively. I am also the primary author of the most widely selling auditing textbook in UK Universities *Principles of External Auditing* by B. Porter, J. Simon and D. Hatherly, published by John Wiley and Sons, UK). However, I am probably best known for my research into the audit expectation-performance gap in NZ and the UK which has spanned two decades. Between 2006 and 2009 I conducted research in the UK and NZ for the American Institute of Certified Public Accountants (AICPA) and the International Auditing and Assurance Standards Board (IAASB) investigating the audit expectation-performance gap and the usefulness of the standard audit report. The research report was submitted to the AICPA and IAASB in September 2009.

I have been following your enquiry into various aspects of external auditing with considerable interest. However, I am concerned that, as with previous enquiries in many countries over the past 40 years, no attention appears to being given to two inherent and fundamental flaws in the current model. These are as follows:

1. **Private vs public interest:** External (or independent) auditing is a profession which professes, and is expected, to work in the public interest. Indeed, the expectation that the profession will work in
the public interest is underscored by the fact that the Companies Act 2006 is silent on who may prepare company financial statements (no qualification requirements are specified) but, unless the audit exemption applies, those financial statements are required to be audited by a registered auditor whose necessary qualifications are carefully defined. This places auditors in the role of the public’s (or, more especially, financial statement users’) ‘safety net’ — to assure financial statement users that the information in the financial statements can be relied upon or to warn them that it is not reliable. Further, with the development of corporate governance requirements, auditors have increasingly been cast into the role, at least to an extent, of ‘society’s corporate watchdogs’. However, auditors’ responsibility to work in the public interest is in conflict with their existence as, or members of, private profit-oriented businesses. In such a situation, their private profit motive will inevitably override their responsibility to work in the public interest.

2. The auditor appointment process: Although under the provisions of the Companies Act 2006 shareholders are responsible for appointing their company’s auditor and fixing the associated fees, this responsibility is invariably delegated to the company’s directors. This places the directors in a powerful position vis-à-vis the auditors (especially auditors concerned about their firm’s profits) as, if the auditors do not ‘toe the line’ they can be readily ‘fired’. Audit committees (especially if composed entirely of independent non-executive directors) have been regarded as a solution to this problem; they have been made responsible (at least in listed companies) for recommending to the directors an auditor for appointment and/or a change of auditor16 and for, inter alia, overseeing the external audit process. However, this overlooks the fact that, under the Companies Act 2006, audit committee members, like all directors, have a fiduciary responsibility to the company per se. Thus, if a situation should arise whereby the auditors wish — for example — to qualify the audit report, and the audit committee (or the board) considers that if they do so it would harm the company or its prospects in some way, they are under an obligation to act in the interests of the company rather than the shareholders to other financial statement users. All the time companies (irrespective of the extent to which audit committees are involved) are in the position to hire, fire and fix the fees of the auditors, they are in a position to pressure the (profit-oriented) auditors to do as they wish. One possible solution to this difficulty is to have the Auditor General, the Financial Reporting Council or some other independent body appoint one or more non-director members to companies’ (in particular, listed companies’) audit committees. Clearly this would alter the legal status of audit committees as they would no longer be composed entirely of the companies’ directors.

Until these two inherent conflicts within the present audit model are tackled, I do not believe that other attempts to strengthen external audits (by broadening the audit market, introducing audit firm rotation, or pressuring auditors to increase their scepticism, or other means) will have the effect of improving the quality of external audits that is sought. According to the findings of the research I conducted for the AICPA and IAASB between 2006 and 2008, the quality control standards (International Standards on Quality Control 1 and international Standards on Auditing 220), combined with the monitoring of auditors’ performance by the Recognised Supervisory Bodies and Audit Inspection Unit, have had a significant beneficial effect on the standard of auditors’ performance. However, the inherent, fundamental conflicts within the present audit model need to be addressed and resolved before we have truly independent auditors conducting high quality audits in the public interest.

Incidentally, although no practising audit partner would agree, in my view, questions of auditors’ legal liability are ‘red herrings’ in the current situation. Quite apart from the fact that, in this day and age of ready access to abundant information on the Internet, plaintiffs find it extremely difficult to prove that their loss resulted from the auditor’s negligence, auditors are in a position to avoid possible exposure to liability. If they devoted as much effort to ensuring that they conduct audits of the highest quality in the public interest as they do to trying to limit their liability, then questions of their exposure to liability should not arise.

