HOUSE OF LORDS

ECONOMIC AFFAIRS COMMITTEE

Auditors: Market concentration and their role
Written evidence

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Memorandum by Mr Duncan Alexander (ADT 52)

1. Following your Call for Evidence, I now enclose my thoughts on this matter and provide answers to the questions that you ask. My perspective comes from being a *working* investor creating and running small businesses and being a *passive* investor by investing in publicly quoted companies around the world. As a *working* investor I have direct, unfettered access to information on my ventures in trade. As a *passive* investor in quoted public companies my information is often restricted to publicly available sources. In view of this restriction, I would suggest that investors need to have verified accounts by auditors who are independent of those running the day-to-day activities of the firm.

2. I would like to confirm that I have made contributions to the DTI Company Law Review, the Auditing Practices Board on Aggressive Earnings Management, the Sandlers' Review Team on medium & long term retail savings, the Treasury Committees' inquiry into the financial regulation of Public Limited Companies and the Review of Non-Executive Directors.

3. ***Question 1. Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?*** Business studies theory says that it is an inevitable reaction in the free market system that the over consolidation into a small number of players will occur as the prize for this is monopoly profits. Competition theory then goes on to say that it is the role of politicians to identify when this "*cornered market*" may have occurred and to arrange systems and processes to ensure free and fair markets. I believe that we have "cornered markets" in many services such as Auditing and Banking. I am convinced that our politicians and regulators have failed to meet their responsibilities in this matter.

4. ***Question 2.*** **Does a lack of competition mean clients are charged excessive fees?**
Yes – that is the prize of "*cornered market*" power!

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

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

6. ***Question 4. Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?***
This seems to be crazy logic! – but does highlight one of the central problems in auditing: Who is the auditors client? As a part owner in publicly quoted companies, I believe the owners/shareholders are the auditor's primary client. Unfortunately, the auditor's view the Board of Directors, who they are auditing, as their primary client. UK politicians need to now clarify who is right - Investors or Auditors.

7. ***Question 5. What is the role of auditors and should it be changed?***
Liz Hughes, head of the ACCA in Ireland said: "*Audit is a simple concept; an independent person, appointed by the investors, but paid for by the company, provides investors with an opinion on how well the financial statements reflect the underlying business performance."* She then said "*However,* ***what an audit does and doesn't, cover is sometimes unclear***. ***Auditors do not see themselves as "bloodhounds", out to detect fraud,*** *but rather as watchdogs, there to determine whether or not a company's accounts are realistic representation of its business."* This is the "*expectation gap*" problem. Investors want auditors to be "*bloodhounds*", out to detect fraud; auditors don't want to deliver that want. Politicians will now have to decide the countries position on this and the auditor's primary client issue.

8. ***Question 6.*** **Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor?** No – The auditors know they are in a "*cornered market*" situation; their main concerns will be to maximising their income while this persists. Scepticism is probably used only as a marketing tool to generate non-audit services. The present audit culture is aimed at revenue generation rather than protecting the interests of owners, creditors and other stakeholders.

9. More competition is the only way to break a "*cornered market*" situation. In an earlier response to audit reform, I suggested that the Regulator should dictate a minimum number of audit firms to service the needs of publicly quoted companies. We know that if the present Big 4 were reduced to 3; that they would be paralysed by conflict of interest problems. I suggested that 10 might be the minimum.

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

11. It is not in the interests of auditors to change the present situation. However, the owners of Banks could have required their auditors to be "*bloodhounds*", out to detect fraud. The Big 4 would probably refuse that requirement. Thus, political intervention is required to give owners the legal right to require that obligation.

12. ***Question 8.*** **How much information should bank auditors share with the supervisory authorities and vice versa.**
Bank auditors should provide as much information as a supervisory authority needs for the execution of their responsibilities.

13. ***Question 9. If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?***
A legal requirement for auditors to be honest and objective towards owners would be helpful.

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

15. There is a fundamental conflict of interest in trying to combine audit and consultancy roles. Auditing your own work in a quoted public company context **is wrong.** To maintain public confidence in the audit process, we should consider the answer may be that we should have audit only firms.

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

17. Yes, we need more competition in an updated auditing market. Recognise that the present market lacks credibility following the financial crisis. Learn from basic business theory (Adam Smith – *Wealth of Nations*) that the capitalistic system has a tendency to monopoly. The Business Secretary, Dr Vince Cable MP has put it more colourfully as: "***Capitalism takes no prisoners and kills competition where it can.***" My solution would be to have audit only firms which recognise that the owners of companies are their primary responsibility. They should also recognise that the detection of fraud and unusual accounting practices is an essential part of their audit assignment. At the members AGM they must take a proactive role in explaining the risks that the firm is taking and the credibility of the Boards' business plan. Overall, the audit market should have a minimum of say 10 firms for quoted public companies. As computerisation has taken away a lot of the mystery of accounting, it should be possible for other specialist labour only groups to adequately do this work.

18. ***Question 12. Should the role of internal auditors be enhanced and how should they interact with external auditors?*** I would wait until we see if the discredited audit system is reformed.

19. ***Question 13. Should the role of audit committees be enhanced?*** I would wait until we see if the discredited audit system is reformed – I don't see the point of going into this element of the process until the basic principles are established or changed.

20. ***Question 14. Is the auditing profession well placed to promote improvement in corporate governance?*** No – their reputation is discredited.

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

23 September 2010

Letter from Baker Tilly UK Audit LLP (ADT 53)

This response to the Committee's Call comes from Baker Tilly UK Audit LLP, one of the ten firms in the United Kingdom on which the Audit Inspection Unit of the Professional Oversight Board[1] publishes an individual firm report, the third-largest UK audit firm outside the 'Big 4', and having a significant number of listed and AIM audit clients.

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

- accept that competition can only be stimulated by direct intervention in the market
- discriminate positively in favour of potential competitors, in order to effect that intervention

[1] The Professional Oversight Board is an operating arm of the Financial Reporting Council, the accountancy profession's principal regulator.

- be mindful of addressing systemic risk when intervening, and of the need to support the owner-managed, SME-led recovery of the economy, and finally
- introduce effective statutory limitation of auditors' liabilities

Our answers to the questions are as follows:-

Q1 Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete? In our opinion, the modern audit-profession has been shaped by three factors, two of them brought about by government intervention, and the other market-led.

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

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

The third factor, and the most decisive one, was the desire of the biggest audit firms to become even larger, to better serve their clients and to become more profitable, through merger. The last twenty years has seen a significant contraction of the numbers of those firms, and a correlative increase in the numbers of audit entities whose appointments as auditor they have been able to secure – over 98% of those entities are audited by the Big 4 firms. The conclusion we have drawn is that market-concentration will not change unless government chooses to intervene to effect it. Government and the Financial Reporting Council have already accepted that there are sound public policy justifications for greater competition[2] and a number of 'mid-tier' firms have responded, reaching the level of capability that they are able to service bigger clients. Their potential will always be fettered, though, so long as government assumes that change can be market-led.

Unless government concludes that it needs to intervene in the market again, the *status quo* will be self-perpetuating, for the reason that we have said: it was commercially-led market-mergers that caused the contraction and it will take positive discrimination in favour of potential competitors to now change it. We do not believe that economies of scale in themselves cause an impediment to competition but such is the degree to which the biggest

[2] See, for example, the conclusions in 2007 of the Market Participants Group set up by the Financial Reporting Council.

firms have been able to use them to secure the numbers of audits they have, it is now incredibly difficult for market-led solutions to bring about change. We return to that theme below, in our answers to Question 10 and 11.

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

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

Q4 Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere? In our view, the mere fact that the numbers of audit firms at the top end of the scale are small neither increases nor diminishes the ease with which unwelcome advice can be delivered to audited entities. Our submission to your Lordships is that the training of auditors, the emphasis in both training and practice on professional ethics, and practitioners' membership of the professional bodies who license their firms provide reliable assurances of sound professional behaviour.[3] The emphasis of audit training and audit practice is the preservation of sceptical objectivity and independence: firms' (and audit practitioners' own) reputations are simply too precious and fragile for them to conduct themselves below that standard. There is no evidence for the proposition, either that the bigger the size of the firm, the greater its capacity to provide objective advice, or the converse, that the smaller the firm, the greater the likelihood that it will compromise its objectivity in order to placate the client. On a pragmatic note, audited entities have a strong disincentive not to change their auditors when faced with unwelcome advice, as potential appointees are alerted (by law and by the requirements of professional conduct) to the reasons for the change in appointment.

Q5 What is the role of auditors and should it be changed? An audit has two essential features: a monitoring feature and an advisory one (which firms often refer to as adding value to the audit, perhaps in terms of benchmarking corporate performance against competitors or providing a risk analysis service). We have two principal submissions to make to your Lordships in answer to this Question.

The first is that, although a number of commentators have expressed disappointment that auditors did not anticipate the banking crisis, that was not a function of having failed in their duties. Audit is a statutory function and the scope of the obligation on the auditor has been largely unchanged since the first legislative expression of it in 1948: it requires audit firms to report on the financial statements produced by an entity's management; its scope is necessarily historical; and it is not a surrogate means of second-guessing the entity's

[3] For example, Beattie, Fearnley, and Brandt, "*Behind Closed Doors: What Company Audit is Really About*" (2001)

strategy, business model, or vulnerability to risk. It may be that an expectation-gap has grown up over time but any change needed now is not a function of failure on the part of auditors hitherto.

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

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

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

Q6 Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor? We refer again to our answer to the previous Question; a number of examinations of the same ground has been entrained already and the results are expected in the near future.

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

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

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

Q10 Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated? We strongly advocate to your Lordships that, far from there being a

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

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

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

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

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

The 'limited liability agreement' régime[4] in the Companies Act presently is not a surrogate for a properly operating limitation mechanism. The absence of an effective means is a significant and unfair detriment to audit firms and a disincentive to competition. The limit of an audit firm's exposure should be the damage directly attributable to any fault on its part. This, *proportional*, liability is demonstrably fair from the standpoint of any stakeholder, including the investor-bodies, and our understanding is that at least one other, modern, English-law based jurisdiction (Australia) has introduced it. We respectfully ask your

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

Lordships to support the principle of proportional liability, fulfilling as it does the necessary tests of all-round fairness and stimulating the public policy objective of competition in the audit market.

We add that we do not see this as the only means by which competition can be encouraged. Taking it as a given that government is already persuaded that having additional 'players' at the top end of the market is an important public policy objective in itself, we began our response with the proposition that change cannot be market-led and will instead need decisive intervention on the part of government. To lend more specification to that proposition, we say that the number of listed audits that any one firm is entitled to carry out should be limited. That will, it can readily be seen, oblige companies to seek their audits from a broader number of audit firms. They can have confidence in doing so: we observed in our answer to Question 1 that regulation is now so meaningful that it has become one of the determinants of audit quality, ensuring that the firms taking on the audit engagements ceded by the Big 4 are supplying services of the same quality.

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

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

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

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

1 October 2010

Supplementary memorandum by Laurence Longe, National Managing Partner, Baker Tilly UK Audit LLP (ADT 54)

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

Letter from Mr A St John Brown (ADT 55)

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

2. I suspect there are three fundamental issues:

a. The auditors are appointed by the people they are supposed to be auditing. Does one really believe that the auditors are going to challenge aggressively the Finance Director/Board of a company when they have many hundreds of thousands, or millions of pounds in audit fees riding on their reappointment (and probably even more valuable consultancy work – see 3 below)? For the auditors to become genuinely independent they need to responsible in a meaningful way directly to the shareholders.

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

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

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

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

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

11 September 2010

Memorandum by Mr Cormac Butler (ADT 56)

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

Memorandum by the California Public Employees Retirement System (CalPERS) (ADT 57)

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

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

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

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

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

Today, accounting firms outside the "Big Four" are not competitive with the Big Four in terms of number of personnel, offices and a presence in foreign countries. In essence, much of the consolidation was the direct result of the large accounting firms responding to the need for a presence around the globe, in order to provide global audit coverage required by businesses operating globally. In addition, the consolidation gave the large auditing firms an advantageous economy of scale that makes it difficult for smaller firms

to compete. The larger auditing firms have lower overhead costs, greater presence on college campuses allowing them to recruit new hires more effectively, the ability to provide audit resources in each major country around the globe, and national offices that can provide necessary resources for accounting, auditing, local and foreign taxes and business issues.

Prior to the GAO report, in 2007 the European Commission (DG Internal Market and Services) commissioned Oxera[5] to examine ownership and management rules related to audit firms, their corporate structures and their access to capital. The Oxera study showed that restrictions on access to capital were one of several potential barriers for smaller firms' entry into the market. Other barriers included reputation, the need for international coverage, international management structures and liability risk.

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

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

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

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

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

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

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

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

We do feel where the audit firm receives significant fees for services other than an independent audit, and the information is not properly disclosed to investors, the lack of auditor independence negatively impacts the auditors' objectivity. We feel that some services are in fact, inconsistent with an auditor maintaining their objectivity, such as services that might result in the auditor having a common financial interest, in auditing their own work, or engaging in management activities.

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

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

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

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

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

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

- Key business and audit risks the auditor believes exist, and which the auditor has considered when conducting the audit,
- The auditor's perspective on what are the key assumptions used in judgments that materially affect the financial statements, and whether those assumptions are at the low, most likely, or high end of the range of possible outcomes,
- Key audit issues and their resolution which the audit partner documents in a final, summary audit memo,

- Changes to accounting policies that have a significant impact,
- Unusual transactions,
- Accounting applications and practices that are unique to the industry, and
- Change of auditor and background thereof.

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

"Financial reporting plays an integral role in the financial system by striving to provide unbiased, transparent and relevant information about the economic performance and condition of businesses. Effective financial reporting depends on high quality accounting standards as well as the consistent and faithful application and rigorous independent audit and enforcement of those standards. Financial reporting is of great importance to investors and other financial market participants in their resource allocation decisions and to regulators and other users. The confidence of all these users in the transparency and integrity of financial reporting is critically important to global financial stability and sound economic growth."

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

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

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

The importance of professional scepticism is highlighted in the Final Report of the Advisory Committee on the Auditing Profession to the U.S. Department of the Treasury released on October 6, 2008 and available at http://www.treas.gov. The Committee notes in V. Background, page V:1 that "Auditors' professional conduct requires an

attitude of healthy scepticism in performing their work and their assurance is critical to investor confidence and, ultimately, the flow of capital. The auditor's role in the effective functioning of the capital markets cannot be underestimated." In Section VI. Human Capital, Recommendation 4 (b), page VIII:19, states, "Develop training materials to help foster and maintain the application of healthy professional scepticism with respect to issues of independence and other conflicts among public company auditors, and inspect auditing firms, through the PCAOB inspection process, for independence training of partners and mid-career professionals."

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

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

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

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

As noted on page 115 of the House of Commons Treasury Committee January 24, 2008 Report, "The run on the Rock," states as follows:

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

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

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

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

- Valuation. Current audit standards do not disclose risks when quoted market prices are not available. Assumptions involved in value estimates should be disclosed.
- Non-Performing Assets. Increase transparency through more stringent non-performing asset auditing standards at the securitization level and creditor level to assist investors.
- Special Purpose Vehicles. Improve disclosure and audit procedures to provide full transparency regarding special purpose vehicles to disclose ownership, capital structure, size of issue, terms of offer, details of the underlying asset pool and its performance history, transaction structure, and service arrangements.

- Sensitivity Analysis. Require stress-testing for securitizations with scenario ratings to take into consideration adverse events such as changes in default rates, decreases in underlying asset valuations, higher prepayment and discount rates, changes in the timing of cash flows, and early amortization triggers.

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

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

- periodically requiring financial returns to be audited – some of the information does not form part of the accounts, for example, regulatory capital ratios;
- greater use of powers by regulators in order to gain more information on the operation and application of controls in compliance with regulatory requirements;
- review the 'Pillar 3' disclosures introduced by Basel II; and
- more regular meetings between the authorities and the auditors.

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

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

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

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

Periodic rotation of the audit firm (rather than just the audit partner) would also provide an incentive to provide objective advice, especially when such advice may come under scrutiny by the subsequent auditor. When an audit firm takes over an audit from

another firm, it does an exceptional job of checking, reporting and due diligence in order to prevent assuming liabilities for the previous audit. This is a compelling argument for rotation every seven to ten years.

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

We agree with the House of Commons Treasury Report, "Banking Crisis: reforming corporate governance and pay in the City," Ninth Report of Session 2008-09, published on 15 May 2009 ("Treasury Committee Banking Crisis Report"), which states in paragraph 237, at page 83, "We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity." As noted on page 82 of the Treasury Committee Banking Crisis Report, "other commercial interests can compromise auditors in their ability to confront directors on difficult issues."

We strongly support this view of auditor independence and not permitting auditors to provide non-audit services to audit clients, including but not limited to the prohibition of the following non-audit services: internal audit, information technology, valuation, actuarial valuation, tax, litigation support, legal, recruitment and remuneration, corporate finance, transaction related, and accounting (See The Auditing Practices Board Ethical Standards, "Consultation on Audit Firms Providing Non-Audit Services to Listed Companies they Audit," October 6 2009, pages 28-31). In addition, a November 15, 2009 Study, "Auditor Independence and the Cost of Capital Before and After Sarbanes-Oxley: The Case of Newly Issued Public Debt," by Eli Amir of the London Business School found that the Sarbanes-Oxley Act of 2002, by enhancing auditor independence, has resulted in a lower cost of borrowing. Investor confidence in financial statements will be enhanced through greater auditor independence, expertise, and effective risk management.

