



# HOUSE OF LORDS

Unrevised transcript of evidence taken before

## **The Select Committee on Economic Affairs**

Inquiry on

### **AUDITORS: MARKET CONCENTRATION AND THEIR ROLE**

*Evidence Session No.9. Heard in Public.*

*Questions 403 - 446*

TUESDAY 11 JANUARY 2011

3.35pm

Witnesses: Mr David Pitt-Watson, Mr Paul Lee, Mr Iain Richards, Mr Guy Jubb and Mr Robert Talbut

#### USE OF THE TRANSCRIPT

1. This is an uncorrected transcript of evidence taken in public and webcast on [www.parliamentlive.tv](http://www.parliamentlive.tv).
2. Any public use of, or reference to, the contents should make clear that neither Members nor witnesses have had the opportunity to correct the record. If in doubt as to the propriety of using the transcript, please contact the Clerk of the Committee.
3. Members and witnesses are asked to send corrections to the Clerk of the Committee within 7 days of receipt.

Members present

Lord MacGregor of Pulham Market (Chairman)  
Lord Best  
Lord Hollick  
Lord Lawson of Blaby  
Lord Lipsey  
Lord Moonie  
Lord Shipley  
Lord Smith of Clifton

---

**Examination of Witnesses**

*Witnesses:* **Mr David Pitt-Watson**, [Hermes], **Mr Paul Lee**, [Hermes], **Mr Iain Richards**, [Aviva Investors], **Mr Guy Jubb**, [Standard Life], and **Mr Robert Talbut**, [Chief Investment Officer, RLAM, and Member of the ABI Investment Committee].

**Q403 The Chairman:** Gentlemen, good afternoon and thank you very much for coming to this Select Committee meeting of the Economic Affairs Committee. As you know, we are coming rather towards the end of our inquiry and I think we are particularly interested in having your views on the subject of our inquiry this afternoon because we haven't really looked at this to date.

I just have to say at the start that copies are available of Members of the Committee's entries in the Register of Interests and also those that they have declared as relevant to the inquiry. I should be grateful if you would speak loud and clear for the benefit of the webcast and the shorthand writer. Since there are five of you, if one of you responds first to the question and you all agree, you don't necessarily have to say that; just nod or keep quiet. But we're happy to hear from all of you.

I should like to begin with the first two questions that are fairly general and I think will probably be setting the tone for some of the subsequent, more detailed questions that you will be getting. The first question is: is the standard audit report useful to investors?

**Mr Richards:** Perhaps if I start on that one. The audit is valued. The audit report adds little value of itself and it tends to be fairly anodyne. The times that it tells us anything, it signals anything, often it's far too late in the day and very often when an issue does arise you have a history of clean audit opinions behind it. It is binary, yes or no. There are some other elements of the audit that get reported on, some on an exceptional basis, and I think there is a great degree of scope to enhance audit reports and make them far more useful to shareholders.

**Q404 The Chairman:** Well, we will be following that up, how you can enhance the audit reports, but is that a general view? When you say the audit is valuable, you mean the underlying work done to produce the standard boilerplate stuff in the annual reports?

**Mr Richards:** The general concept of an audit. There obviously have been concerns about some individual audits and concerns about the nature of some audits under the standards, but the fact that we have an audit is valued by investors.

**Mr Pitt-Watson:** Chair, may I expand on that? I think audit and accountancy are absolutely fundamental to the integrity of our capital markets and the good governance of our companies. In the UK—and this is different from other countries—the role of the auditor is to provide the information necessary to allow shareholders to play their role as owners of the company. The existence of the audit in itself, like the existence of lots of information, does not require that it's given to the shareholder and then the shareholder acts. The very fact that this is going to become a document that is given to shareholders changes the behaviour of companies and, therefore, is fundamental to the good governance of companies in this country.

**Q405 The Chairman:** As you know, this was a quote from a Hermes publication and it seemed to raise the question that one was really doubting the standard audit report but it wasn't querying the underlying work that's gone into it.

**Mr Lee:** That's absolutely right.

**Mr Jubb:** One of the challenges for investors is that the output of the audit is the audit report and that is what we see. We have very little transparency currently as to what the actual audit process involves. This is where the audit committee clearly plays a very important role on behalf of the board and on behalf of shareholders, but it is the audit report that is the aspect that investors ultimately see. As my colleagues have referenced, the reliability that we have to place upon audited financial information is the lifeblood of capital markets. If we didn't have an audit that would clearly be a matter of great concern.