16 A recommendation the directors must put to the company’s shareholders or explain why they are proposing an alternative auditor.
Supplementary letter from Mr Ian Powell, PricewaterhouseCoopers

I am now responding to the requests for additional information that were set out in your letter of 1 December. These are addressed in the appendix to this letter.

In response to question 271, relating to the audit of the Bank of Ireland, I would like to advise you that the Irish member firm of the PricewaterhouseCoopers (PwC) network has been the sole auditor of the Bank of Ireland group since 1990. PwC is structured as a network of separate member firms, owned and operating locally in a number of countries around the world. As a result, I am not able to provide you with further information about this audit.

If the Committee would like to discuss any of these issues in more detail with my firm’s banking or accounting experts, I would be happy to make the necessary arrangements to assist.

4 January 2011

Appendix 1

Q 283 – Going concern judgements

1.1 As requested, we address below how going concern judgements were reached as part of audits of banks before and during the financial crisis of 2007-09, including the following specific issues:
   a) In the case of Northern Rock, the basis of the unqualified going concern judgement reached for financial statements for the year ending December 2006, before Northern Rock collapsed in 2007.
   b) How auditors reached unqualified going concern judgements on banks for the year ending December 2007.
   c) The basis for going concern judgements on banks’ financial statements in December 2008.

We respond to each of these issues individually in paragraphs 1.4 to 1.13 below.

1.2 The primary significance of the going concern disclosure is in relation to the basis on which the financial statements have been prepared. The requirement for management to assess, and auditors to review, going concern is within the context of selecting an appropriate accounting basis for items within the accounts. The auditor is only required to conclude whether there is any material uncertainty that may cast significant doubt on the company’s ability to continue as a going concern and to report only if any such material uncertainty is identified. The crisis has shown that neither the purpose of these disclosures nor the auditor’s reporting duty is well understood and, arguably, that neither meet the common expectations of readers of financial statements.
1.3 At Annex A\(^{17}\), we attach a copy of our written submission dated January 2009 to the House of Commons Treasury Select Committee inquiry on the Banking Crisis (Session 2008-09) which sets out, inter alia, a summary of the requirements relating to the audit of going concern, including the additional considerations that are relevant in a banking environment. In particular, these involve a consideration of sources of liquidity and the adequacy of an institution’s capital, but are not a guarantee of future solvency. Our comments below should be read in the context of that submission. Auditing standards are explicit that a review of going concern is not undertaken to provide shareholders with any guarantee that a company will continue to survive.

**Note:** Not published here.

(a) **Northern Rock – financial statements for the year ended December 2006**

1.4 At Annex B\(^{18}\), we attach the follow-up written memorandum dated January 2008 to the House of Commons Treasury Select Committee inquiry on Northern Rock “The Run on the Rock” (Session 2007-08) with respect to the audit of Northern Rock. This identifies the considerations and actions that were taken in respect of the financial year ending 31 December 2006 including the work we carried out in respect of management’s assessment of the bank’s going concern status prior to signing the 2006 financial statements in January 2007.

1.5 As indicated in that evidence, at the time of the conclusion of our audit in January 2007, Northern Rock had a history of profitable operations and had a track record of ready access to funds at low spreads over LIBOR from a wide range of sources, indicating willingness by lending institutions and investors to provide finance. In addition to these positive trading and financial characteristics, we looked at the post year end trading results, the most recent reports to the bank’s asset and liability committee and studied the bank’s operating plans. We also studied external information about forecasts for the UK domestic mortgage markets. None of the information available to us indicated anything that would constitute a “material uncertainty” that “may cast significant doubt” that Northern Rock may not be a going concern and consequently, in accordance with auditing standards\(^{19}\) we concluded that in our opinion there were no matters relating to the going concern basis of accounting that were required to be reported to shareholders.

**Note:** Not published here.

(b) **Audit opinions on financial years ending 31 December 2007**

1.6 Whilst Northern Rock was unable to obtain refinancing in August 2007 it is notable that other banks were all still funding themselves in the short term wholesale markets at the end of 2007 and market conditions were still showing signs of easing when the banks announced their results in February 2008. Auditors, therefore, had no reason to believe that a going concern qualification was appropriate with respect to the financial reports for the financial years ending 31 December 2007.