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

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

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

banks have been required to do, develop a plan for orderly and legal hand over of audit clients should a firm be in terminal difficulties.

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

"Recommendation 1. Reduce barriers to the growth of smaller auditing firms consistent with an overall policy goal of promoting audit quality. To address these issues, the Committee recommends that policy makers press for the reduction of barriers, to the extent consistent with audit quality and other public interest factors, to the growth of smaller auditing firms. For smaller firms, this includes encouraging and promoting development of technical resources in such areas as international financial reporting standards (IFRS) and fair value accounting, and development of specialized or "niche" practices or industry "verticles" where they are in the best interests of investors and can lead to more effective competition. Pressure also should be applied against-nonjustifiable resistance to using smaller firms on the part of a variety of market participants."

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

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

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

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

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

13. Should the role of audit committees be enhanced?

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

1. Standards for serving on an audit committee;

2. Education of the audit committee;
3. Audit committee charters setting forth the objectives of, and work carried out by the audit committee; and
4. Transparency of the work of the audit committee.

Audit committees should be comprised of diverse members who are:
1. Knowledgeable of the industry and business in which the company operates;
2. Knowledgeable of the financial statements and disclosures;
3. Informed with respect to external and internal audit practices; and
4. Informed of their responsibilities to investors.

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

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

- From the perspective of an investor, were there any independence issues with respect to the independent auditor?
- Significant matters that were discussed with the auditor including audit scope, significant risks, internal control weaknesses, audit staffing, etc.
- Whether the auditor would make any changes to the financial statements?
- Whether the auditor would make any changes in internal controls?
- Did the auditor receive sufficient cooperation and information?
- Are there accounting practices that the company or institution uses that are acceptable, but not the preferred method of accounting?

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

Currently no, as audit firms around the globe have themselves often times lacked transparency and have not adopted preferred governance practices. This is not the case in some model countries such as the U.K. where the largest audit firms have provided greater levels of transparency with the recommended Audit Firm Governance Code".[6] We believe that globally, audit firms should first proactively address their own

[6] The Audit Firm Governance Code, A project for the Financial Reporting Council, January 2010.

governance structures and practices before advising clients on such matters by agreeing as an international firm to do the following:

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

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

24 September 2010

Memorandum by Corporate Value Associates (ADT 58)

Introduction

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

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

Response to questions

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

iii. The principal role of an external auditor, in the generally accepted definition of the term, is to ensure that the published accounts of a business organisation are "true and fair" and correctly and consistently reflect its profit and loss and its assets and liabilities, using applicable accounting rules and practices. Whilst the valuation of assets and liabilities and

the profit and loss account will to some extent reflect future probabilities, the published accounts are predominantly a historical reflection of performance to date. Financial auditors look at book value, not at future value. Audited accounts do not embrace actions taken today or planned to be taken in future, whereas corporate success and reward is as much to do with future expectations as it is with historic performance. There is generally a significant mismatch between the accounting or book value of an organisation and its value under other definitions such as liquidation value, sale value, going concern value and quoted market value.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

13. Should the role of audit committees be enhanced?

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

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

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

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

24 September 2010

Memorandum by Mr A F D Ferguson, MBA, MS, BSc, CEng, MIChemE (retired) (ADT 59)

Although I have studied accountancy in the UK and USA I never became a professional accountant but instead held senior executive positions in several medium sized companies in this country and a large multinational company in the USA. As a result over the period from the mid 1950s to the late 1980s I had close contact with accountancy partnerships which have now become members of the "Big Four". As requested, I will number my sections in this submission.

1. A number of experts have claimed that accountants have too big an influence in this country. Frequently the City feels that the appointment of an accountant to be a CEO is always a "safe" option. This is not true in the USA and other parts of the world. This effect could be quantified by examining the number of directors executive and non executive in the FT 350 who are accountants and where they were trained. I suspect, the result would show a certain amount of imbreeding, where company executives would remain loyal to their alma-mater. Unfortunately a "safe pair of hands" do not often produce a growing enterprise, usually the reverse, the long term is sacrificed for short term gain.

2. In the 1970s most companies had two audits a year. The mid year audit examined the controls and procedures in the organisations as well as measuring the financial statements. As these were carried out by the same staff as would carry out the end of the year audit, it meant that the practice managers knew better what was going on and could establish relationships at department levels. In view of escalating costs this was dropped and instead within a few years consultancy was introduced. I have had personal experience with accountancy consultancy on three occasions. In each case it was a short exercise intended to lead to a wider one. In all cases the result was embarrassing – in one case the report remained in a draft form it was so poor. Unlike the established consultancies those were in a start up phase. Things are much better now (I hope) but this service was introduced to produce income and apart from contacts at a senior level the accountancy practices were offering nothing new or unique. The costs to the client companies were high and to a certain extent they were a tied market.

3. With the development of the "Big Four" the difference between them and their smaller competitors continually widens. The "Big Four" gets the pick of the students with their in house training and the salaries and benefits offered to partners and staff ensure that they should get the cream of the profession. Unless one is in the position like Sir Anthony Jolliffe it would be impossible to start a practice to operate within the City.

   The country depends on the small companies to grow the economy and whereas the large companies can afford their own accountancy staff the small expanding ones cannot. Yet they are the ones that need the help but they cannot afford to pay the fees of the "Big Four" and what is equally frustrating the "Big Four" with their specialist departments are not equipped to handle them.

   We therefore have a double whammy. The UK needs and depends on this section and yet it is badly provided.

4. Accountancy principles are continually changing. They are developed through committees and working parties. The "Big Four" can afford to support these with experts but can their smaller competitors? The more tortuous the principles, the more they favour the bigger practices, the larger the annual reports and the more difficult to find out what is going on.

5. What is the object of having reports audited? If it is to report to the management it is a waste of time – they should know it already. If it is to report to the owners of the company i.e. the shareholders, then it should be able to be understood by them and should contain commentaries and even warnings. Boards would not like this as they pick the auditors, to all intent and purposes, we are left with expensive large documents which are barely understood by financial analysts far less the owners of the company. How can truly independent be appointed?

6. Possible solutions to improve the situation:-
   i. Separate auditing from consultancy
   ii. Make the qualification in accountancy more like engineers and medicine, even like lawyers. In my generation accountants were apprentices and not the students they are today with in house lectures.

iii. Ensure that Central and Local Government employ the smaller practices and do not discriminate on the grounds of complexity and convenience.
iv. Help with taxation and company law to encourage individuals to form practices.
v. If any of the "Big Four" wish to acquire another practice in this country, it must be approved the Office of Fair Trading.
vi. Compare and contrast how the "Big Four" operate in other countries and how they are regulated.

7. This is not in the remit, but we tend to think of accountants only as auditors. In most organisations the day to day work is done by the "management accountants". There is a snobbery about this and you find unbelievable ignorance amongst accountants trained by professional practices, but who are qualified by the Institute of Cost and Management Accountants despite having no experience in this area.

I hope the about may be of interest and value to you.

20 September 2010

Memorandum by Mr Michael A. Hadfield (ADT 60)

1. The Auditing became so concentrated on four global firms because the Institute of Chartered Accountants in England and Wales (ICAEW) allowed and encouraged them to do so.

The ICAEW withdrew all controls over the large firms as it was and remains a case of he who calls the piper calls the tune.

2. It is obvious to all that the lack of competition has resulted in excessive fees. This has resulted in the firms being complicit when errors are found and they have given clean and unqualified Audit Reports upon which the members and Creditors have relied in order to retain the Audit Fee.

3. The ICAEW were aware of this but have taken no action against them. However in order to try and influence Government that they are effective prosecute small firms for minor errors that make no difference to the accounts in an effort to show they are "doing the job".

4. The role of Auditors should be restricted to just that. Other advice should be sought from other firms (possibly in conjunction with the Auditors).

5. The Auditors should not give clean reports unless they are able to say that they fully understood the Banks transactions. If they claim that they did then they were acting in a criminal manner if they did not then they should have resigned. In either case they did nothing nor did the ICAEW who, it would appear, is capable of taking action against them.

6. Of course they were not sufficiently sceptical because the juniors sent out on Audit did not understand what was happening.

7. They should have acted honestly and qualified the accounts.

8. All matters should be shared with the body to which they belong i.e. in the main the ICAEW but as already indicated they had already, in self interest, abdicated their responsibility.

9. There should be no need for an honest broker to receive incentives. The only incentive should be exactly the same as small firms which is either having their Audit Registration removed and /or being struck off. All firms irrespective of size should be on the same level playing field.

10 to 11 No comments.

23 September 2010

Letter from Mr Jim Sylph, Executive Director, Professional Standards, International Audit and Assurance Standards Board (ADT 61)

I understand from Jon Grant that you have requested information from the International Audit and Assurance Standards Board (IAASB) about which International Standards on Auditing (ISAs) are being revised in the light of the banking crisis.

In March 2009, the IAASB completed a major undertaking called the 'Clarity Project.' This project involved a comprehensive review and redrafting of all 36 ISAs and IAASB's International Standard on Quality Control to improve their clarity and understandability and, thereby, facilitate their consistent application. In addition to improving the clarity of the ISAs, the IAASB substantively revised approximately half of the standards including ISA 540 that deals with the audit of accounting estimates, including fair values, and related disclosures – a topic of particular relevance in relation to the audit of banks. These efforts led to substantial improvements in the ISAs aimed at strengthening practice in a number of areas, including the following:

- The general approach to the audit, to instill a focus on objectives, promote a thinking audit, and emphasize the importance of professional judgment and skepticism;
- Those aspects of financial statements that generally pose a higher risk of material misstatement, for example, estimates and fair values, and related party transactions;
- The quality of audit evidence, particularly with regard to external confirmations and written representations;
- Using the work of others, particularly in the context of group audits, to ensure that auditors are satisfied that there is an appropriate basis on which to use the work of others, and to use others only when it is appropriate to do so;

- Communication in the auditor's report where it is necessary to draw users' attention to a matter(s) that is fundamental to users' understanding of the financial statements or relevant to their understanding of the audit, the auditor's responsibilities or the auditor's report; and
- Communication with those charged with governance, to promote effective two-way communication between the auditor and those with responsibility to oversee the financial reporting process, including a new ISA addressing communication of deficiencies in internal control.

The new Clarity ISAs apply to the audits of financial statements for periods commencing 15 December 2009. Audits of financial institutions during the banking crisis were undertaken in accordance with the ISAs that were in issue at that time, not the new Clarity ISAs.

The new Clarity ISAs and have been widely accepted internationally. They are being applied by many of the EU Member States including the United Kingdom and Ireland. The European Commission is considering when and how to introduce ISAs in the EU.

The degree to which auditors have been criticized for their audits of financial institutions during the banking crisis varies internationally. To the extent that difficulties have been reported to the IAASB they are largely in the area of auditing the fair values of complex financial instruments and we hope that difficulties in this area would have been reduced had the new ISA 540 applied at that time.

Effective implementation of the new Clarity ISAs will involve extensive training at a national level and, to provide a period of stability during the implementation period, IAASB announced that it would not introduce major changes to the ISAs that would become effective before 2011. While the IAASB is not therefore planning to issue any new or revised ISAs at this time, it is undertaking work to review the ISAs relating to using the work of internal auditors (ISA 610) and the auditors responsibilities relating to other information in documents containing audited financial statements (ISA 720).

More specifically in relation to the banking crisis, the IAASB has:

- Published an exposure draft of a new International Auditing Practice Statement (IAPS 1000) which provides both educational and practical guidance on the audit of complex financial instruments, with particular emphasis given to auditing considerations relating to the valuation and disclosures issues for financial statement items measured at fair value(one of the challenges that bank auditors faced during the banking crisis);
- Published, this month, a discussion paper that addresses the challenges faced in determining the meaningfulness, completeness, adequacy, and understandability of disclosures, and explores matters such as adequacy of evidence, materiality and misstatements in the context of disclosures (some regulators have commented that bank auditors should have done more in this area); and
- Released a number of Audit Practice Alerts and similar staff publications (e.g., Questions and Answers) that address issues relevant in the financial crisis and of particular audit concern. These publications highlight areas within the ISAs relevant to the audit of fair value accounting estimates, the going concern assumption, auditor considerations regarding significant unusual or highly complex transactions, and use of external confirmations in gathering audit evidence.

The IAASB has also maintained dialogue with prudential supervisors, market regulators, investors, audit firms, and other stakeholders on key auditing issues, including those that

address financial institutions. As part of this dialogue, the IAASB has implemented a more systematic approach to liaison with the IASB to identify issues during the development of new International Financial Reporting Standards which may give rise to significant challenges to auditors should those accounting standards become adopted.

Core to the IAASB's work program are initiatives aimed at supporting and enhancing audit quality. This month the IAASB released a thought piece aimed at raising awareness of the concept of audit quality and its main components. Intricately linked to the topic of audit quality is, of course, auditor reporting. The IAASB therefore also has a project on the topic aimed at gaining an understanding of user's perceptions of the auditor's report, thereby helping to inform the IAASB on whether the standard auditor's report needs to be improved and, if so, how. Matters that the IAASB intends to explore include how users view the current scope of the audit, what information they desire and how the auditor's report may address these needs.

Importantly, the IAASB has also begun planning a comprehensive effectiveness review of all of the Clarity ISAs starting in 2012. This effectiveness review will be an important precursor to determine the nature and extent of future changes to the ISAs. We expect to be working closely with the regulatory community as well as national standards setters and the auditing profession in undertaking the review.

The Auditing Practices Board (which is part of the Financial Reporting Council) is the body that determines the Auditing Standards that apply in the UK and Ireland. The APB have been active in the banking crisis and we have used their work where it has been applicable, including when developing the guidance in IAPS 1000 on the audit of complex financial instruments.

I hope this information will be of assistance. Please do not hesitate to request further information should this be needed.

About the IAASB

The IAASB develops auditing and assurance standards and guidance for use by all professional accountants under a shared standard-setting process involving the Public Interest Oversight Board, which oversees the activities of the IAASB, and the IAASB Consultative Advisory Group, which provides public interest input into the development of the standards and guidance. The structures and processes that support the operations of the IAASB are facilitated by the International Federation of Accountants.

25 January 2011

Memorandum by Kingston Smith LLP (ADT 62)

Following on from the House of Lords announcement on 27 July 2010 that you had decided to conduct an enquiry into auditors, specifically market concentration and their role, we are pleased to provide our response.

Although we have responded to the questions posed in the announcement in turn below, we wish to stress the following key points:

- The enquiry appears to follow on from the banking crisis and subsequent increasing focus on the auditing profession, including the Treasury Select Committee report on the crisis (The McFall Report);

- The Big Four firms, and indeed the profession as a whole, make a significant contribution to the UK's gross domestic product and therefore the Government should be encouraging such businesses and assisting them to grow for the benefit of the UK, rather than seeking to place further obstacles in their way;

- There is no evidence whatsoever of problems arising, either in the banking industry or elsewhere, as a result of issues caused by audits, or of any systemic issues with the way audits are conducted;

- There has been much institutional investor focus on what an audit should deliver and it is clear that there is an expectation gap which may arise from misperceptions of what an audit is designed to do. However, it is not clear how that gap can be addressed without prohibitive costs (and other implications) for the profession and potentially for businesses;

- It must be stressed that the vast majority of UK companies are owner managed and do not therefore have institutional investors. The views of institutional investors should not therefore be prioritised over those of other stakeholders, particularly the companies themselves and their directors;

- The profession is already subject to stringent professional standards, not least the ICAEW Code of Ethics, and the Ethical Standards for Auditors, which already create some barriers to the provision of efficient client service in certain respects;

- The already high degree of regulation, together with misperceptions of the role of auditors, the lack of a workable liability limitation mechanism, and the risk of adverse public comment, acts as a barrier to increased competition for the audits of larger public interest entities. In particular, there is an urgent need to find a workable solution to allow auditors, and indeed other professions, to limit their liability in a meaningful and fair way, proportionately to the degree of fault so that auditors are not at risk of a ruinous action due to being perceived to have the deepest pockets. The threat of such an occurrence is very real particularly as the largest firms are unable to obtain adequate insurance cover.

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

In the first instance, it is not entirely correct to state that 'auditing' has become concentrated on four global firms. Whilst it is undoubtedly true that the audit of major listed entities, and particularly banks, has become concentrated on the Big Four, the audit of smaller listed companies, those traded on AIM and Plus, and particularly the audit of smaller owner managed businesses is much more evenly spread across the profession. Small companies often look to smaller audit firms for their professional advice as they believe such firms will better understand their needs; the same logic applies to entrepreneurial businesses which will look to firms that specialise in such businesses and are able to address their needs, including, where appropriate, pursuing flotation.

There are various reasons why the audit of major listed entities has become concentrated on the Big Four. Undoubtedly, the raft of mergers which has taken place in relatively recent times has aggravated the situation. A 'Big Eight' became a Big Six and then a Big Four within a relatively brief time frame following the merger of Price Waterhouse and Coopers and Lybrand, and the collapse of Andersen; indeed the situation could have been worse had the proposed merger in the late 90's of KPMG and Ernst and Young actually gone ahead.