**Mr Talbut:** If I may just add on that one. The point is that the more information that is going to be available to shareholders the better position that shareholders are in to be able to discuss that information with members of the audit committee or elsewhere within the company and, therefore, discharge their duties as institutional shareholders of the company. I think, in particular, that the type of information that would be extremely useful to understand within a better quality audit report would be issues where there have been questions of judgement, perhaps, or nuance within the report and accounts, or where the particular issues were where there might have been more contention between the company and its auditors. Because those are types of things that it would be much easier for shareholders then to be able to have further questioning on and, as I say, properly discharge their duties.

**Q406 The Chairman:** Well, I think that's of interest to this Committee as well because we would be interested to know your views as to what kind of information and where the

relationships aren't quite right at the present time. We will be following that up. Does anyone else want to add anything on the actual report?

**Mr Jubb:** You asked about the usefulness of the report. Let me just take it one layer down into the content of the report. One of the criticisms that I think investors and most certainly we have of the audit reports is that they are very, very standardised in their content. They are often—I have used the expression elsewhere—riddled with “get out of jail free” clauses in terms of what is in there. The aspects that colleagues were referring to, such as matters of emphasis just to help guide the investor and reader, would make the audit report a good read rather than otherwise.

**Q407 The Chairman:** As you know, we have been partly looking at the question of audit market concentration in the Big 4 and I think it would be fair to say that we are getting quite a lot of concern from a number of our witnesses on those grounds and particularly, of course, if the Big 4 came down to the Big 3. I'd just like to know from the investors' point of view whether this audit market concentration—we note also that there are very rarely changes of auditors among the FTSE 350 and especially the FTSE 100, so there is a longstanding relationship there—causes unease among investors.

**Mr Lee:** Shall I take that first? Absolutely it does. I think the major concern is the lack of competition, but particularly the lack of competition on audit quality. I think it was very clear from the evidence that you received from the Hundred Group that the only competition that they experience is on price and certainly that is all that we are aware of occurring in the market. Part of the problem is the invisibility of audit quality. We've all referred to problems with the audit report not providing useful information. That's just an example of the lack of information there is about audit quality. In the absence of that information it's no wonder that there's no competition on that topic.

**Mr Jubb:** Could I add a slightly different shade to that, because from our standpoint, while we believe strongly that the concentration of audit markets is fundamentally unhealthy and represents a systemic risk that has the potential to undermine confidence, it is not so much the competition issue but it is the lack of choice that is the area of particular concern to us. We made representations to the European Commission and others in 2009 asking them to address this particular issue with a sense of alacrity. But we have come to this position where we are no longer comfortable with relying on market forces to create the resolution to this. We do believe that there has to be some intervention. We have waited a decade, give or take, for market forces to make a change and the strength of the oligopoly is not making any progress.

**Q408 The Chairman:** Quite a bit of the evidence we have had suggests that in the global market in which so many companies, particularly in the FTSE 100, now operate, you do need to have that global reach from the auditors. That's a very expensive thing to provide. A great deal of expertise is required worldwide and this very much restricts the scope of any others entering the market. Have you any comments on that?

**Mr Talbut:** A particular point that I would emphasise on that one is that while we may well accept that with some of the very largest, the most international, companies, that is a reasonable argument, we don't believe that that, therefore, applies right the way down the size scale. The degree of concentration within, for instance, the 250 companies within the UK is broadly similar to the degree of mix within the 100 companies.

Now, I think that there are many, many companies within the 250 where those arguments of extreme complexity and extreme internationalism of the business just does not apply at all. But it doesn't appear that the market is operating, even within those sub-100 companies, to introduce a greater degree of competition and choice. I would echo the point that has

already been made; we don't believe that reliance upon market forces will bring about any fundamental change in this marketplace whatsoever. There have been plenty of opportunities over the last 10 years or so for there to be and the Market Participants Group came up with a set of other possible recommendations that should be implemented.

I would still observe that there is relatively little movement taking place in terms of the degree of concentration. That is why I would certainly support the idea of, within the 250 companies at least, a forced degree of intervention in the marketplace to lessen the grip of the Big 4 within the marketplace, to be overseen by the FRC, so that there is a reasonable opportunity of starting to create another organisation that can take on a number of audits. Given the fluidity between the 250 and possibly moving up to the 100, that would, over time, I think, bring about a better opportunity of improving competition and choice in the larger companies as well as the 250 companies.

**Mr Lee:** Robert is absolutely right that the argument about internationalism doesn't apply to many companies in the 250. There are certainly a number of companies in the FTSE 100 to which that argument does not apply. Admittedly, many are very multinational but not all are and it would be entirely possible for certain of them to be audited by a decidedly smaller, less international firm.