1.7 In terms of capital requirements the banks PwC audited were still profitable in early 2008 and had levels of capital well above regulatory minimum requirements. The outlook for 2008, both in terms of the banks’ internal profit forecasts and external economic forecasts, did not appear to pose any threats to capital adequacy based on the conditions prevailing in January and February 2008.

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\(^{17}\) Not published here.

\(^{18}\) Not published here.

\(^{19}\) ISA 570 para 7
1.8 In the context of the financial statements for the year ending 31 December 2008, two factors were again particularly relevant for management’s assessment of going concern status and the auditor’s review of that assessment: liquidity and capital adequacy.

1.9 On liquidity many of the banks were, post the Lehman Brothers collapse in September 2008, dependent on the Government and the Bank of England for liquidity support, given the freezing of the wholesale markets.

1.10 There were two principal schemes that were relevant in our assessment of the going concern status of banks: the Bank of England Special Liquidity Scheme and the Government’s Credit Guarantee Scheme.

(a) The Bank of England Special Liquidity Scheme

Under this scheme, first published on 21 April 2008, banks could borrow from the Bank of England against various types of securities lodged as collateral. On 8 October, the government announced that the scheme would be extended and widened as part of the UK support package for banks. Full details of this scheme, including the level of support available, were published in final form on the Bank of England website by the time the relevant audit opinions were published in February/March 2009.

(b) Credit Guarantee Scheme

The second scheme allowed the banks to issue medium term debt securities guaranteed by the UK government. Full details including the aggregate limit across the industry had been announced by HM Treasury on 13 October 2008 as part of the UK support package.

1.11 During this time, this firm’s banking audit partners were having tripartite meetings with the Bank of England and clients to understand how the schemes would operate and what sums were available.

1.12 All the banks which we audited had been advised of their allocation under the Government guaranteed medium term debt scheme by the time the opinions for the financial years ending 31 December 2008 were issued.

1.13 In order to support our audit opinions, we reviewed our individual clients’ forecast requirements, and the various stress tests which they carried out and ensured that their funding needs were matched by the available finance for which we had external evidence.

Q288 – Impact on bank audits of IFRS accounting standards

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2.1 As requested, we address below the impact on bank audits of IFRS accounting standards in the two main areas addressed by Mr Timothy Bush in his written and oral evidence to the Committee: the classification and measurement of financial instruments and the impairment of loans. References to UK GAAP relate to the standards that were applicable for UK banks prior to the implementation of IFRS for listed companies in 2005. As a general rule, UK listed banks also adopted IFRS for the individual accounts of their subsidiaries at the same time, which was permitted, although not required, under the Companies Act.

**Classification and measurement of financial instruments**

**UK GAAP**

2.2 Under UK GAAP only limited guidance was provided on the accounting treatment of derivatives or other financial assets and liabilities. To address this deficiency for banks, the British Bankers’ Association issued a series of Statements of Recommended Practice (BBA SORPs) which were initially best practice but which were made mandatory for banks for accounting periods ending on or after 22 June 2001.

2.3 Under the Companies Act 1985 banks were allowed to fair value financial instruments. The BBA SORPs recommended that assets carried in a bank’s long term (banking) book should be accounted for at amortised cost (including derivatives hedging positions in the banking books) and that assets carried in a bank’s trading book should be carried at fair value. Transfers between books were permitted. There was no guidance on how to determine the fair value of financial instruments.

**IFRS**

2.4 The relevant international accounting standard addressing the classification and measurement of financial instruments is IAS 39 “Financial instruments: Recognition and Measurement”. This requires financial assets to be classified into four categories which drive their subsequent measurement. The four categories are:

- Financial assets at fair value through profit and loss (essentially all derivatives, all assets held for trading and other financial assets that the company has elected to carry at fair value)
- Loans and receivables
- Held to maturity investments
- Available for sale financial assets

2.5 Loans and receivables and held to maturity investments are carried at amortised cost. All other financial assets are carried at fair value, with fair value movements taken to the income statement for financial assets at fair value through profit and loss and through other comprehensive income for available for sale financial assets.