Another issue is the reluctance of major listed entities to look outside the Big Four for their auditors. This may be due to (unjustified) perceptions of the capability of the mid tier to service such entities; in some cases, it may be due to restrictive covenants (for instance the availability of bank finance being dependent on having a Big Four auditor). There is perhaps a perception among major listed entities that having a Big Four auditor is the best guarantee of audit quality but this is a misperception. Mid tier firms have demonstrated themselves perfectly capable of auditing major listed entities, one obvious example being Partygaming which at one point was part of the FTSE 100 and which was (and still is) audited by BDO.

There are various other reasons why smaller firms do not compete in this market, particularly in respect of banking audits. Because banking audit is entirely concentrated among the Big Four, there has been no opportunity for mid tier firms to develop the necessary level of expertise; indeed it is difficult to see how such expertise could be developed unless, for instance, a banking audit team decided to move from a Big Four firm to a smaller firm en masse (and even in this case there is no guarantee that banking clients would follow). Indeed, the risks and costs of attempting to compete in this market would be likely to far outweigh the benefits.

This is less of an issue in other sectors, where the key issues affecting (say) a large haulage company preparing its accounts under IFRS may not be significantly different from those affecting a smaller one. There may be issues of headcount and logistics to overcome but these could potentially be dealt with. Experience can, however, only be obtained by undertaking the relevant work and it is disappointing that many larger public companies do not give smaller firms the chance to show what they are capable of.

However, at present we believe that a key issue is that mid tier firms may well consider that the risks of taking on major listed entity audit work outweigh the benefits of doing so. The risks of taking on this work are both financial – as noted in our introduction, the risk of a ruinous action being taken against the firm because it is perceived to have the deepest pockets - and reputational, given the degree of adverse public comment and misinformation there has been about auditors in the media in recent years.

The additional levels of regulation involved also act as a barrier and ultimately these factors combine to make the rewards of taking on such work simply not worth the risk. What is needed in order to increase competition in the audit market is for it to be made more attractive to mid tier firms, not less, and this requires government to ensure that the regulatory framework is streamlined rather than added to – and that a workable limitation of liability mechanism is incorporated in statute as a matter of urgency.

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

Again, this question appears to presume a lack of competition 'across the board' in the profession which is simply not the case.

In respect of major listed entities – and particularly banking entities – the fees charged by any practice will reflect the size and complexity of the entity and the regulatory environment in which it operates, as well as the specialist knowledge which the audit team will require. It is simply not possible to generalise by stating that the fees charged by a large firm would necessarily be excessive. Moreover, competition does exist within the Big Four, and the fee that one of the large firms may charge for a particular audit will not necessarily be the same as what one of the other firms would charge.

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

There is no particular reason why a narrow field of competition would necessarily affect the objectivity of advice provided. The Ethical Standards for Auditors combined with the ICAEW code of ethics provide a robust framework of ethical standards and guidelines to ensure that auditor integrity is not compromised.

What is more likely as a result of a narrow field of competition is the existence of conflicts of interest. Again, there are mechanisms in the ethical framework for managing these, but the concentration does mean that issues are more likely to arise.

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

It is not clear from this question what the Committee means by 'unwelcome advice'. There may be many situations where an auditor is required, as a result of maintaining their own professional standards, to give advice which may not be what the client wants to hear. An

obvious example is where the auditor does not agree with the client's interpretation of a particular accounting standard, or where there is significant uncertainty over whether the client can continue as a going concern meaning the auditor needs to draw attention to this in his report. Giving such 'unwelcome advice' is entirely right and proper, and increased competition would not make it any easier for clients to obtain advice they liked (i.e. agreement with an incorrect accounting treatment) so long as accounting, auditing and ethical standards were correctly applied by audit firms.

There may however be an issue in terms of the numbers of firms that advice can be obtained from in other areas – for instance if a banking company wishes to obtain a second opinion in respect of a particular taxation issue. In this instance there will be relatively few firms that can be approached which inevitably does restrict client choice in this area.

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

The role of an auditor is, quite simply, to report to the members of the entity whether the financial statements give a true and fair view. This is the statutory purpose of an audit and we do not believe that there is any need for a change.

There have been calls recently for more detailed reporting by auditors, for instance expanded audit reports with more detailed discussions of audit issues. This call has come largely from the institutional investor community. However, the vast majority of UK companies simply do not have any institutional investors and any re-think of what the audit report contains, or the wider role of the auditor, must take account of this and not enforce additional burdens on auditors in providing an expanded report, or service, to clients who neither have a need for it or want it.

Moreover, the auditor's report is prepared as a result of the auditor's statutory requirement to report to the members and for no other purpose. Any expansion of the auditor's role risks creating a wider duty of care which would make it even more imperative for a workable liability limitation mechanism to be put in place.

As a side point, the provision of additional services – for instance taxation or corporate finance – by audit firms is not itself an expansion of the auditor's role; instead, it is a means of providing the best possible comprehensive service to the client.

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

Without examining the audit files of the auditors of major banks, it is impossible to say whether auditors were sufficiently sceptical (or not) in the run-up to the financial crisis. This point appears to be going over ground already covered by the McFall report, which whilst calling for prohibitions on non-audit services, did not conclude in any way that auditors

were to blame for the crisis. There is no suggestion that the audit profession was at fault and therefore no need to query the level of scepticism generally exercised. Professional scepticism is a key principle which underpins how audits are performed and although there has been public comment about auditor scepticism as well as comment from the Audit Inspection Unit (leading to the issue of an Auditing Practices Board discussion paper) it is debatable whether there is any hard evidence of pervasive issues.

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

Other than exercising their usual professional rigour when performing audits, it is difficult to see what auditors could have done to mitigate the banking crisis or how they could contribute to better supervision of banks. As noted above the role of an auditor, including the auditor of a bank, is to express an opinion to the members on the truth and fairness of the financial statements. The auditor has only failed in that role if something has not been brought to the attention of members that should have been, for instance going concern worries or an incorrect accounting treatment.

Clearly banks and other major listed companies have a public profile but the auditor has no duty of care to the general public; in any event, the accounts of such companies are available to the general public on their websites.

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

This will inevitably depend on the outcome of question 5 and must necessarily take into account the primary responsibility of auditors and their principal duty of care. Obviously for financial services clients there are already additional requirements for auditors to report to the FSA in respect of certain matters.

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

We do not believe that any additional incentives are necessary as audit firms should already be providing objective advice – even if it is not what the client wants to hear – if they are applying professional standards properly.

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

We would stress that a mechanism for avoiding or mitigating conflicts of interest between audit and non-audit services – which includes consultancy – already exists in the form of the Ethical Standards for Auditors and specifically Ethical Standard 5 which covers the provision of non-audit services to audit clients. If applied properly the Standards are effective in addressing such issues. Indeed there is no evidence whatsoever that the provision of non-

audit services by audit firms has had any adverse effect on audit quality. Rather, the provision of non-audit services by auditors results in the provision of a better service to the client.

This is clearly an issue which has been the focus of adverse comment in recent years particularly in the wake of Enron however it remains the case that auditors can provide non-audit services, including consultancy (which is an extremely broad term that can cover a wide variety of different services) so long as potential conflicts are identified and managed.

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

As noted in respect of the earlier questions, the issue is really whether more competition is needed for the audits of major listed entities, not whether it is required across the board, as for other entities the dominance of the Big Four is much less of an issue.

We do not believe that it will be possible to achieve more competition in the banking audit sector unless either a break-up of one of the Big Four takes place or a large number of their specialists (together with some major clients) defects to another firm. This is because of the level of specialist expertise required to audit banking entities, which will otherwise be extremely difficult for other firms to obtain.

We do, however, believe that there is scope for more competition to be introduced for the audit of other major listed entities because the mid tier firm are capable of serving such entities. The difficulty will be in convincing such entities that they do not need a Big Four auditor and this is something that would be difficult to achieve through statute. There may be mechanisms which could achieve better visibility for other audit firms to audit committees, for instance requiring all companies listed on the London Stock Exchange (except banks for the reasons noted above) to tender for new auditors every five years, and to include at least one non-Big Four auditor on the tender list; this would allow the mid tier, should they wish to, a chance to demonstrate their capabilities without enforcing any more draconian requirements such as mandatory rotation of auditors, which we believe would be counterproductive and lead to a reduced level of client service.

In terms of mechanisms which could be introduced through statute, as noted above the key mechanism to improve competition would be to agree a workable mechanism for limitation of auditor liability so that the risks of entering the market do not outweigh the benefits. It would also be beneficial to prohibit 'big four only' (or indeed any size restriction) clauses in a company's governing document or in banking covenants.

However, as noted in section 1, at present we believe that mid tier firms may well consider that the risks of taking on major listed entity audit work outweigh the benefits of doing so. This issue must be addressed as a priority. We would also stress, as noted in our introduction, that the larger firms (and the profession as a whole) make a significant contribution to the UK's gross domestic product and such businesses should be encouraged

to grow not only by encouraging competition but enabling them to service their clients without putting unnecessary barriers in their way as a result of misperceptions.

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

The role of the internal auditor is essentially that of an internal control and as such the external auditor may, or may not, place reliance on this control in the same way as any internal control. The role of internal audit and the scope of what internal audit does necessarily depends on the particular entity and indeed many smaller companies. including smaller listed companies, do not have an internal audit function. There does not seem to be a particular need to enhance the role of internal audit.

13. Should the role of audit committees be enhanced?

Following the consultation on non-audit services, there is likely to be an increased role for the audit committee in approving non-audit services supplied by the auditor to increase perceived transparency and make it clear that the entity, as well as the auditor, has considered any perceived or potential problems arising. As a result the FRC has proposed revisions to its guidance for audit committees. It is difficult in reading this question to know what the Committee has in mind other than this proposed enhancement.

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

The auditing profession can certainly assist in promoting good corporate governance, for instance advising clients on the extent to which their corporate governance does or does not comply with the Combined Code, and sharing examples of best practice. The profession also can and does assist by providing feedback on proposed new corporate governance requirements when they are still at a draft stage.

In summary, we would stress again that there is no evidence of systemic issues with audits and that the level of regulation already in place, together with the inability of the profession to limit its liability in a meaningful way, is profoundly inimical to competition in the audit market and needs to be addressed urgently.

8 September 2010

Letter from Mr Keith Labbett (ADT 63)

I attach a response to your invitation to submit evidence to the enquiry on auditors. The evidence represents my individual view and reflects on practice from within my organisation, where I am the Head of Audit, and others.

Letter from Mr Keith Labbett (ADT 63)

I have provided comment and ideas to those questions that apply to this organisation. These comments should be put in context to the size of my organisation, which has a £200m turnover and total assets of around £670m. This places us roughly as FTSE 350 equivalent.

I refer to a three tier governance model introduced in my organisation which may be of wider application in helping sort out and clarify roles and responsibilities of internal auditors, external auditors and the audit committee. In case it helps with understanding my points, I therefore also attach a schedule summarising our three tier governance model.

21 September 2010

Response to the questions posed by the Committee

1 Question 1: cause of concentration

1.1 It is suggested that concentration of references to the Big Four creates the perception of a restricted market and may create an unnecessary Barrier to entry. We have found the perceived restriction in the market unfounded.

1.2 We had, for many years, selected our external auditors from the largest eight accounting firms. In 2005, with fewer large firms, we extended the invitation to those outside of the Big Four to submit proposals for the external audit service. A firm outside of the Big Four was selected. This was because the proposed service levels outstripped the quality of service previously supplied to us and at lower rates. Five years on, the annual assessments of the external auditors by the Audit Committee have shown that the proposed service levels had been met each year. The extent and quality of value added services received from the previous auditors had not lessened and indeed, in some areas, the level of advice has increased.

2 Question 2: fees

The fee levels we pay have not been restricted by a lack of competition. While there may be insufficient competition between the Big Four we found adequate competition available outside of the Big Four. In the appointment competition, we found the fees proposed by firms in the Big Four were noticeably higher.

3 Question 3: objectivity

We found that there was no lessening of objectivity following the appointment of a firm outside of the Big Four. The firm's internal quality review arrangements provided us with assurance.

4 Question 4: unwelcome advice

Our observation comparing current and previous auditors is that the flow of advice, including that of an unwelcome nature, the extent of challenge, the content of the management letter and communication with stakeholders has not been affected. Indeed, this has reinforced our decision to make a change of appointment.

5 Question 5: role

It is necessary to read the whole annual report, including the Operating and Financial Review, to make an assessment of the performance of the organisation. As assurance on the annual report, it would be useful for the Board and stakeholders if the external auditors were to provide a summary of their view of the effectiveness of governance and management of risks to the corporate objectives as well as their conclusion on the accounts. While the Board determines the level of risk it is willing to take, the external auditors could usefully report whether the risk management framework was appropriate to the level of risks.

6 Question 6: banking scepticism

No comment.

7 Question 7: banking crisis mitigation

As part of their annual audit, our auditors have assessed the cash flow for the coming twelve months and the banking covenants against potential performance. With some significant projects having a longer development period, there may be merit to extending the review of cash resources beyond a 12 month horizon.

8 Question 8: sharing with supervisory bodies

No comment.

9 Question 9: incentives to provide unwelcome advice

There may be merit in requiring regulators to enquire of auditors whether or not they ascertained the reasons for any change in market performance of the company and whether they can demonstrate that such views had been shared with the company.

10 Question 10: consultancy

There is a difference between consultancy as added value to the company based on items observed during the external audit and consultancy in lieu of management identifying a recommended course of action. The first type of consultancy may not impact on subjectivity and, if performed within pre approved cost limits, may demonstrate their involvement in the management decision was limited. The second type of consultancy may have a significant impact on the organisation and, if performed by the external auditor, may be seen as affecting their objectivity and independence from management action. The size of any consultancy fee may also affect the perception of the objectivity and independence of the external auditor.

11 Question 11: competition

The issue is partly because of use of the term Big Four. It may be an unnecessary extra level of certification to set down criteria that allows smaller firms to be assessed by the market as competent. Instead, market perceptions and practice may change if the term is widened to include firms that audit the FTSE350, say.

12 Question 12: enhancing the internal audit role

12.1 Internal Audit is a function of scope, standing and capabilities and the strength of the surrounding governance process. It is the eyes and ears of the audit committee.

Current practice is for audit committees to approve the scope of internal audit and its plan of work. It would help if best practice was for the audit committee to approve the appointment, resourcing and reward of internal audit.

12.2 Internal audit value to an organisation increases as the extent of its strategic coverage widens and as the management level reading the audit reports increases. Such internal audit provision can be provided by a small team of management literate auditors and should be seen as distinct from the checking and monitoring functions which should rest within management. In essence, we would strongly advocate the three tier governance control model as an effective way of enhancing the role of internal audit. [7]

12.3 Internal audit, as an informed source of information of corporate priorities and processes, could assist the external auditors in understanding and planning their work. The external auditors could use the model to assess where they could place reliance - not just for reliance on internal audit but on the wider control process.

13 Question 13: audit committees

While many audit committees may not need any incentive or support, there may be merit in identifying why some audit committees are effective. A driver for effectiveness may be from greater visibility of the work and coverage of the audit committee. This could be detailed in the annual report, on the organisation's website and at the annual meeting. Often, the ability for an audit committee to provide adequate challenge depends on its sources of quality, relevant information. This should relate to reviewing the key management reports, rather than restricted to the external financial statements. Further enhancement could be by extending a statement that it had undertaken a review by providing the extent of its findings on such a review. This could be applied to compliance with regulations and to risk management.

14 Question 14: promoting governance

The profession, lead by the Institutes, should be well placed because of the number of its members employed in relevant positions within organisations and also with its network for influencing leaders. This role may weaken if the Institutes focus more on financial aspects rather than business performance.

[7] In the three tier governance model, Level 1 control is the ongoing checking of transactions, Level 2 is the monitoring of the checking process to determine improvements, and Level 3 is the overview provided by the audit committee and internal audit function.

Letter from Mr Keith Labbett (ADT 63)

Governance control model: showing how the Executive is supported by a three tier control: delivery unit - functional specialists - audit

Executive

Accountability: Executive reports to the Board

Plan: address foreseeable demands, setting resulting business planning assumptions followed by preparing a three year corporate plan
Do: set targets, approve standards, mandatory processes and competences
Monitor: forecast reviews, identifying changes to plan
Correct: revised forecasts and actions followed though to implementation

1st control tier Audit

Accountability: Audit Committee assesses effectiveness of controls over business risks

Plan: Audit Plan covering major risks to the corporate plan over a three year period
Do: report level of assurance to the Audit Committee
Monitor: Audit Committee oversight of the results and that the proposed actions accurately deal with the cause of risks
Correct: monitoring of timely implementation of management actions

2nd control tier Central functional specialists - technical, safety, heritage, environmental, personnel, finance, customers

Accountability: setting and monitoring standards

Plan: propose process, standards, competences having agreed the resource impact
understanding the external environment that might impact on standards and priorities
Do: publish process and task definitions with accountabilities clearly allocated
Monitor: validate business unit reported achievements of targets and compliance with standards including competence by personal observation and testing. Frequency of monitoring adjusted by extent of non achievement.
Identify trends, systemic weaknesses, training need, lack of clarity in processes, changes in business and customer relevance, simplification opportunities

report to Executive on reliability and integrity of unit management reports using tools such as league tables, traffic light reports and lead and lag indicators.

Correct: revise standards, revise process and tasks as a result of best practice, innovation and continuous improvement
refer up unmanaged risk

3rd control tier Delivery unit - local business units, shared services, commercial teams

Accountability: delivering targets and standards.

Plan: undertake risk assessments to determine proportionate level and frequency of action

Do: delivery function: follow process and task definitions
ensure people have appropriate competences
identify areas for efficiency and innovation including process improvement

Monitor: measure targets and standards and check their reliability and integrity by personal observation and testing. Tools include, operating statement, lead and lag indicators and traffic light reports from Central Functional teams
report measures to Executive

Correct: identify corrective actions and timetable, redirect resources, and follow up implementation
refer up unmanaged risk

17141w

Memorandum by Professor Kevin McMeeking[8] (ADT 64)

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

1. Auditing is ***not*** concentrated on four global firms in all segments of the market. The level of concentration varies from one country to another and increases with entity size. Small and medium sized accounting firms compete effectively for the contracts of unlisted entities and small listed companies in the UK, in some cases winning contracts where there is no requirement to have an audit because the company is below the size threshold. Small and medium sized accounting firms also have an active presence in the medium size listed company market in the UK and across all listed companies in many countries.

2. In the UK, the Big Four accounting firms provide the audit and consultancy advice for virtually all of FTSE350 market. Small and medium sized firms are unable to effectively compete in this segment of the market for a number of reasons. From a supply side perspective, the mergers between the leading accounting firms and the demise of Andersen contributed significantly to the increase in concentration. Consistent with signaling theory, the Big Four accounting firms promote themselves as industry specialists (Zeff and Fossum, 1967; Danos and Eichenseher, 1981, 1982), using the popular press and their websites to advertise their expertise in specific industries and to claim to provide a higher quality service and greater value (Berton, 1995). From a demand side perspective, companies have become more globalised and their control systems and financial statements have increased in size and become more industry specific. Multinational companies have increasingly sought the services of a brand name firm that offers higher (industry specialist) levels of audit performance and expertise beyond the generic level mandated by statute (Shockley and Holt, 1983; Bonner and Lewis, 1990; Ashton, 1991) and is able to significantly reduce industry-specific agency and other costs (Jensen and Meckling, 1976). Companies are willing to pay a premium for the services of a brand name audit firm (McMeeking et al., 2006) which may be more capable of mitigating earnings management (Krishnan, 2003).

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

3. Industrial economists argue that market structure is intrinsically linked to firm behaviour and financial performance. Scholars urge regulators to be wary of the pricing effects of increases in market concentration (Scherer and Ross, 1990; Stigler, 1968; Gist and Michaels, 1995; Romeo, 1999). The extant literature on the welfare effects of mergers on the economy is mixed (Francis et al., 1999). Consumer welfare will increase if mergers reduce marginal costs, create efficiencies and enhance product differentiation but will decrease if mergers enable tacit collusion over prices or if unilateral anticompetitive effects arise from non-tacit price collusion (Sullivan, 2002).

4. Studies argue that the high concentration has not improved the level of price competition in the UK audit market (Oxera, 2006; McMeeking et al., 2006) but without cost data it is difficult to test whether accounting firms are engaging in anticompetitive pricing

[88] This paper summarises the opinion of Associate Professor Kevin McMeeking, of the University of Exeter, on an individual basis. The paper responds to the questions raised by the committee drawing from the academic auditing, financial reporting and corporate governance strands of extant literature. I am grateful for the helpful comments of Professor Peter Pope but take sole responsibility for any remaining errors.

strategies. Companies are free to change auditors if they feel they are being overpriced, assuming that there is a viable alternative, although the significant switching costs for both the company and the auditors may explain why the rate of rotation (around 4% p.a.) is very low.

Does a narrow field of competition affect objectivity of advice provided? Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?

5. Choice and the governance of accounting firms have attracted more attention in recent years than pricing (Financial Reporting Council, 2007; Murray, 2010; Abidin et al., 2010). The limited choice, which is as low as one accounting firm in some industries, is often attributed to desire for specialist advice. This lack of choice could provide accounting firm with the opportunity to exercise monopolistic pricing and/or reduce the quality of the advice offered. If poor assurance is defined as an entity that enters into insolvency proceedings or is bailed out by the government shortly after receiving a clean audit report then the size and scope of recent failings suggests that there is an association between choice and the quality of advice.

6. This potential quality issue has been exacerbated by the acknowledgement of the FRC, SEC and PCAOB that they cannot afford to lose another Big Four audit firm. The Big Four used the market uncertainty, threatening a ‘four to zero’ scenario to leverage favourable legislative changes in the form of a cap and proportionate liability (McMeeking, 2009; Sikka, 2006) which if not carefully monitored may cause audit firms to cut corners in the interest of profit. It is not clear whether the regulatory bodies have a plan for ensuring the integrity of financial information if the current model collapses. Critics argue that the Big Four firms are ‘too big to fail’ (Greenwood and Suddaby, 2006) do not fear being indicted, and is worryingly reminiscent of the banking sector prior to the crisis. Since the partners are heavily exposed on an individual level, the assurance provided by firms that are severely strained financially and strategically by the size of pending litigation may be compromised and there is a significant risk that leaders spend most of their time addressing, evading or settling claims rather than improving audit quality. The potential for another major failure will always exist because personal gain may cloud professional judgement and ethical values. The firms, institutes, regulatory bodies and universities have a vital role in stressing the virtues of ethics, professionalism and high quality assurance, particularly in this period of economic uncertainty.

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

7. The auditor’s role is to be a gatekeeper, a watchdog not a bloodhound. Although auditors work for the shareholders, the relationship is unusual because the company contracts with them and pays the fees. Auditors have a public duty to shareholders but there is a risk that they may become too close to management. I do not envisage any major changes in the role of the auditor in the future.

Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor? What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?

8. The scale and scope of the financial crisis and the scarcity of unqualified audit reports suggests that audit firms were not sceptical enough prior to the crisis. It is difficult to say that a lack of competition caused the crisis because of the limited counterfactual evidence but the financial services market had an extremely limited choice of auditors and was worse hit than other sectors. It is vital that auditors act as gatekeepers, any methodological failings are removed and more audit effort is exerted if confidence is to be fully restored in the market. If accounting firms respond to the economic downturn by cutting corners on audits then further problems are inevitable.

9. All of the blame for the banking crisis cannot be levelled at the audit firms. The lack of understanding of new financial products, particularly credit default swaps, also had a major role to play in the economic downturn. Management are responsible for reporting the size and scope of the risks that their entity is exposed to. Whether through ignorance or avoidance several banks failed to acknowledge and/or disclose sufficient information about the credit and liquidity risks associated with their financial instruments. More work is required to improve the quality of financial reporting (e.g. IAS32, IAS39 and IFRS7) for both financials and non-financials and the education and training of directors in the area of financial instruments.

10. The banking crisis represents a failure of corporate governance. Following previous scandals, considerable effort has been expended on improving the corporate governance of companies (Combined Code). Although accounting firms do not have the same separation of ownership and control issues that companies possess, similar best practice requirements have been introduced for the eight leading accounting firms in the UK (the Murray Code). It is not clear a priori whether the Murray Code will improve corporate governance. For example, the appointment of non-executive directors should improve governance if the best individuals are chosen that are able and willing to contribute to the operations and decision making of the firm. Regulators can then consider the cost/benefit implications of rolling the Murray Code 'best practice' to small and medium sized accounting firms. On the other hand if the eight leading accounting firms recruit individuals that lack independence, pedigree, application or attention to detail, then this aspect of the Murray Code will not improve corporate governance.

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

11. There are clear potential conflicts of interest between audit and consultancy roles that have the potential to impair independence. These issues have been highlighted many times, most notably perhaps in the Sarbannes Oxley Act: "*They (Auditors) also performed significant non-audit or consulting work for the companies they audited. Many of these consulting agreements were far more lucrative than the auditing engagement. This presented at least the appearance of a conflict of interest. For example, challenging the company's accounting approach might damage a client relationship, conceivably placing a significant consulting arrangement at risk, damaging the auditing firm's bottom line*." The only failsafe solution to minimise these conflicts is to prohibit the provision of consultancy advice by accounting firms to their audit clients. Accounting firms have long argued that they are best placed to provide consultancy advice and they have 'Chinese Walls' to segregate their audit from consultancy wings. However, critics have long cast doubts about the validity of these segregation claims. Prohibition may improve independence but will not enhance choice if the consultancy contracts of large companies are cross referred amongst the Big Four.

12. An alternative solution is to require companies to disclose the fees paid to auditors and other firms for consultancy work on both individual audits and at firm level. Shareholders that take an active role in the stewardship of the company can decide with the audit committee whether or not the existing provisions are appropriate. This is a less draconian measure but requires the input of stakeholders in the corporate governance process. One problem with this model is that accounting firms have the potential to manipulate their figures because audit and consultancy advice may overlap.

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

13. It will take many years, if it is possible at all, to increase competition in the large company audit market using market measures. The Market Participants Group annual reports indicate that there has been little if any improvement in choice since the publication of the Oxera report. The Market Participants Group will continue to monitor developments but the lack of change in the market is unsurprising (McMeeking, 2009). If improving choice is deemed essential to improved corporate governance, an alternative option is for regulatory bodies to intervene and break up the Big Four. This would be controversial and possibly problematic (requiring the authority of regulatory bodies across countries) but it has been enforced in Japan (Accountancy Age, 2006) and might improve quality by overcoming the 'too big to fail' issue.

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

14. I believe that the role of internal auditors and audit committees is appropriate but there is scope for more active engagement and interaction with external auditors.

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

15. The auditing profession is well placed to improve corporate governance. Altering the mindset of auditors, company directors and banks is fundamentally important to the prevention of future scandals. The search for high yields, short term strategies and a reduced cost base is excessive risky and must be overturned to improve the sustainability of the business entities.

September 2010

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Memorandum by Mr Cliff Moggs (ADT 65)

"The need for openness, providing transparency to increase confidence."

Preface.

It took only one Engagement Partner to bring about the demise of Arthur Andersen in the Enron scandal. USA legislation created the 'formal approval of the audit opinion' by a process under the responsibility of the Engagement Quality Control Reviewer. The profession remains relatively quiet on this responsibility and the work performed. Regardless of the size of an audit firm these two individuals significantly influence the confidence in the market for the work undertaken. Are there

not two impacts that with ease can bring about significant improvement in the process of an audit of financial statements?

Discussion.

Two changes to current behaviour will provide greater confidence from the work of the audit. It is based on 'openness enabling transparency leading to increased confidence in the published results'. Both parties contribute in changes to culture for the entities and the auditors; in being open, it creates transparency, knowing will establish confidence for the work performed. It will be in the public domain open for observation and criticism.

The audited entities will release the fact that auditor changes were made or not made to the financial statements as prepared by the Board of Directors before an audit opinion was approved for release. In so doing shareholders will be informed as to why changes, if any, were necessary. This facilitates transparency of the differing view and reasoning for understanding. For those entities that demonstrate corporate integrity in the preparation of their financial statements clear recognition will be acknowledged by this clarity. Shareholders will have increased knowledge of the work of the Board of Directors in its ability to present financial statements that are worthy of an unqualified opinion. The sceptical assessment by an independent auditor approved by the Engagement Quality Control Reviewer ratifies the Boards judgement of its financial position.

On the audit side; it is a requirement that before release of the proposed opinion the Engagement Quality Control Reviewer (EQCR) will have examined all of the Engagement Partner's (EP) critical judgements and evidence used to arrive at their proposed opinion. However, there is no public (open) recognition that the EQCR granted their approval to enable the EP to issue the opinion. The work of the EQCR and name can quite easily be as an appendix to the auditor's opinion statement. It is interesting to note that in the USA "Sarbanes-Oxley Act of 2002" Section 103 (part) quote "provide a concurring or second partner review and approval of such audit report……" This addressed the issue of the Arthur Andersen EP rejecting AA's expert opinion on specific accounting treatment in the Enron scandal. Although this is now part of the audit standard on Quality Control (ISQC 1) the language used is passive and "approval" is excluded from the definition of the EQCR's responsibility; whereas the definition of the EP is complete.

Perhaps a 'step too far' would be to re-look at the 'proposal' made by Alex Arthur (Dept of Accountancy & Finance, Univ. of Aberdeen). His suggestion was to 'untangle and re-arrange the relationship between directors, shareholders, auditors and professional liability insurers (PII).'

PII's would sell to Directors indemnity insurance to cover themselves against shareholder's claims for false accounting (The auditors no longer need PII and the PII fees are now collected from the Directors who pay from funds of the not needed audit fee). The 'auditors' now earn their fees from the PII who engages them to be risk assessors (auditing the entities financial statements and internal controls).

The auditors are now truly independent and the Directors can advise their shareholders the 'cost of indemnity insurance' to cover for falsification of the financial statements. The entities financial statements would carry the PII's risk assessment category. In that the 'liability insurers' pick up the tab anyway they benefit from having the risk assessment task considerably simplified.

The first step of 'openness, transparency, confidence' could be accomplished in essence overnight. This in itself would minimize market firm concentration concerns by putting the EP and the EQCR in the public domain which coupled with such added knowledge, "were the financial statements changed to enable an unqualified opinion to be expressed?" will lead to increase confidence levels.

The re-alignment of the 'parties' to capture true responsibilities clearly would take longer.

23 September 2010

Memorandum by Mr P J Morgan (ADT 66)

Introduction

1. This submission concerns the near collapse of West Bromwich Building Society ("WBBS") at the height of the credit crunch, discusses whether the audit arrangements contributed to that near failure, and makes suggestions for improvements in the audit arrangements for this and other entities.

2. After the merger of the Chelsea with the Yorkshire, WWBS is the 6th largest UK Building Society in terms of gross assets. Though the Nationwide is larger than the other 48 Societies combined, at 31 March 2010 WBBS employed 871 staff and reported assets of over £8.3 Billion.

3. The writer is a member of the Society. He both has an ISA direct savings account in WBBS and is a holder of WBBS Permanent interest bearing shares (PIBS). As a direct result of the near collapse of the Society and the sudden capital restructuring in June 2009, the writer lost virtually all of the value of his PIBS investment. Because of this personal loss and because he has extensive large firm auditing experience himself (PWC), the writer has a keen interest in the subject of the committee's enquiries.

4. The submission is set out under the following headings:

- WBBS business and capital restructurings and the circumstances thereof
- WBBS audit arrangements, their possible relevance to its near collapse and suggestions for improvements
- Responses to questions posed by the call for evidence

WBBS business and capital restructurings and the circumstances thereof

WBBS business restructuring

5. In October 2008, WBBS replaced its CEO and subsequently its financial and commercial directors, the first two executives at considerable severance cost. The new CEO, Robert Sharpe, announced a completely new business strategy which he describes as "back to basics". The main components, according to the 2009 accounts, are: cessation of commercial lending and a new concentration on provision of prime residential mortgages; a drastic reduction in wholesale funding and concentration on retail deposits; a drive to

become the UK's most cost efficient society, reducing the cost base by at least a quarter; and to recognise and manage the inherent risk in the balance sheet.

WBBS report significant losses and a capital restructuring

6. The need for change became clear on 12 June 2009, when WBBS announced post tax losses for the year of £39.3 Million, including provisions for doubtful and bad debts of £65.2 Million (see attached accounts).

7. At the same time, it announced an unexpected capital restructuring, the so-called 'Capital Exchange'. The main elements were: (1) holders of £182.5 Million of listed debt would immediately convert all of their debt into Profit Participating deferred shares (PPDS), a new loss absorbing financial instrument created on 1 June 2009 by the FSA for Building Societies, with a 25% share of profits (and losses) in lieu of interest, and (2) interest payable to its £75 Million PIBS holders would in future be restricted to the lower of the coupon (6.15%) and the yield paid to PPDS holders in the previous financial year.

8. The effect of these changes was to increase the Society's core I capital ratio from 6.8% to 11.6%. The effect on the market value of listed PIBS was a loss of approximately 85% in their £1 Nominal value. The accounts disclosed that the CEO and FD were paid bonuses of £250,000 in total for saving the Society.

9. In his letter to PIBS holders dated 11 August 2009, the WBBS Chair stated "In order to address the possibility of administration and break up, like Dunfermline Building Society, and the likely adverse impact that this would have on the Subordinated Debt and, by clear implication the PIBS (because they ranked below the Subordinated Debt), the Society's Directors concluded that it was necessary and in the best interests of the PIBS holders and the Society's other members to agree to the Capital Exchange on these terms." The CEO had earlier told the writer at a meeting on 2 July 2009 that if the Capital Exchange had not been agreed, the auditors would have qualified the accounts on a going concern basis and the Society would have gone into administration.

10. The subsequent AGM on 29 July 2009 was described by one national newspaper (Financial Mail) "as hostile a building society meeting as we have ever seen as one member after another (some three times) stood up to berate the Board." According to the minutes, the Chair conceded, inter alia, that "the Board had certainly not gambled; judgements were made (which dated back several years) which proved in the circumstances over the past 12 months to have been wrong."