**Impact on bank audits**

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22 FRS 18 “Accounting Policies” published by the Accounting Standards Board in December 2000
23 Schedule 9
2.6 The main relevant impact of the change from UK GAAP to IFRS in the context of the classification and measurement of financial instruments was in relation to investments carried for long term purposes in the banking book. In order to meet the criteria for classification as held for maturity investments and thus to be carried at amortised cost, banks needed to demonstrate a positive intention and ability to hold investments in corporate or government debt to maturity. Since many of these investments were held in liquidity portfolios, it was not possible to demonstrate such a positive intention and ability and, consequently, significant portfolios of such assets were reclassified as available for sale and carried subsequently at fair value. They were also subjected to more stringent impairment rules that required fair value losses to be recognised in the income statement if there was a significant or prolonged decline in fair value below cost.

Changes proposed to IFRS

2.7 As a result of the financial crisis, and with the encouragement of the G20, the IASB is proposing a series of fundamental changes to financial instruments accounting, to be embodied in a portmanteau standard known as IFRS 9 “Financial Instruments”. These revisions are being completed in phases, the first of which, on classification and measurement, was published in November 2009.

2.8 The new standard acknowledges the need to address the rationale for holding financial assets in determining the appropriate accounting treatment. Under IFRS 9, financial assets are classified as either carried at amortised cost or at fair value on the basis of both the entity’s business model and the contractual cash flows of the instrument. If an asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows, and the contractual terms of the asset give rise to cash flows on specified dates that are solely payments of interest and principal, they are carried at amortised cost. All other financial assets are carried at fair value with fair value movements taken to the income statement.

2.9 This simplification of the classification model is likely to result in more debt instruments held in banking books being carried at amortised cost.

Impairment of loans

UK GAAP

2.10 Under UK GAAP, banks established loan loss provisions in accordance with the BBA SORP on Advances. Banks made specific provisions in relation to assets for which there was objective evidence of impairment and, in addition, made general provisions (eg 1% or 2% of a mortgage loan book) to account for unidentified losses that were likely to exist, based on past experience, at the balance sheet date for those assets without specific provisions.

2.11 Under the recommendations of the BBA SORP, loan losses were only recognised where an impairment event had been observed or, in the case of general provisions, where past experience indicated that an impairment event was likely to have occurred even though it had not yet been specifically identified. This is known as an “incurred loss” model.

IFRS

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2.12 The IFRS requirements for loan loss provisions are set out in IAS 39. This standard, like UK GAAP, requires the application of an incurred loss model but IAS 39 provides more detailed guidance than UK GAAP and does not distinguish between specific and general provisions. Specifically, IAS 39 requires banks to recognise a loss when a credit event has happened – in other words, when the payment status of the borrower has deteriorated since the loan’s origination to such an extent that the loan is impaired.

2.13 Under IAS 39, impairment is only recognised when there is objective evidence that the loan has been impaired since the date on which it was originated. This objective evidence may relate to an individual borrower (for example, a default in payment of interest or an indication that they are in significant financial difficulty) or to a portfolio of similar loans (such as an increase in the number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount). For loans that are not individually significant, the assessment of impairment is carried out on a portfolio basis.

Impact on bank audits

2.14 In practice, there was relatively little difference in the aggregate amount of loan loss provisions recognised by UK banks under UK GAAP and under IFRS. This was partly due to the fact that the two most significant differences between the two models had an offsetting effect on each other. IAS 39 requires there to be objective evidence to support the level of provisions made. This resulted in the release of excess mortgage provisions by some banks. However, IAS 39 also requires expected losses on impaired loans to be discounted to take account of the time value of money. This was not required under UK GAAP and consequently resulted in increased provisions in some cases.

Changes proposed to IFRS

2.15 One major criticism of the accounting during the financial crisis was that an incurred loss model tends to result in a deferral of the recognition of losses during an economic downturn. If losses cannot be recognised until a credit event has happened, it is not possible for banks to make additional provisions for losses which they can reasonably expect to be incurred as the cycle continues.

2.16 In response to this criticism, and with the encouragement of the G20 and the Financial Stability Board, the IASB has issued proposals as part of the second phase of its review of financial instrument accounting for a fundamental change to the accounting for loan loss provisions. The proposal is to replace the current incurred loss model with an expected loss model, that will require a bank to recognise the losses it expects to incur on the loan and to update those expectations regularly. The proposals have been issued for consultation and are now being redeliberated by the IASB. It is anticipated that this phase of the financial instruments project will be finalised by June 2011.