11. It is clear that the high risks involved in the previous business strategy became all too apparent in 2008/9. That said, one should always bear in mind that where there has been a complete change of top management and business strategy, as in this case, it is natural for the new management to insist on the maximum provisioning for the costs of the changes in direction.

WBBS audit arrangements, their possible relevance to the near collapse, and suggestions for improvements

Method of appointment of external auditors

12. Whilst the auditors report formally to the members, the appointment of auditors is, according to the regulations applicable to all Societies, on the annual recommendation of the Board. That recommendation is then, effectively, "rubber stamped" traditionally and overwhelmingly (as with other AGM resolutions 90%+) by members' proxy votes. Those proxy votes are lodged prior to any discussions at the AGM and, usually, without sight of the minutes of the previous year's AGM. WBBS AGMs seem relatively well-attended but, even so, attendee members total less than 200, whereas the total voting membership is reported to be over 600,000. Proxy votes on all resolutions are, therefore, of such significance that the Chair of the meeting announces the result of the votes on all resolutions prior to the counting of the votes actually cast at the meeting.

13. The minutes of the previous AGM (normally agreed by the Board at its first meeting after the AGM) are not automatically distributed to members along with the notice of the meeting and voting papers. This is normal practice of course in any large organisation. However, it means that comments made by members at the previous AGM (whether on audit or any other matter) are generally not available to members lodging proxy votes, unless they specifically ask for a copy of the previous minutes. Absence of the minutes of the previous AGM can have an impact on the way proxy votes are cast. As such, it also reduces the incentive for members to attend and make the effort to put forward dissenting or challenging views at the meeting.

14. In effect, therefore, the auditors are appointed annually by the Board, on whose accounts they report.

Relationship between external auditors and members

15. The auditors of the Society for many years have been KPMG. Their formal audit reports (which are addressed to the members) have been unqualified, so far as the writer is able to determine. It is noteworthy that no questions were raised with the auditors at either the 2009 or the 2010 AGMs.

16. There is currently no forum for concerns to be raised *in detail* directly with the auditors by members as a group, other than at the AGM. The AGM is not an appropriate forum for detailed discussion on technical matters and, in any case, the accounts are approved (by the Board) at that stage. Nor is there any forum on a routine basis, nor incentive, on the part of the auditors, to raise any concerns with the wider membership, the audit appointment being a commercial arrangement, in effect in the gift of the Board (see above).

17. In fact there can be little member involvement with the auditors, unless individual members should take it upon themselves to write to them. As can be appreciated, raising concerns in that way may have limited, if any, effect, compared with open and transparent debate with members as a group.

18. For the committee's information, in this case, the writer has in fact recently written to KPMG to express concerns about several matters of accounting treatment in the WBBS annual accounts and awaits a formal response. Though individually the matters concerned are not that material, the writer is also concerned about the cumulative effect. To be fair to the auditors, KPMG were courteous when initially approached and offered a meeting with the writer to discuss the points.

19. The reason for mentioning this correspondence is that where there are alternative accounting treatments for potentially contentious issues, it would be helpful to members if the auditors have an opportunity to explain, directly to members, the different accounting treatments which could be adopted, the implications of the different treatments, and the reasons for the auditors' decisions. Whilst discussion of such matters no doubt takes place in the Board's audit committee behind closed doors, that is no substitute for direct dialogue with members as a group.

20. Over highly contentious issues, it is in effect often left to the financial press to raise concerns amongst the wider membership and public, etc. For the debate of complex technical issues and "gray areas" of accounting treatments, that is not the most appropriate forum. In any event, in most cases, such issues will not attract media attention.

Possible relevance of audit arrangements to the near collapse of WBBS

21. In the years prior to 2008/9, it is quite possible that the auditors had reservations about the previous business strategy of the Board and the previous management – and hence, the adequacy of provisioning, etc.

22. Thereby the writer does not mean to impugn the professional integrity of the auditors in this, or in any other similar case. It is not the auditors' responsibility to second guess the Board's business strategy. No doubt the ever increasing proliferation of accounting standards and formal guidance (no doubt well intentioned and properly established), together with the size and complexity of organisations like WBBS, have also contributed to a shift in focus in this respect. However, in retrospect, if members had been able to question the auditors' views *routinely*, about the possible implications of the apparently high risk business strategy the Board was pursuing, this may have averted the need for the drastic action subsequently required.

Suggestions for improvements in the member/auditor relationship

23. Such a forum might, for example, be a requirement of auditors to report more comprehensively at the AGM and submit to questions from members? As part of that process, entities should be required by law to circulate minutes of the previous AGM to members (or make them available on their websites) along with the notice of the meeting and the accounts. Difficulties, such as attempts by attenders to use AGMs for self promotion, are in my view of far less concern than members' not having access to these minutes prior to their lodging proxy votes.

24. Whilst such developments would be welcome, the AGM is not, in my view, an appropriate forum for discussion of technical detail. In any case, the AGM occurs well after the year-end and after the accounts have been approved. A better solution to more involvement of members would be the establishment of the equivalent of a shareholder committee chaired by a Board member (such as supported by UKSA), with a right, inter alia, to question the auditors? A copy of UKSA's summary paper on this proposal is attached to this submission. I have mentioned this suggestion to both the Board and the auditors, but so far there has been no reaction.

Response to questions posed by the call for evidence

25. The questions posed by the call for evidence suggest that the effectiveness of external audit services can be improved by such factors as:- increased competition, better audit committee arrangements, separation of consultancy from pure audit services, increased dialogue with regulators, and even changing the role of auditors. Whilst all of these could have some effect, the single most important element in my view is, with respect, missing from this list of suggestions. That is to make more effective the *role of members* in the appointment, work and output of external audit services.

26. After all, *who* is the client in question 9? Is the Board, which is the legal representative of the audited entity, the client of the audit firm? This is seemingly implied by that question? So often that is the case in reality. Whereas, it is usually the activities of the *Board* that the *members* (to whom the auditors are supposed to report) want independent opinions about!

27. And is the Board otherwise accountable to members? At a Building Society, whilst the Board is theoretically appointed by the members, long gone are the days when members were presented with alternative candidates to choose from, for election - with curriculum vitae and a personal statement. At WBBS, for example, non-executive positions are routinely filled via the casual vacancy provisions, after vetting by the FSA. Accountability of the Board to members is in practice severely limited, as it would appear to have been the case at two of the UK's major banks.

28. So I suggest that the committee should give some thought to how the role of members of all large organisations, and particularly *the private investor* (see below), can be enhanced in relation to audit services. In that way we may be able to return, in some measure, to the relationships between members, the Board and the auditors, which became the cornerstone of our successful limited liability capital structures.

29. As regards members' input, a distinction needs to be made here between the interests and perspectives of institutional members and non-institutional members (private investors). At WBBS, the PIBS changes affected non-institutional PIBS holders directly (their income and their personal capital wealth). Hence, such investors were inclined to protest, and indeed protested volubly at, what they perceived as unfair treatment in the capital restructuring, especially when they were not consulted and were usually unable to vote at the PIBS holders' meeting (because of holdings via pooled ISA and SIPP accounts).

30. The perspective of institutional PIBS holders was different, because they are an intermediary, managing other people's money. WBBS PIBS would undoubtedly represent a very small proportion of funds under management. Displaying a more passive reaction to the changes, they were more inclined to accept the changes without undue protest. No doubt many institutional PIBS holders concluded, understandably, that they would not be acting in the best interests of their investors if they devoted disproportionate resource to this problem, when that resource might be better employed on potentially more fruitful activities on behalf of their investors.

24 September 2010

<u>Annexes</u>

WBBS accounts for years ending 31 March 2009 and 2010 (re para 6) (not republished here)

UKSA summary paper on shareholder committees (re para 24) (not republished here)

Letter from Mr Bob Pigeon, Chartered Accountant (ADT 67)

You ask for evidence to your Select Committee upon the role of Auditors. I am a 65 year-old Chartered Accountant, trained as an Auditor but spending most of my career in Industry.
Coincidentally I have just written to my MP, Mark Hunter as follows: -

"The Government is proposing to close down the Audit Commission and pass its work to Accounting Firms. They must be salivating. I attach a copy of the lead from this month's Accountancy magazine. Are these safe hands into which to pass this work? (Not reprinted here)

I give you another alternative: -
1) Transfer all Company Audits to a beefed up HMRC
2) Obviously HMRC look at these companies anyway. This change would allow them to do much more detailed checks, which has to improve the tax take.
3) Then give HMRC the responsibility of auditing Public Bodies as well

I reckon that Points (1) & (2) should save £2.9 Billion annually as per the attached (Appendix 1) calculation and you should save 75% more out of the Audit Commission transfer.

Of course fellow members of my Institute will cry Blue (or Orange) Murder but they do not deserve any less. I personally have been ashamed of the recent Audit failures particularly Enron. Audit reports have been diluted so much from my early days of a "True and Fair View" that actually meant something. This proposal will put a lot of my fellow members out of work but in the medium term that will be to the benefit of UK PLC because so much talent goes into the Accounting profession, which could be more productively used elsewhere. Last time I looked the proportion of Engineering and Chemistry Graduates going into my profession was ridiculous. Admittedly that was some time ago.
The General Public would welcome such a move almost as much as the Bankers getting their comeuppance!

Please get Vince Cable to tell me why this would not work or preferably implement it."

For the sake of completeness, I attach the leader from this month's Accountancy[9], which you may well have seen and my calculations.

Reverting to the questions asked, I would reply as follows: -

1. *Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete?* Partly yes but perhaps more importantly if you do not have one of the big four as the Group FD you are putting your neck on the block. Taking one of them is the easy option. Any other course would have to be heavily justified. Also nearly 50 years ago I did my Articles for a firm called Cooper and Cooper, now Cooper Adamson. Prior to the first World War that company was actually one of the big ten because it ran Rubber Settlement

[9] Not published here.

House when Rubber was king. The firm had dwindled as Rubber dwindled but still held onto a few big Audits including EMI. I think we did a pretty good job but Cooper Brothers as they were then, now PWC, found it easy pickings to persuade the Board that we should be replaced by them. When they focus their power and influence, a small audit firm has no chance. Certainly in those days it would have been the attraction of their other specialities such as Tax that would have influenced the decision.

2. *Does a lack of competition mean clients are charged excessive fees?* Probably not. Any FD worth his salt will have held a beauty parade at least once every 5 years

3. *Does a narrow field of competition affect objectivity of advice provided?* A good FD will run rings round the Auditors because he knows the business and they can only scratch the surface. Is he likely to be open to advice? If he wants advice he will have got it from one source or another before the audit. If, as is likely he has got it from his auditors on a particularly sticky point, they are not going to exactly query it as can be seen from the disastrous green light given to the Banks' off balance sheet items that would not have been acceptable to an American Auditor. So it is not the "narrow field of competition" but other issues that turns the audit into largely a rubber stamping exercise. Only when a company is in real demonstrable trouble will the balance of power move from the FD to the Auditor

4. *Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere?* See 3. Limited competition is irrelevant

5. *What is the role of auditors and should it be changed?* You will see from my letter my personal sadness at the way the audit has diminished. It HAS to be changed and I like to think that I have given you a rather clever alternative.

6. *Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008?* Absolutely not but it would have needed a very strong man to stand up against the perception of what was acceptable however erroneous. "The Emperor's new clothes" surely is an apt description of events except that we did not even have the small boy to point out that "the King is in the altogether...". But then what is new? Enron when you look at it in any detail was much worse. There was a "small boy" crying foul and everybody laughed at her and she was fired for her trouble if I remember correctly. More importantly the way that dubious profits were manufactured and all taken up front could never be justified to even a first year articled clerk. I was and remain disgusted at the antics of the Auditors shredding the records of their incompetence after trying to justify their actions on the Today programme. Get a transcript of that interview. I am sure that it is relevant evidence. I was and remain disgusted that a once well respected English Chartered Accountant was a member of the Audit Committee.

   If not, was the lack of competition in auditing a contributory factor? Lack of competition has nothing to do with it. The relationship is just too cosy.

7. *What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks?* Go back to earlier failures. Usually you find that either the CEO and most of the Board either know that there is something

badly wrong and are doing a cover up job or they really do not understand what is going on in their own business but "Trust" their underlings. In either of those circumstances you have to have an extremely cynical, very objective and highly experienced team of auditors to pick it up. Or do you? If the underlying principle of every thing was KISS (Keep It Simple Stupid) and if it was not explicable to the uninitiated then it was not acceptable, then surely we would all be a lot happier. For example, why do they need off balance sheet transactions? Because the Company is up to no good either to avoid tax, regulation, its auditors or its shareholders. It takes a brave man to say I do not understand and I am not signing off your accounts until I do. So Auditors, regulation and Tax all need to go hand in hand. Again I have given you a potential solution, which actually will save money.

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

9. *If need be, how could incentives to provide objective and, in some cases unwelcome, advice to clients be strengthened?* Whilst Auditors are in thrall to the Board they will never be strong enough.

10. *Do conflicts of interest arise between audit and consultancy roles?* Of course
    If so, how should they be avoided or mitigated? See my e-mail to Mark Hunter.

11. *Should more competition be introduced into auditing? If so, how?* By taking it out of the hands of the current Auditors.

12. *Should the role of internal auditors be enhanced and how should they interact with external auditors?* How is somebody paid by the Company going to comfortably rat on it to the Auditors? Occasionally perhaps but very seldom. It is a "red herring"

13. *Should the role of audit committees be enhanced?* I do not see that you can enhance it whilst the whole operation is so cosy. The answers to question (6) & (7) are relevant. Like Internal Auditors, it is a useful tool but when the going gets rough it will either be swamped or totally ineffectual. There is no alternative but to make Auditors entirely independent of the Board and to give them real teeth allowing them to be "red in tooth and claw".

14. *Is the auditing profession well placed to promote improvement in corporate governance?* No way. Radical change is needed and they have 100% vested interest in avoiding that.

I hope that helps you. I am sure that you appreciate that at 65 I find it very sad that I should be so dismissive of so much of my profession. I could be equally critical of the legal profession. Of course the largest impediment that will be put in your way in the unlikely event that you choose to support my proposal is that any change has to be done Internationally to avoid undermining our competitive position as a Financial centre. Sadly there is merit in that argument but you will never have a better opportunity of persuading the Americans to go along a similar course. Job Done.

2 September 2010

Appendix 1

Theoretical Savings from HMRC taking over Company Audits

				24th August 2010	
				£ Million	
1	Audit Fees for the FTSE 350		2005	897	
	Source	http://images.vnunet.com/bif_static/pdf/FD_jan05_auditfees.pdf			
	Inflate by	10%		89.7	
				986.7	
2	Estimated Hours at	£200	per hour	4,933,500	
3	HMRC Cost	£60,000	p.a.		
	for an average employee				
	Chargeable time			£/hour	
	200 days @	6	hours	50	
					£ Million
4	"Profit"				740
5	2010 Corporation Tax			£ Billion	
	per Office for Budget Responsibility			43	
6	Closer scrutiny has to increase this take by at least				
				5%	2,150
					2,890

Notes

a) Assume legislation fixes Audit fees at there 2010 % of turnover

b) Inspector's Time would have already been spent on the Tax Review

c) HMRC take no longer to do the work than private firms.
Indeed they would employ 4,111 Accountants direct from the profession just for this task.
This also removes the oft repeated complaint that there are not enough Accountants monitoring Government spending

d) Appoint a Senior Accountant from Industry not the profession to implement this

e) The biggest problem will be International acceptance but why should not the USA take up the idea too?!

Memorandum by Professor Brenda Porter, Professor of Accounting (retired) (ADT 68)

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 visa 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 auditor[10] 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

[10] A recommendation the directors must put to the company's shareholders or explain why they are proposing an alternative auditor.

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 ensuing 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.

12 November 2010

Memorandum by Sir Michael Snyder, Professional and Business Services Group (ADT 69)

This paper is submitted on behalf of the Chairman of the Professional & Business Services Group, Sir Michael Snyder, and gives an overview of issues and topics discussed within the Group meetings. The P&BSG was recently established to advise Government on the policy framework to promote the competitiveness of the UK professional and business services sectors. The P&BSG will be providing consolidated advice to Ministers later in the year but we consider that one of the topics under discussion, namely the limitation of professional firms' (not only auditors') liability to parties with whom they contract, and to third parties, is germane to your Lordships' consideration of market concentration in the audit market. Ministers thought we should therefore offer a contribution to your own enquiry.

Our principal submission to the Committee is that, so long as auditors are not able to limit the liabilities we mention, then the capacity for the market to admit competitors outside the Big Four will be restricted. In our view, a new statutory form of limitation, based on fairness and balance to all stakeholders, on the one hand, and the promotion of competition as a legitimate and proper deployment of public policy, on the other hand, is necessary and urgent.

We preface our remarks by also noting that a number of papers are in preparation in relation to a number of questions raised, in particular:

- the role of auditors looking forward, and whether they have any case to answer so far as the causes of the financial crisis of 2008 are concerned;
- conflicts of interest between the services auditors provide and those other services their firms supply to audit clients; and
- corporate governance

The brevity of our answers to these issues reflects the above and the Committee will wish to consider these forthcoming reports in the context of its own enquiry

To conclude these initial observations, we confirm we would be happy to present further evidence, either oral or written, at your discretion.

Our answers to the Questions are as follows:-

Q1 Why did auditing become so concentrated on four global firms? For example, do economies of scale make it too difficult for smaller firms to compete? In addressing this question, it is perhaps worthwhile recalling that the present dominance by four firms has only come about in little more than the past 20 years and the largest single change was perhaps brought about by the demise of Arthur Andersen, one of the biggest firms, at the turn of the century.

We consider that the growth in concentration, brought about by business rationalisation, had two main causes:

- globalisation of business required audit firms to expand in order to meet the needs of trans-national clients;
- the statutory regulation of audit, which began with the introduction of the Companies Act 1989, and obliged Recognised Professional Bodies (essentially, the Institutes of Chartered Accountants, and the Association of Chartered Certified Accountants) to license audit firms. The licensing process was itself determined by firms' ability to satisfy 'fitness and properness' criteria. In the course of the next two decades, the regulatory framework for auditors became more sophisticated and exacting (arguably more so for auditors than any other profession: case-by-case examination of auditors' conduct and competence is likely unique to their profession). That process caused the numbers of firms entitled to be licensed for the conduct of audit to contract substantially, as systemic weaknesses were identified and audit became the province of specialist practitioners. The advent of the Financial Reporting Council and its operating arms, the Professional Oversight Board, the Auditing Practices Board, and the Audit Inspection Unit, brought the rationalisation phase to a virtual end, introduced a competence-measurement one, and has formed a platform for a third phase, the audit competition phase. There is a co-efficient of audit firm-size and capability to service larger audited entities but the overall standard of audit is very high and the next tier of firms have invested heavily in the international associations to which they belong. The growing systemic capability, both in UK and international terms, may allow firms which do not currently participate in the larger end of the audit market to participate, should a real opportunity present for them to penetrate that end of the market.

We should add that, having played its part in contributing to overall audit quality, the regulatory framework now needs to focus on where the systemic risk to the economy is greatest and be commensurately tempered where possible to ensure that audit firms do not

face disproportionate regulatory burdens or costs. This is particularly so in respect of firms servicing the SME community, including companies listed on the AIM and Plus markets. The Audit Inspection Unit is also seeking to extend the boundaries of restrictions on professional firms beyond that set by the Auditing Practices Board, making it even more difficult for smaller firms to carry out listed company audits That seems to us unnecessary and contrary to the Better Regulation Principles.

There are a number of ways that one might assist the audit market-penetration process but in our submission, limitation of liability is a key barrier to the entry of smaller audit firms to the larger end of the audit market and should be addressed without delay, although it is not the only factor. We expand on this thought below (see our answer to Q11).

Q2 Does a lack of competition mean clients are charged excessive fees? We should begin by reiterating that the audit market as a whole is not subject to a lack of competition.. There is no empirical evidence to suggest fees charged to clients are excessive, although, inevitably fee payers do from time to time believe that such charges are too high.

Q3 Does a narrow field of competition affect objectivity of advice provided? The Ethical Standards for Auditors (promulgated by the Professional Oversight Board) and the Codes of Conduct (promulgated by the audit licensing bodies) are an essential part of the regulatory framework for the profession. Firms are measured by the bodies granting their audit-licences and by the Audit Inspection Unit against compliance with the Standards and Codes. The tried and tested 'threats and safeguards' approach taken by regulators provides a robust template for ethical behaviour and underscoring auditor integrity.

Q4 Alternatively, does limited competition make it easier for auditors to provide unwelcome advice to clients who have relatively few choices as there is less scope to take their business elsewhere? The relationship between auditors and those who have the stewardship function in audited entities is a complex one but all auditors have certain characteristics not necessarily shared by company directors: professional training and qualifications, and membership of a professional body. The emphasis of auditors' training is independence and objectivity, and being able to show independence *in fact*, and there is considerable academic evidence to support the contention that the content and exacting nature of auditors' training, including the compulsory examination of candidates' awareness of, and ability to apply, the Standards and Codes in practical auditing situations, together with membership of a professional body, provide a reliable guarantee of professional behaviour. As noted above, the ethical framework already in place is both robust and effective.

Q5 What is the role of auditors and should it be changed? In response to this question we would note that there is substantial current work already underway (sponsored by the Financial Reporting Council and the Financial Services Authority) to which the Committee ought in our view to have regard. Audit firms will undoubtedly also wish to express their own views.

Q6 Were auditors sufficiently sceptical when auditing banks in the run-up to the financial crisis of 2008? If not, was the lack of competition in auditing a contributory factor? We have not responded specifically to this question and the Committee may wish to consider reports already in preparation.

Q7 What, if anything, could auditors have done to mitigate the banking crisis? How can auditors contribute to better supervision of banks? A question asked in quite similar terms already by the Treasury Select Committee of the House of Commons, there is no evidence to suggest

auditor-failure in the run-up to the crisis. We again commend the Committee to have regard to the other work going on in these respects.

Q8 How much information should bank auditors share with the supervisory authorities and vice versa? It may well be that the extent of 'regulatory disclosure' (both from auditors to bank regulators and flowing the other way) will change in the future, a process informed by the current work of the Financial Reporting Council and/or the Financial Services Authority.

Q9 If need be, how could incentives to provide objective and, in some cases, unwelcome advice to clients be strengthened? It is a misunderstanding of professional conduct to suggest that it is possible to 'incentivise' auditors to give objective or unwelcome advice: their training and experience sensitise them *against* providing partial or biased advice. Indeed, auditors are already bound by professional standards that preclude the provision of anything *except* objective advice; that is incentive enough.

Q10 Do conflicts of interest arise between audit and consultancy roles? If so, how should they be avoided or mitigated? Conflicts of Interest, as we pointed out above, are addressed in the context of the Ethical Standards for Auditors. Our principal observation, though, is that in the vast majority of cases, the service to the client is improved, not compromised, by auditors' ability to provide NAS. All companies like the facility of a suite of advice alongside the satisfaction of their Companies Act obligations. Government will be in the best position to judge, from the conclusions of its enquiry into the banking crisis, whether there is any impairment of objectivity brought about by dual-provision but we do not believe there has been. Indeed, the latest consultation paper emanating from the Auditing Practices Board on the provision by auditors of Non-Audit Services appears pre-disposed to the conclusion that dual-provision is fundamentally good for business and controlled adequately by the 'threats and safeguards' approach; the responses to the previous consultation on NAS indicated that the market is comfortable with the status quo.

Q11 Should more competition be introduced into auditing? If so, how? Though audit firms may have specific suggestions for encouraging competition, one major factor which acts as a barrier to entry for smaller firms entering the large audit market is limitation of auditors' liabilities. Other factors, for example, are reputation al risk, scale, and previous experience.

We have been asked by BIS to develop a model of proportional liability for all of the professions. Limitation of liability would remove the discouragement they presently experience, lest the level of a claim for damages against them should exceed their assets and the professional indemnity insurance cover they hold. Indeed, firms are very unlikely to be able to find the levels of PII cover they would need to discharge a claim of sufficient size: PI insurers simply do not provide adequate levels of insurance, a difficulty that has been addressed in another Commonwealth jurisdiction, Australia. Australian professional standards legislation allows professional bodies to register with a government oversight body on behalf of their practitioners a scheme which provides all the protections for consumers and other stakeholders (concerning training, education, codes of conduct, and monitoring) which would be easily replicable in the UK. Successful registration means that the professional firms can elect from a number of means of providing proportional liability.

In response to the BIS request, and as one possible method of addressing this issue, we are developing advice on how the Australian model might be introduced in the UK. In the meantime, we would advise the Committee that the audit profession and indeed the other liberal professions could better compete and grow at home and abroad if a workable form

of liability-limitation was in place. The European Commission has already concluded that, "in order to ensure a sustainable international audit market, more players are needed to meet the demand by international companies", and has encouraged Member States to give effect to meaningfully functioning means of limiting auditors' liabilities. The opportunity to fulfil both UK and European public policy objectives presents now, in our opinion.

Q12 Should the role of internal auditors be enhanced and how should they interact with external auditors? The role of the internal auditor is essentially different from the external function: it has a different focus and different reporting lines. The size and speed of financial transactions differs enormously between sectors and the internal audit function of a firm needs to be commensurate with that firm's exposure to risk in relation to those transactions. External auditors can and should advise firms of the adequacy of their internal audit processes, eg to protect the shareholders from fraud, but it is important for objectivity and audit independence that dealings between the two are at arm's length.

Q13 Should the role of audit committees be enhanced? Our view is that the current consultation on the provision by auditors' firms of Non-Audit Services will result in an increased role for the audit committee in approving non-audit services supplied by the auditor, in order to increase perceived transparency and to make it clear to other stakeholders that the entity, as well as the auditor, has considered any perceived or potential problems arising from dual-provision. The Financial Reporting Council has already proposed revisions to its guidance for audit committees and we are not aware that further change is necessary.

Q14 Is the auditing profession well placed to promote improvement in corporate governance? The auditing profession can certainly assist in promoting good corporate governance by, for instance, advising clients on the extent to which their corporate governance does or does not comply with the Combined Code, and sharing examples of best practice. The profession can, and does, assist by providing feedback on proposed new corporate governance requirements when they are still at a draft stage.

24 September 2010

Memorandum by The Lord Smith of Kelvin (ADT 70)

I am writing in a personal capacity with views which may help the committee's consideration.

By way of background, I am Chairman of two FTSE 100 companies, served on the FSA and the FRC and chaired the FRC committee which produced the Smith Report on Guidance to Audit Committees. I am a past president of the Institute of Chartered Accountants of Scotland and spent a lifetime in venture capital and fund management.

Dealing with your questions:

1. Why did auditing become so concentrated on four global firms?

Businesses in all sectors of advanced economies have tended to merge to deal with international markets. Smaller businesses serve local needs. Auditors to the larger global companies are therefore themselves global so that they can provide global coverage, global standards and the level of technical service and training not available in small accountancy

firms. Thousands of private companies in the UK use hundreds of local accounting firms who can provide the local service they require.

A look at the FTSE 100 shows that the vast majority of turnover, profits and assets come from outside the UK. This applies as much to oil, engineering and mining companies as to pharmaceutical, technology and financial services companies. These large complex and global businesses need large, technically advanced, global auditors. Even retailers in the FTSE 100, by their nature providing local services, are very large complex businesses.

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

No, I do not believe auditors charge excessive fees. Indeed, there is a danger that if they do not at least cover their costs, the quality of the audit could be compromised. Non executive members of the audit committee who ultimately decide on auditor appointment and remuneration will see regularly the level of fees in different companies. I do not think that excessive fees are an issue here.

3 & 4. Does a narrow field of competition affect objectivity of advice provided or does it make it easier to provide unwelcome advice?

No, objectivity is not improved by more competition or by lower fees. Objectivity is about strength of character and ethical behaviour.

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

These duties are set out clearly in the Companies Act 2006 and in many publications by the Institutes of Accountants.

You will be aware of the May 2009 Treasury Select Committee on the Banking Crisis which was concerned that the audit process may result in "tunnel vision".

Auditors are not paid to run the companies they audit; indeed, they can really only audit the process of risk assessment in a business. There are risks in any business. It is the duty of the board to assess those risks and decide what level of risk is worth taking and what mitigation is available if things start to go wrong. This could be a decision to move manufacturing, say, to the Far East with its attendant risks or to decide not to move manufacturing overseas with its attendant risks, to sell a business or buy a business. Risk can be, among other things, regulatory, financial, reputational, risk associated with the ability to recruit, train and retain staff, develop new products and enter new markets. All companies I have been involved with have a risk map/risk register but the most difficult thing is not to assess likelihood and impact but to think of new or undiscovered risks that could damage the company (Donald Rumsfeld's unknown unknowns).

External auditors cannot easily contribute to this process but they can ensure that a good process is in place. Risk is fundamentally a matter for the whole board, not a risk committee, although detailed work could be done in committee.

However, a lot of audit work is around accounting standards and ensuring compliance with financial reporting standards. In my young days, as an apprentice chartered accountant, the overriding maxim was not whether accounts were exactly accurate but whether the results were true and fair and ones on which reliance could be placed by those investing in, trading

with or working for an entity. Perhaps the accuracy, compliance with standards, detail, length and complexity of sets of accounts make the reading of them and therefore reliance on them somewhat difficult. I suspect even professional, sophisticated investors have difficulty judging the health or future prospects of a company from its published accounts. Another major tenet I remember from those earlier simpler days was the Principle of Conservatism, sometimes referred to as "profit smoothing". I was interested to see suggestions by very senior regulators recently that big banks should put aside profits and build up reserves in good times (presumably instead of increasing bonuses and dividends) and use those reserves and reduce capital in difficult times – a somewhat Biblical response that recalls those earlier days.

I do think that auditors should report on "going concern" but not as a boiler plate statement, more of a commentary on any concerns they have or indeed reassurance they can give to users of accounts. I can tell you that auditors do challenge what is said in the Chairman's and CEO's statements as well as in the body of the accounts. It might help if they were obliged to say something on this area in their report.

6&7 <u>Were auditors sufficiently sceptical when auditing banks and what could they have done to mitigate the crisis?</u>

I am not close enough to these events to comment on whether greater scepticism would have helped. I am certain lack of competition was not a contributory factor.

In my maiden speech in the House I spoke about complex products in banking and a lack of understanding of risks being undertaken. However, governments in several countries were encouraging wider home ownership, house buyers wanted 120% mortgages with low interest rates and deferred repayments, bankers made money repackaging loans and "spreading the risk", regulatory authorities were well aware, or should have been, of the build up of assets in our banks and of their reliance on wholesale deposits/loans from other big banks and investors were overwhelmingly supportive of the growth of the banks and their acquisitions and rights issues. Quite what an auditor, given the duties detailed in the Companies Act, could have contributed against this background is unclear. If an auditor had suggested that at some point in the future big banks would not lend to other big banks at any price I am not sure what a board could, or would, have done about that. To eliminate reliance on wholesale deposits and announce that they were in future going to depend on retail deposits would mean a total collapse in share price as the banks reduced in size. Government would have deplored the withdrawal of funding to SMEs and home owners, investors would have been appalled, rating agencies aghast, employees fearful of job cuts and boards would have been obliged to resign.

Because banks could not value the huge sub prime assets because there was no "market price" liquidity disappeared. Even if the banks had had twice the capital that would not have saved them. Only Governments at that stage could supply the necessary liquidity.

8. <u>How much information should bank auditors share with supervisory authorities?</u>

Bank authorities need to know everything and bank auditors should share with them as much as they are legally allowed to do. I do not know what rules of confidentiality govern supervisory authorities but it would seem surprising to me that if an authority had information that would affect an auditors assurance of a company's report and accounts that that information would be withheld leading to misleading information in the marketplace.

9. How could incentives to provide objective advice be strengthened?

Auditors do give unwelcome advice; a lot of discussion goes on between auditors and audit committees and management. No incentive produces objectivity. This is a behavioural and ethical issue.

10. Do conflicts of interest arrive between audit and consultancy roles?

Conflicts can arise, that is why in the Smith Report we insisted on a policy on non audit fees with limits to be set. Sometimes an auditor can be used for advice, on say tax, but auditors should not be doing work which they subsequently have to audit. The audit committee is the watchdog and has to report to shareholders. This works well.

11. Should more competition be introduced in to auditing?

Some medium sized firms are more content to do consulting work (eg due diligence, advisory) rather than staff up to do a large company audit which is not that remunerative. I do not think more competition is needed.

12. Should the role of internal auditors be enhanced?

Absolutely, internal audit is vital. Internal auditors probe deeply in to an organisation and can detect changes in behaviour. A book on recent corporate failures by Professor Stewart Hamilton demonstrates that the seeds of failure lie in behaviour e.g. dominant CEOs, greed, hubris, desire for power, poor strategic decisions and over-expansion. Internal auditors are best placed to detect these behavioural changes which can lead to serious problems. Internal audit needs to have a high status in companies and as with external audit direct access to the audit committee. External audit already place considerable reliance on the work of internal audit.

13. Should the role of audit committees be enhanced?

I believe the framework is there. The audit committee can exercise a powerful role in all companies at present. They need to use internal audit well. They can oversee risk committee procedures but risk, as I mention above, is the responsibility of the full board.

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

Yes, absolutely.

21 September 2010

Supplementary memorandum by Lord Smith of Kelvin (ADT 71)

I regret very much that I was unable to attend Evidence Session No. 8 but you have kindly sent me transcripts and submissions and invited me to express my views. I am grateful for that opportunity.

I will address the papers you sent to me in order.

i) Institute of Internal Auditors' written evidence

This is relatively straight forward. I agree totally with all six points in the summary of key points. On point 6, companies cannot always have a large enough full time internal audit department to cope with all activities but if they use external help, it must not be from the company's external auditor (para 28-30) but can be from another audit firm. Care must be taken to ensure that internal audit on a regular basis checks on this external work to ensure the benefits of IA are not lost. The status of IA and the backing of a powerful and independent audit committee are very important (para 54).

ii) Uncorrected transcript of the EAC's evidence session 14 December

I thought that the transcript was full of useful advice from the witnesses. I do not intend therefore to go through the paper paragraph by paragraph. Here are some observations.