Q290 - Audit report scope

3.1 We welcome the opportunity to respond to your request for us to address the areas which wider audit reports might address. We are in no doubt that audit needs to change to respond to the lessons from the financial crisis. We summarise below some of the initiatives we are pursuing to achieve this.
**Increasing transparency of the audit**

3.2 The way auditors communicate externally needs to be revisited to improve understanding and raise the awareness of the value added by an audit. The current statutory audit report is formulaic; there is no opportunity for the auditor to give any commentary on how they have done their work. To change the statutory audit report would take time. In any event, it may be better to leave it in its current form to preserve the clarity of its purpose. We think the most immediate way to give greater transparency to the audit would be through further disclosures in the audit committee’s report where there is greater discretion over content.

3.3 We are discussing this idea with our listed clients to see if, working together, we can agree to give public disclosure to some of the key matters which, as auditor, we are obliged to report to their audit committee. This would include the significant risks of misstatement addressed by the audit and the key judgments made by management in preparing the financial statements. The results of this initiative will be available as the next round of annual reports become available in the spring and Committee will be able to take account of this in developing their thinking further.

**Extending the scope of the audit in relation to narrative disclosures**

3.4 The crisis has called into question the effectiveness of some of the narrative disclosures that accompany financial statements. These include the description of the inherent risks in a particular business and the uncertainties and judgments that underlie a set of financial statements. In general terms, the auditor is currently required to report, by exception, if they identify errors or matters where the information given in those disclosures is not consistent with the financial statements.

3.5 The clarity of some of these disclosures could be improved. We also accept that the assurance that can be derived from the auditor’s reporting as described above is not clear. Reporting and assurance over these matters inevitable interact; and so standards and practice for both need to be considered together in order to give clearer and better assured information:

- We think that improvement in the clarity of disclosure of these matters by companies is primarily a matter of encouraging adoption of good practice (for which there are examples). Further detailed rule making is, in our view, likely to be counter-productive. It would not be appropriate for auditors to be required to offer their own commentary or volunteer new information as such disclosures must remain the responsibility of the directors.

- However, auditors already act as agents to encourage such good practice and this could be further enhanced if they had a more explicit assurance role. We recognise that some companies have reservations about this and any change would need to be framed in a way that an auditor would be competent to do. We are currently working on proposals for how this could be made workable.

**The role of the auditors in relation to financial institutions**

3.6 The Committee is already aware of a paper prepared by the Institute of Chartered Accountants in England & Wales “Audit of Banks: Lessons from the Crisis”. We
support its main findings including the following which relate specifically to the role of auditors:
- Better two-way communication between regulator and auditor to enable both parties to perform their roles more effectively; and
- Greater scope for private reporting by auditors to supervisory regulators.

3.7 We also support a closer working relationship between auditors and banking and other supervisors and we are participating in the working party sponsored by the Bank of England which is currently considering this.

Written answers to questions not addressed at the hearing on 23 November 2010

Question One - In recent years the share of non-audit fees in the Big Four’s total fees has fallen sharply, partly because fees for ‘audit-related work’ (including ‘extended audit services’) are reported as if they were fees for auditing. So that we can have a clearer picture of how much fee income you earn for work you do for audit clients which is not essential in order for you to provide your audit opinion, could we please have a breakdown of the proportion of total fees earned from:
(a) Essential audit work
(b) ‘Audit-related work’ excluding extended audit services’
(c) So-called ‘extended audit services’, and
(d) Consulting and other services?

4.1 The summary schedule below identifies the following analysis of the figures for the financial year ending the 30 June 2010 for PricewaterhouseCoopers LLP:

(a) Essential audit work £522.8m (57.7%)
(b) Audit related work £ 25.2m (2.78%)
(c) Extended audit £15,000 (negligible proportion)
(d) Consulting/other £358.0m (39.52%)

4.2 As explanation for category (a), extended audit work is essentially work carried out at the request of clients as part of the audit that is not required to support the audit opinion. A recent review carried out at the request of the AIU indicated that we only did this for one client and that the amount involved was negligible.

Question Two - Should audit firms be free to provide internal audit services to their audit clients? If they do, isn’t it extremely unlikely the external auditor would ever tell the audit committee that the internal audit is rubbish?

4.3 Under UK Ethical Standards for auditors (ES 5), audit firms are not allowed to provide internal audit services to an audit client where it is either reasonably foreseeable that the auditor would place significant reliance on the internal audit work or the work would require the audit firm to undertake part of the role of management. Consequently, as I indicated in my response to question 249 at the 23 November hearing, as a firm we do not provide any outsourced internal audit functions to audit clients.
4.4 This Standard otherwise permits the provision of internal audit services provided that the auditor is satisfied that there is informed management and that appropriate safeguards (such as the use of separate teams and the review of the work carried out by an independent partner).