I agree with Sir David Walker's recommendation that banks/insurance companies should have separate risk committees. I would further suggest that the executive Head of Risk should have a very high status in the bank or insurance company, possibly at main board level. However, risk must remain ultimately a matter for the full board. You cannot have a situation where some board members feel they have delegated the risk to a board committee. Even in a complex financial company it is important that someone is asking "daft laddie" questions.

On separate advisors (page 9), committees should be free to hire help when they need it. In answer to Lord Forsyth's query, any mature board and chairman should be able to deal with this without causing disunity. It is not possible for the non execs to have all the detailed knowledge necessary in every subject. I have experience of two tier boards and in my view they do not work in the area of proper challenge. A unitary board is the right model inside which debate and challenge can be quite fierce but a skilled chairman can ensure that after debate unity is restored.

I think it is a good suggestion (and it is something that most ACs already do) that ACs should explain how they choose auditors, ensure their independence, the scope of the audit and, say every five years, explain (if there is no change of auditors), why they did not go out to tender. I am opposed to tendering for good reasons explained in iii below but I am certain that AC/boards should explain why there is no change every five years.

I was a bit surprised by the discussion on non audit services. The Smith Guidance clearly states that ACs should have a clear policy on non audit fees for external auditors. This may be: none; only for certain defined services; never for work that they might later audit; limited in amount. The rules should be made available, certainly in the Annual Report, but in most companies on their website. Each year the AC must report against these rules. On no account should IA audit services be supplied by external auditors.

On Lord Lawson's point on page 19/20 there is certainly a mechanism for IA or external auditors to raise any subject with the AC however sensitive. The chair of the audit committee would talk to the Chairman/board. If external audit did not get satisfaction they would indicate that they would have to go to the regulator and they must do so if they feel something is wrong and the board are ignoring it. The threat of auditors going to the

regulator would get the attention of any chairman or AC chairman. With IA it is trickier since they are employees of the company but ultimately their position is the same, provided they are sure of their facts and their actions will not later be taken (if wrong) to have been prejudicial to the company. If the AC or board are seen to have ignored warnings without very good cause they will be judged on their behaviour.

In pages 25 onwards, Lords Lawson and Forsyth make excellent points on the "stampede". Governments, particularly in the US, were encouraging and legislating for wider home ownership – extending loans to people who would not normally qualify on credit scoring. An industry grew up providing these loans. Investment banks provided the funding by packaging these into CDOs (previously corporate debt, now tens of thousands of promises to replay mortgages) and selling them to investors. With the help of insurance "wrappers" from the likes of AIG, these CDOs were declared AAA securities by the rating agencies. Pension funds and banks could then purchase these as top rates investments. The investment banks put pressure on the mortgage originators to sell more of these loans which yielded very high fees and there were clear cases of mis-statement of salaries, job titles, etc. amongst small borrowers who were encouraged by agents to take interest rolled up/balloon repayment loans. By reslicing these CDOs (CDO^2) investment banks could satisfy any level of investor risk. The risk was thought to be so diversely spread that only a global systemic breakdown could cause calamity.

The point here is that Governments were encouraging the growth of the business, originators and investment banks were earning high fees and investors had AAA investments on their balance sheets. If a head of risk or AC member had suggested to a bank board that the global systemic collapse (that is big banks would not lend at any price to big banks, a total liquidity freeze which no-one had ever seen) was possible or imminent, it is difficult to know what boards would have done. Winding down all borrowing from other financial institutions would have severely affected profits, share prices and would probably cost them their jobs. The example of a more risk averse Lloyds (pre HBOS) was mentioned by their Lordships. When Governments were providing encouragement, shareholders, the public who wanted the loans, investment banks and originators all felt they were benefitting, the rating agencies were happily providing AAA ratings and regulators both here and in other countries were well aware of the build up of assets, I am not sure what external auditors could have done assuming they realised the risks.

We know that in some US originators voices were raised against the practices but these people were terminated. Even Fannie May and Freddie Mac got sucked in and some of the biggest names in US investment banking disappeared. Could their auditors (internal or external) have done anything?

In South Africa, the head of the Reserve Bank and his team have "trilateral" meetings with the full boards of the major banks and the external auditors (joint auditors in some cases). IA, Head of Risk etc. are all present. The Reserve Bank talks about concerns they have in the banking sector eg build up of assets, bad debt provisions, build up of client indebtedness and there is general discussion, no holds barred. There is perhaps a model for us here.

From my own experience, most of us address issues when there is a crisis. It is when things are going well, perhaps too well, that we need to be most vigilant. Your Lordships will well remember the property boom in the 1970s (fully secured loans), the sovereign debt opportunity in the 1980s (countries do not go bust), the dotcom boom the late 1990s (the high tech paradigm) and our latest debacle in banking.

iii) Suggestions for Change[11]

I suppose one of my issues with the focus of this enquiry is that it is about competition and lack of choice, rather than, to me, the more important issue: Do external auditors actually give us assurance about financial results and the soundness of a business model and if they do not then what can we change about the scope of an annual audit or the auditing approach that could give investors and the stakeholders the assurance that they need?

I will deal with each suggestion for change in order.

1. There would be no harm in including a non big 4 firm in a tendering process but I would be against "independent oversight" if this meant the AC board would lose decision making powers.

2. I am against mandatory rotation and I would interested in evidence from Italy that it leads to better audits. My reason is that it is expensive and very disruptive for a company and may not lead to any improvement of quality of audit or cost. Far better to rotate audit partners regularly and for the AC to ensure that audit firms are really independent, well governed, well trained and staffed. Cost is an issue that should not cloud objectivity and expertise. I would pay more for an audit on which I could place great reliance. Finally, the last year's audit by an outgoing auditor and the first two audits by a newly appointed incoming auditor could place a large complex company at greater risk for three years.

3. I am against mandatory rotation but in favour of regular rotation of auditor partner and senior staff.

4. I do not know enough to comment on this possibility.

5. An interesting suggestion. However, I think audit is too firmly entrenched now. In any event shareholders, suppliers, customers and employees have a right to be able to depend on the financial results of a company. An audit gives them a level of assurance they cannot get for themselves as they cannot attend board meetings, analysts presentations etc. I would guess that companies with unaudited accounts would find an adverse reaction from the capital markets and would quickly put audits in place.

   It is a fascinating subject because although an audit is mandated, oddly enough it is for boards, whose own figures are being audited, to appoint the auditors, decide their remuneration and determine the scope of the audit.

6. I have no problem with shared audits. One overseas bank, of which I am an NXD, has shared auditors and it works well. Again I would be against compulsion.

7. I am against mandatory joint audits. I take the points about regulatory capital and the too cosy relationship but in a joint audit (in my experience) the work is divided between the firms so cosiness could still exist in compartments. They do not audit each others audit.

[11] The list of suggested changes which the Committee have so far heard can be found in Appendix 1 to this paper

8. I think boards would have to be convinced that the non big 4 would deliver. Complying with a code of conduct would have to be on the basis that the AC board were happy with the audit of those parts of the business being awarded to other firms. Co-ordination would be an issue too.

9. Risk committees should be free to use whatever expertise they need. This is not a point about audit but about how non audit fees can be earned by others.

10. I really do not see how this works in practice. Would regulators and investors force the board of a company to change auditors? Who then would carry the responsibility if an audit was carried out ineffectively? How does this affect the accountability of boards to their shareholders and other stakeholders?

11. In all my experience I have never come across a covenant restricting the choice of auditor, let alone to one of the big 4.

12/13. The audit committee should be prepared to justify its appointment of the auditor and explain how it evaluates internal and external auditors.

14. I don't know what is meant by "strengthen" audit committees. The guidelines are clear on composition and duties of ACs and in my experience they are powerful committees. They already publish the report on audit work carried out and quite rightly should be able to justify their appointment of external auditors and decisions not to tender.

15. Outside my scope of knowledge.

16-21 I would support proportionate liability or a cap on auditor liability. I do not believe the old system where partners could be made personally bankrupt (which led to the formation of LLPs) actually made the partners more responsible auditors. Indeed, it may be that unlimited liability leads to more boilerplate cautious audit reports with less willingness to be controversial or brave.

Encouraging increased investment is fine but I would be cautious about the introduction of outside capital. Investors look for a return. Audit firms could move from beacons of professional integrity to businesses which have to show increasing returns which could lead to unwanted changes in behaviour.

I know that some second tier firms have a sound business model based on consultancy, insolvency, due diligence, tax, accounting, smaller audits, advisory and other corporate and private work that suits them very well. Many do not want to build up an audit practice capable of handling very large complex companies.

22. This is alluded to in 10. above. If we are to go this route it should apply to all audits but presumably the company still has to pay the cost which has been negotiated by regulators and shareholder panels. Presumably, also, the board of the company would not be accountable if the audit was badly carried out. Moreover, the appointment and remuneration of the auditor are only part of the story. The scope of the audit, the process, the findings and the direct relationship between auditors and the AC are more important.

23. Auditors are, in effect, appointed by the AC but the decision is ratified by the board. I have never seen a recommendation on the appointment of the auditor nor of the scope of the audit or auditor's remuneration being second guessed by the full board. Sometimes year end accounting treatments lead to a discussion at the full board. Sarbannes Oxley is referred to; in view of recent US events this may not be the best model.

24. I would need to know what this meant. I guess it would "creep" back to full audit in time.

25. This is a carefully monitored area in all companies. As we said in the Smith Guidance there are occasions such as tax returns and some advisory work where it would be very inefficient and costly to introduce a separate firm but on no occasion should an auditor do non audit work which they may subsequently audit. Non audit work should be kept to a minimum and the AC must have a clear policy on this and be prepared to defend it.

26. Totally agree. In all companies I am involved with this proportion is clearly stated and published.

27. I don't see why not.

28. Financial reporting and auditing standards are now so complex that even quite expert financial people have difficulty understanding a set of accounts. This is not just about helping small audit firms; it extends to the efficient working of capital markets. However, it is easy to suggest reducing complexity and much harder to do.

29. Can this be done in such a way that capital markets can have confidence in a company's figures?

30. Desirable, but it is taking decades to get to a point where accounting standards alone apply globally.

31/32 Desirable

33. I agree, this is a very big issue. The demise of Arthur Andersen was handled remarkably smoothly. The failure of one of the remaining big 4 might not be so easy to handle.

34. See 33.

35. I assume there are independence tests already. The trouble with such a technical area is that you need accountants to explain the finer points. Generally, it would be good if the perception could be eliminated but I personally do not believe that regulators have been infiltrated and weakened by members of the accounting profession.

36. A nice idea but as stated above, where does this leave the "powerful independent" ACs and the board of the company? Whose fault is it is the audit is substandard.

37. This could be useful.

38. Do not understand the proposal.

39. This is a good place to start and several of the FTSE100 are not much bigger in market capitalisation than the top tier of the next 150 and some are less complex companies.

As I began in this section let me reiterate that unlike a competition enquiry the question should be less about cost and choice because large companies can resist overcharging and are informed enough about levels of service. The reliance placed by capital markets (from small intra day punters to long only institutions) on the attesting of a company's statements is vital. Investors have a right to be able to rely on published information and an audit report should give them that assurance. The audit firms of large complex companies need to have independence, good governance, good training and integrity and the ability to handle scale and complexity. We need contingency plans in event of a failure of one of the big 4.

Appendix 1

MEASURES AIMED DIRECTLY AT FORCING MORE COMPETITION

1. *Reforms to achieve fair and regular public tendering (perhaps once every five years) with independent oversight to provide opportunities for firms to increase their market share. Mazars in their written Evidence suggest the tendering might be 2-stage 'providing for the submission of a short document at the first stage by a number of firms from which a shortlist would be selected for the final presentation.' Kingston Smith in their written Evidence suggest that at least one non-'Big 4' firm should be included in the tendering process.*

2. *Mandatory rotation of audit firms as in Italy (but, if specified inappropriately, mandatory rotation of all audits might compound the problem of market concentration if it led to 'Big 4' firms supplanting 'Mid-Tier' firms – not a problem if mandatory rotation limited to FTSE 350).*

3. *Greater rotation of auditors (FSA)*

4. *Transformation of the Audit Commission into a large audit firm.*

5. *Removal of the mandatory requirement for an audit, leaving it to market forces. It has been argued that government intervention has stifled competition in the audit market and is responsible for the market concentration.*[12] *If this is so, then this Inquiry needs to be cautious about recommending measures which would entail further government intervention.*

MEASURES AIMED AT INCREASING THE MARKET SHARE OF NON-'BIG 4' FIRMS

6. *Greater use of shared audits by leading listed companies.*

7. *Mandatory requirement for joint audits (as distinct from shared audits) of large companies or just of large financial entities. Possibly mandatory joint audits with one of the two firms required to be a 'non Big 4 + 2' 'Mid-Tier' firm (Mazars evidence). With a joint (as distinct from*

[12] Benedikt Koehler, (2006): 'Audit Market Failure', in *Economic Affairs*, journal of The Institute of Economic Affairs.

'shared') audit, both audit firms provide the overall audit report and opinion, and the audit work would be required to be shared equitably in order to encourage the 'Mid-Tier' firms to grow. Joint audits make it less likely that the auditors develop a too-trusting 'cosy' relationship with the client. Mandatory joint audits would create 'regulatory capital' for non-'Big 4' firms (Oral evidence on 07Dec10).

8. *A regulatory code of conduct promoting the use of non-'Big 4' firms: this might be as auditors of subsidiaries within large, public groups.*

9. *Board's risk committee of large companies should be advised by someone who isn't the firm's auditor (another source of advice which would not require the same sort of global network and could therefore be provided by a non-Big 4 firm. A bit like a joint audit. (Baroness Hogg, 9th November).*

MEASURES AIMED AT REDUCING 'BIG 4' DOMINANCE

10. *Placing limits on the market share of firms measured by the number of appointments held, say, over a five year period, monitored by representatives from regulators and investors (Grant Thornton's suggestion in their written Evidence to this Inquiry)*

11. *Elimination of covenants restricting choice of auditor, which even sometimes stipulate which of the 'Big 4' should be used.*

12. *The audit committee's report to explain why they considered the need to appoint a 'Big 4' firm.*

13. *According to Standard Life's March 2009 response to the EC's consultation on 'control structures in audit firms and their consequence on the audit market', Standard Life considers another catalyst to accelerate access to international audit markets would be for boards and/or their audit committees to disclose when and how periodic formal evaluations of the internal and external auditors were undertaken and the key conclusions arising therefrom.*

14. *Strengthen audit committees and require them to report/justify publicly their work and rationale re. audit and no-tendering decisions.*

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

MEASURES AIMED AT STRENGTHENING NON-'BIG 4' FIRMS

16. *Relaxing the limit to the amount of outside capital of an audit firm. The 8th EC Audit Directive caps outside capital of audit firms at 49%.*

17. *Ownership rules of auditing firms need to be changed (FRC – 9th November). The 8th EC Audit Directive requires that the majority of the management board of an audit firm should be approved EU auditors.*

18. *Increased investment by, or mergers of, non-'Big 4' firms in order to create one or more larger ones (Mr. Ashley Almanza, Hundred Group and BG in oral evidence on 07Dec10).*

19. 'Second-tier' firms must be encouraged to invest more (to enhance their international networks, etc) (Lord Sharman's oral evidence – 14th December).

20. Defection of a large number of specialist bank auditors from a 'Big 4' firm to a 'mid-tier' firm.

21. A workable mechanism for the limitation of auditor liability, so that the risks of auditing large entities do not outweigh the benefits. Possibly a cap on auditor liability (as in Austria, Germany, Greece) and also the introduction of proportionate liability.

MEASURES AIMED AT BREAKING THE CLOSE RELATIONSHIP BETWEEN MANAGEMENT AND AUDITORS

22. Alternative appointment processes for auditors, e.g. involving shareholder panels, or appointment by regulator.

23. The audit committee to appoint the auditors, as in the US under Sarbanes-Oxley and report in some detail their decision (E&Y witness).

24. Introduce a financial statements insurance approach as an optional alternative to the present audit.[13]

25. Debar the auditor from undertaking any non-audit work for their audit clients.

26. Limit the proportion of non-audit work that an auditor is permitted to undertake for an audit client.

27. Require fees for 'audit related work' and 'extended audit work' to be reported by audit firms separately from fees for audit work.

MEASURES AIMED AT REGULATORS AND STANDARDS SETTERS

28. Reduce complexity of financial reporting and auditing standards to better enable smaller audit firms to cope with the audits of large companies.

29. Narrow the scope of the annual audit, so that companies can get other advice from other firms, so allowing mid-tier firms to compete better.

30. Consistency/alignment of the regulatory framework globally would help, but may be insufficient (Shell: oral evidence, 07Dec10).

31. Make sure that regulators of cross-border activities do not act as an effective barrier to using non-'Big 4' audit firms.

32. The regulator should be less burdensome of the profession (Q50 of transcript of 19Oct10 session – answer by Mr. Hodgkinson of ICAEW: 'Oblige regulators to consider how regulation affects availability of choice. Make it a criterion for regulatory action because it is clearly of public interest.')

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[13] Joshua Ronen, (2010): 'Corporate Audits and How to Fix Them', in *Journal of Economic Perspectives*, Spring, vol . 24, no. 2, pps 189-210.

33. The regulator needs a contingency plan for orderly transition of audit clients if a Big 4 firm fails (Mr. Ashley Almanza, Hundred Group and BG in oral evidence on 07Dec10).

34. Develop living wills for the largest audit firms to mitigate the risk of any exiting the audit market (Deloitte witness).

35. Take measures to eliminate the perception and/or reality of regulatory capture of auditing regulation (reduction in members of the accountancy profession who are members of regulatory boards; making sure that chairs of regulatory boards meet generally accepted independence tests, e.g.)

MEASURES AIMED AT INVESTORS

36. Find a way of ensuring that the largest institutional investors act together to influence large companies to consider 'Mid-Tier' audit firms, as 'they usually get the changes they are looking for.'

37. The FRC should convene a group of large institutional investors to come up with audit market intervention initiatives.

GENERAL

38. Ignore the present system and build an alternative in parallel, alongside the present system.

39. First, work to reduce market concentration in FTSE 250 audits so as to build a sustainable platform for the 'Mid-Tier' firms to be able later to compete effectively for FTSE 100 audits.

Memorandum by the UK Shareholders' Association Ltd (ADT 72)

INTRODUCTION

About the UK Shareholders Association Ltd (UKSA)

1. UKSA is the leading independent organisation which represents the interests of private shareholders in the United Kingdom. We campaign to protect the rights of shareholders in public companies, and to promote improved standards of corporate governance. Our educational activities, regular regional meetings, company "analyst" meetings and the resources of our web site, help to inform the public on investment management. UKSA is a "not for profit" organisation which is financed by its individual members.

2. In accordance with the terms of the Companies Act, 2006, auditors report to the members (shareholders) but in practice they deal entirely with the directors without even an opportunity for the members to question them at the AGM. We believe that this is a significant factor in weakening the accountability of auditors, and the companies they audit, to the owners of those companies. This concern has been reinforced by the recent banking problems none of which appear to have been anticipated by auditors.

AUDITORS: MARKET CONCENTRATION AND THEIR ROLE

Effect of and reasons for market concentration

3. There appear to be conflicting factors at work here. The very limited number of firms involved in the audits of large listed companies ought to make those firms more confident in challenging their clients. However, the evidence does not support this as is shown by the recent FRC review of 2010 audits which criticises several firms for not showing, and applying, greater scepticism.

4. We believe that it is the depth of resources and their geographical breadth that have resulted in the present level of concentration, rather than economies of scale.

Role of Auditors

5. The role of auditors is to ensure that the accounts show a true and fair view. This should not change but should be reinforced and strengthened.

Audit scepticism

6. It appears that auditors were not sufficiently sceptical in recent bank audits. However their position was compromised by certain accounting standards, such as the rules on providing for bad loans. This does not, though, provide sufficient excuse for the failures which occurred in not ensuring that accounts were properly prepared. There is still in UK law the overarching requirement to ensure that a true and fair view is shown. If it is necessary, in order to achieve this, to override the standards, then they should be overridden.

Supervision

7. In UK law the auditors act under contract to the company to act on behalf of the shareholders. We do not believe that this should be changed by making the auditors part of the regulation process. The obligations of regulators differ from those of auditors and should not be confused.

Objective Advice

8. We believe that the introduction of shareholder committees to which the auditor must report could help here. The auditor should have the responsibility to report what he regards as significant discussions with the board and the outcome of those discussions to that committee which acts on behalf of the beneficial owners. The present audit review process conducted by the FRC will help in due course to improve standards.

Conflicts of interest

9. To the extent that knowledge of the client gives greater efficiency in the provision of non-audit advice, this has value. However it appears that in the majority of cases consultancy advice will be provided by staff other than the audit team who should know the client well. Thus this potential advantage may not be obtained.

10. If this is so the advantage to the consultancy arm of the firm also being the auditor will be mainly the one of having access to the client via the audit principal. This will provide a conflict if the consultant can explicitly, or implicitly, place pressure on the audit process.

11. We would suggest that research should be undertaken to discover whether the boards of companies genuinely believe that having the auditor as adviser gives real commercial benefit. We would distinguish real commercial benefit from the possibility of placing

pressure on the audit principal to the apparent advantage of the management.

12. If shareholder committees were introduced it should be one of their responsibilities to decide whether they were agreeable to the company having advice from its auditors.

Competition in the audit market

13. This was reduced by permitting mergers which, with hindsight, perhaps were inappropriate, coupled with the demise of Arthur Andersen. Various steps have been taken to widen the market but with little success. There is pressure from corporate and agency investors to use the big four on the grounds that they will be "safe". Whether this view is justified is questionable. UKSA would support a fresh consideration, perhaps with the FRC, as to the relative "safety" of the big four as against the second tier.

Audit committees

14. These were introduced to enable those board members with particular and relevant skills to seek to improve the quality of the audit process.

15. Two questions arise:

A. Is there a fundamental problem with accounting that it needs these special skills to be comprehensible?

B. Does the use of audit committees reduce the interest and commitment of other board members, consciously or unconsciously, in ensuring that the accounts for which they are all responsible do in fact show a true and fair view?

Corporate governance

16. The job of the auditor is to report on the accounts. It is not the auditor's job to interfere with the way in which the board acts. The auditor should be able to give advice as to good practice in accounting but it is not the auditor's function to influence the way the board conducts itself.

24 September 2010

Memorandum by Mr James Wood (ADT 73)

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

Memorandum by Z/Yen Group Limited (ADT 74)

Background

In response to your email of 28 July requesting that our firm provide evidence, we set out below some information which we hope aids your inquiry. Z/Yen Group Limited (Z/Yen) was founded in 1994 as a commercial think-tank in the City of London to promote societal advance through better finance and technology. Our clients include the majority of global investment banks and many other financial services firms, but also clients in other sectors, such as technology, government organisations and non-governmental organisations. Three accountants were among our founders, two of whom remain as directors of the business today. Our interest in the proper functioning of markets, and our research studies, have led to many of the observations and references below, and our desire to aid your inquiry.

Overall Comment

We would preface our remarks by noting that there are several different audit markets both internationally and in the United Kingdom. A quick categorisation of these markets might be – small and medium-sized enterprise (SME) audits, audits for SME firms listed on exchanges, audits for large firms not listed on exchanges, and audits for large firms listed on exchanges. One can identify other sub-sets of interest, e.g. audits for large firms listed on exchanges with significant international activity or, as is clear from your questions, audits for large financial firms listed on exchanges with significant international activity. The SME audit markets do not exhibit the intense concentration implied in your questions, so our remarks are focused on audits for large firms listed on exchanges and, where appropriate, some comments on the sub-set of audits for large financial firms listed on exchanges.

We would summarise our remarks below as:

- ♦ the audit market for large firms listed on exchanges is overly concentrated on four firms, and this concentration seems to coincide with lower competition and lack of diversity in approach;
- ♦ lower competition appears to have resulted in higher prices and poorer service over time and low, if any, productivity improvements;
- ♦ lack of diversity appears to have resulted in little innovation and, in the case of large financial services clients, increased herd behaviour;
- ♦ given that auditors have, over time, acquired a preferential economic role (i.e. their use is mandatory for large companies) that allow them to extract economic rents it is right to consider how to ensure a vibrant, competitive market, albeit perhaps less vibrant or competitive than other sectors – as well as what social benefit is given in exchange for a preferential role;
- ♦ structural changes seeking to increase competition and transparency in the audit market are desirable. Elements of such changes we would consider might include:
- ➢ enforcing competition policy clearly, which in other markets might lead to capping the market share of the largest firms, or breaking them up, or requiring compulsory audit retendering;
- ➢ making it easier to take legal action against audit firms for poor opinions;
- ➢ treating auditing standards under the same regime as ISO standards, i.e. open processes, a single accreditation body (auditor of the auditors) backing certification (company audits) within a competitive market;
- ♦ structural changes seeking to increase competition and transparency in the audit market we would particularly recommend for closer examination include:

- ➢ providing ways to ascertain the quality of auditors' performances over time, or 'confidence accounting' as we term it;
- ➢ requiring audit firms to provide an "indemnity" of some form for their opinions.

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

Concentration was clear by the 1980s, as evidenced by the term "Big Eight", followed by "Big Six" in 1989, "Big Five" 1998 and "Big Four" in 2002. We would pick out for comment:

- ♦ globalisation – though firms in the 1980s were handling large global corporations, typically through joint audit arrangements;
- ♦ need for a single firm approach - the large firms often cite the need for single firm arrangements rather than joint audit arrangements, and moves towards single firms have progressed, but equally note that Arthur Andersen very rapidly split into national components when under stress and the structural arrangements of the large practices are inordinately complicated – 'living will' proposals for banks might find analogues in auditing firms;
- ♦ regulation – a variety of licensing arrangements and barriers to entry restricted new audit firms;
- ♦ cost – large, single firms are presented as more efficient than smaller firms, despite the lack of evidence of more efficiency (in fact, overall costs have increased, which is attributed to increasing costs of compliance);
- ♦ quality – that larger firms provide higher quality, though there is no evidence to support or refute this.

Your inquiry will undoubtedly have many submissions on similar points, however we would note that the point on quality is paramount. Without available information on audit quality, the only two differentiators are size of audit firm and cost. In a market where corporate finance directors have to justify moving from one audit firm to another, 'justifiable' reasons to move are limited to size and cost. Recall that any move to a new firm which seems to indicate a dispute with the existing auditor will invite adverse comment – "something must be fishy if they had to move auditors". As the industry has become concentrated, and the cost is published (a competing audit firm need only look for their competitor's price in the published accounts), there is little need to compete on price. This leads to size being the only differentiator. Imagine a FTSE100, let alone FTSE top 10, company announcing it had selected to a new, small audit firm. The FTSE100 finance director would be unable to prove to shareholders any move towards a higher quality firm (there is no objective evidence). The only facts would be that the new audit firm is indubitably smaller, and possibly (if the smaller firm so bid) cheaper.

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

To form an opinion on "excessive" one needs to examine Big Four audit fees over time, including:

- ♦ audit costs as a percentage of corporate turnover, profit and assets;
- ♦ profits per partner and comparative salaries for staff against other professionals;
- ♦ increases in the rates charged against inflation;
- ♦ measures of risk, i.e. comparing audit costs against share price volatility, profit volatility, balance sheet volatility and company failure rates;

- rates of change in appointments and price movements during those changes;
- productivity improvements, if any.

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

We agree that this is a possible working hypothesis. A Big Four auditor with a client in a defined client sector (e.g. banking) will have a fairly clear idea of what the other three firms might well do in a particular situation. He or she will know the other firms and their teams well, not least because he or she may well have trained, qualified or worked for the other three, and may well see his or her future career depending on finding employment with one of the other three in the event of employment disruption with his or her existing employer.

Further, the narrow field means that, with the profusion of deals and joint ventures, the Big Four are constantly finding themselves working together on similar deals and, arguably, less able to provide advice that conflicts with another firm's.

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

We agree that this is a possible working hypothesis. However, we would point out that there are legitimate disagreements on interpretations of financial reporting and that the implication in the question is "the auditor is always right".

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

This is an intricate question taking in market structures, law, regulation, and numerous other topics. The role of the auditor is to provide an opinion on whether or not financial statements provide a true and fair view. We would not change this. However, sticking to the brevity you requested, we would point out that auditors provide an opinion without a clear indemnity. This is, in many ways, similar to the position of rating agencies who provide an opinion without indemnity (though their defence is largely based on the premise that their opinion falls under "free speech"). Auditor opinions are subject to more direct contractual relationships, but if auditors provide a poor opinion, the suggested recourse is legal proceedings. Commercial and financial legal proceedings are inefficient and expensive, and frequently result in awards out of proportion (both ways) to the commercial effects of a poor opinion. Further, audit firms are opaque structures with ostensibly little capital, i.e. a lawsuit may be of little commercial use.

We would suggest clear indemnities and indemnity rules (or liability mechanisms), for example:

- providing strong guidelines on the range which constitutes a poor audit opinion, e.g. more than a 15% adjustment in the total balance sheet valuation of the prior year;
- a ratio for the indemnity, e.g. five times the audit fee, or up to 10% of the company's balance sheet;
- providing confidence that such indemnities and liabilities are limited, thus encouraging smaller entrants into the market;
- clear arbitration procedures that avoid, as much as possible, high legal costs.

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

The financial crises of 2008 certainly bring audit quality issues to the fore. The audited balance sheet and going concern statements for many major financial firms over this period were clearly wrong. Virtually all of the major financial firms were audited by the Big Four. There was no discernible dissension among the Big Four. It would be easy to claim that more variety would have increased diversity of opinion, but we could not substantiate such a claim. One could equally claim that smaller firms would have been even more eager to agree with clients (though it's difficult to see how a smaller firm could have been more eager than the Big Four were) in order to gain clients.

We would argue that, with few or many firms, forcing firms to provide indemnities is the way to increase their scepticism during a boom. If the indemnities were proportionate to the boom, e.g. rise with the valuation of balance sheets, then auditors would have more reason to be careful when needed.

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

Auditors were amongst the thick of the banking crisis, recommending balance sheet arrangements and advanced valuation formulae (see entries for Ernst & Young in Jenner & Block's "Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report"). It may seem controversial, but taking into account question 6 above where audited statements were of limited use, rather than seeking to have auditors "contribute to better supervision of banks", would it not be better to focus on getting them to provide better audits first?

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

No opinion, nor thoughts on substantive change.

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

Objective and unwelcome advice is hard to give. Incentives fall into two categories, carrots and sticks. We put forward our principal 'stick', clear posting of indemnities, above. In a competitive market, the principal 'carrot' is profit. Firms that provide objective advice should become more profitable over time. This can only be achieved if the marketplace has the information to see the quality of advice over time.

We have suggested a fundamental reform of auditing and accounting that would allow external validation of audit quality. The approach is termed 'confidence accounting', where uncertainties (ranges) are presented to investors and managers, rather than discrete numbers. The balance sheet of Company X is worth £Y, plus or minus £Z, and we are 95% confident that it falls within this range. This would make auditing a 'measurement science', cf. with the way most laboratories report measurements. A single number for accounting terms such as profit or balance sheet value is clear and simple, but wrong. Confidence accounting would be the presentation of audited accounts in a probabilistic manner. If an audit firm's estimates move too far outside the stated confidence ranges, their clients would

be able to make their own decisions about audit quality. We would refer you to the following publication for more detail:

Confidence Accounting: Putting Essential Uncertainty Back Into Auditing And Accounting	Michael Mainelli	2009	Journal of Risk Finance, Volume 10, Number 3, Emerald Group Publishing Limited

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

There are anecdotal stories of conflicts of interest of course. Evidence of conflicts of interest are difficult to prove, though we would refer to the following publication where we tried to examine this:

The Auditor's Cross Subsidy (Statistical Modelling Of Audit Prices)	Michael Mainelli, Ian Harris and Alan Helmore-Simpson	2003	Strategic Planning Society E-Newsletter, Article 1 . (Also published as Anti-dumping Measures & Inflation Accounting: Calculating the Non-Audit Subsidy, www.mondaq.com)

In our opinion, audit firms hold a special position in law, therefore they have special obligations. The simplest way to avoid conflicts of interest would be to restrict audit firms to audit only.

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

Structural changes should be sought with the objective of encouraging new entrants into large company audits and making it easier for clients to evaluate the quality of audit. By implication, yes, this should result in more competitors and better competition. There are numerous suggestions for more competition, e.g. compulsory audit tendering periods. We would particularly recommend for closer examination:

- providing ways to ascertain the quality of audit, for example providing the ‘confidence levels’ around their measurements that would permit external assessments of auditors’ performances over time, or ‘confidence accounting’ as we term it.
- requiring audit firms to provide an “indemnity” of some form for their opinions, for example “financial statements insurance” as proposed by Professor Joshua Ronen of New York University. For further information:

Accounting: Progress May Lie In Insurance (Put Your Money Where Your Audit Is: Financial Statements Insurance In The UK?)	Michael Mainelli and Joshua Ronen	2006	Financial World, pages 38-39, Institute of Financial Services and Centre for the Study of Financial Innovation

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

External auditing is a regulatory, legal and commercial arrangement. Internal auditing is an internal function structured differently within different firms. Many firms do not have an internal audit function. Further many common internal audit functions are performed

throughout many different control systems with or without internal audit function involvement, e.g. procedural compliance being audited by standards organisations or information technology checking stock locations. Internal audit reports to management against management-set objectives and we see little purpose in bringing internal audit into regulatory structures.

13. Should the role of audit committees be enhanced?

The audit is primarily for shareholders. All directors should be acting in the best interests of shareholders. We see no reason for promoting further separation of the interests of the audit committee directors from other directors.

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

Again, as in question 7, rather than seeking to have auditors "promote improvement in corporate governance", would it not be better to focus on getting them to provide better audits first?

Conclusion

We would emphasise that the financial crises of 2007 to 2009 require serious investigation of reform, including the role of both the professions and their disciplines:

Just Doing My Job: Intelligence Versus Integrity In Financial Professionals?	Michael Mainelli	2010	Journal of Risk Finance, Volume 11, Number 2, pages 235-237, Emerald Group Publishing

May we thank you for your time and consideration of our thoughts and wish you success in your inquiry.

September 2010