4.5 The Auditing Practices Board recently consulted again on this area but is not proposing to prohibit all internal audit services to audit clients provided the threats and safeguards approach is properly applied.

4.6 The International auditing standard (Clarity ISA 265 on “Communicating deficiencies in internal control to those charged with governance and management”) that deals with this area requires the auditor to communicate in writing significant deficiencies in internal controls identified during the audit to those charged with governance on a timely basis. An internal audit function is regarded as an internal control over financial reporting.

4 January 2011

Memorandum by The Rt Hon Lord Tebbit CH

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

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

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

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

My conclusion is that the answer to your Question 6 is self-obviously “No – auditors were not sufficiently sceptical in bank audits”. However, I do not think lack of competition was the cause – rather was it fear of losing consultancy income? On Question 10, I think it might be prudent to limit consultancy income in relation to audit income of a client company.

6 January 2011

Memorandum by Mr James Wood

I thank you for your letter of 4 November suggesting that I may wish to record my views on this broader question in a form which could be shared more widely.

Since you wrote I have given the matter further consideration and would like to cover the following two main issues:

Auditors Role
In the case of private and public limited companies audit firms should be able to undertake opinion based ‘basis of accounting reviews’ and ‘financial investigations’ in companies which have existing auditors. However, they should not thereafter take on the appointment as auditor of that company principally because they could be auditing, reporting and certifying their own work with the added possibility that their work was ‘inappropriate’ or ‘flawed’. In addition:

- The results of their pre-audit review / investigation work could have been based on pressure from the Chairman / Director / Directors to achieve and support a specific result covering a raft of issues such as share valuations, organisational changes, the raising of disciplinary action or to discredit a previous Chairman / Director / Directors or Senior office bearer. This lays the audit firm open to the charge that it is ‘currying favour’ to secure the audit. Having obtained a ‘satisfactory answer’ following their ‘basis of accounting review’ or ‘financial investigation’ the audit firm is then in a favoured position to take over and secure the audit role and in so doing capture a greater share of the audit market.

- In the case where disciplinary action for example is taken as a result of the audit firms ‘opinion based report’ against a qualified accountant the ‘Big Four’ can dominate the internal self-disciplinary process of governing accounting bodies particularly where they are well represented on Accounting Councils or their committees, because of their sheer size and potential influence. This is a serious regulatory weakness and is very much against the public interest. If a disciplinary case involves any of the ‘Big Four’ auditing firms their governing Accounting bodies should lose their ability to Self Regulate. This task should be taken over by new Accounting Complaints Commission in the same way as the legal profession has established a Legal Complaints Commission.

**Audit Engagements Contracts**

For public and private companies there is now an urgent need for a major re-think of the audit role. To date the perception of most shareholders is that auditors certify accounts on a ‘true and fair’ basis in compliance with the 2006 Companies Act. This is now inadequate and out of date against the background of today’s economic climate. As a shareholder in several banks I believe that a much more comprehensive certification regime requires to be put in place.

It is now time for a major re-think on the role of auditors. Audit Reports require to become more robust, comprehensive and meaningful to cover such issues as risk analysis and assessment, operational effectiveness, financial ratios and performance indicators. This will require a major re-think on accountancy training within the accounting bodies and universities on the whole question of the work content of audits and audit reports.

As a result of recent experiences particularly with the banks I now have little faith in the present role of audit firms. Their roles should become more comprehensive and believe that their roles should be defined in an Audit Engagement Contract which should be available to all shareholders before an audit firm is appointed. It would provide greater reassurance to shareholders, the public at large and the Government and would mean that audit firms would be held to more effective account.

15 November 2010
is grateful to the Committee for this opportunity to give an update on its work in relation to the market for audit services24.

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

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

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

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

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

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

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

9. The OFT will update its website25 with further information on its work in the audit market as it becomes available.

24 Please note that throughout this document ‘audit’ refers to external audit only.
25 See: http://www.oft.gov.uk/OFTwork/markets-work/othermarketswork/accountancy-audit
10. The OFT would be happy to provide any further information that the Committee may find useful.

2 March 2011