**Mr Jubb:** To develop the theme further, we have suggested to the European Commission that it should send a clear signal to the Big 4 networks to give the Big 4 networks time within which to organise their affairs in a way that will enable the global service to be provided but, at the same time, will enable greater choice without prejudice to audit quality; but within that message make clear that it is prepared to intervene in order to take action in the event that the Big 4 and other firms do not take action consistent with that objective.

**Q409 The Chairman:** I think it's clear that a lot of the recommendations, many of them quite small, that have been made in the last 10 years have not produced much result. Is that what's driving you to looking for more of a regulatory or even legislative solution?

**Mr Jubb:** Yes.

**Mr Talbut:** We have been talking about this issue for years and years and there is no movement whatsoever. There is no change in the concentration and there appear to be far too many vested interests in preserving the status quo.

**Q410 Lord Lawson of Blaby:** Have you put your specific proposals in writing?

**Mr Richards:** Yes, and I've handed them to the clerk ahead of the meeting. If I may, I fully agree that an ultimatum has to be set down to the Big 4 that the market needs to change with a specific deadline and some measures agreed in terms of the targets for change, but that of itself won't be effective. Within the markets, there are some very entrenched perceptions in audit committees that the Big 4 is what you need to go for. That is reinforced by the fact that investors and the markets go for the Big 4. In the absence of any real insight into the audit, big is safe. So the market punishes people who don't go for the Big 4.

The bankers take exactly the same approach. You see there's been a debate around some of the clauses in debt instruments requiring the use of Big 4 firms. So there is a very persistent attitude throughout the market and through the players in this dynamic, all of whom tend to focus too much on the Big 4. So just tasking the Big 4 with changing things isn't adequate.

There needs to be a wider range of change. Audit committees need to be forced to be much more transparent and thoughtful in what they're doing, and the audit committee report does need to be beefed up. Equally, the position of investors and shareholders needs to be addressed and one of the ways of doing that might be to ask the FRC to review the stewardship code to incorporate this whole area of auditing and accounting more specifically



within it. But unless there's a package of reforms, any one reform is unlikely, of itself, to be effective.

**The Chairman:** I'm afraid the Committee haven't seen the written evidence that you've given. Certainly, if we have any further questions on it, we would like to come back to you.

**Q411 Lord Moonie:** You say that it's not price that you're concerned about but quality. Surely, if appropriate external standards are set and rigorously applied, the number of firms available to you is largely irrelevant because the appropriate standards are being applied anyway. What counts is that you have an audit committee that does its job.

**Mr Richards:** If I may come back on that, I think there are two things. Between the Big 4 dominance of the markets and standards that have become much more process-orientated, the audit has become commoditised. So competition does not appear to be around audit quality. That seems to be confirmed by the ongoing findings of the Audit Inspection Unit that has repeatedly raised concerns about the appraisal of audit partners or Big 4 firm partners giving inadequate emphasis to audit quality compared to other things. I believe, in its most recent report in relation to PwC, it noted that the proportion of KPIs for partners relating to business growth had been increased from 25% to 40%, those relating to quality had been reduced from 25% to 20%, and there are a number of other indicators that illustrate the emphasis away from audit quality.

**Q412 Lord Hollick:** Mr Richards, you mentioned that investors—not your exact words—take comfort from the fact that one of the Big 4 is auditing a firm. Is there any evidence in the experience of the four firms you represent that companies are punished in any way for not having one of the Big 4 or that you avoid making investment in them because they don't have one of the Big 4 audit firms?

**Mr Richards:** Perhaps I may give an example of the opposite. It was a case where we didn't own any of the shares, Sanctuary. The auditor was a tier A firm that was seeking to blow the whistle on bad practice, accounting problems and internal control failures within the company. It was sacked by the directors, who brought in a Big 4 firm. The shareholders said nothing. There was no issue made of it. There is anecdotal evidence that people in discussions persuade companies perhaps to go the other way and also in the market reaction, which is something that the academics have looked at. There is evidence of it.

**Mr Lee:** There certainly is a perception that investors favour the Big 4 and one thing that we and five other institutions, including Iain's, did five years ago was write to all the FTSE 250 companies and say essentially, "It is not necessary, in our view, for you to be audited by one of the Big 4. Please take a look at the tier A firms". In the five years since, the one thing that has happened is that the market has moved entirely in the other direction. So not only did we get a very limited response to our letters; the reaction over time was entirely contrary to our aspirations.

**Mr Talbut:** When surveys have been undertaken of the attitude of institutional investors towards the Big 4 and other, say, tier A organisations, it is true to say that there is a perceived issue with respect to the very largest companies going for an organisation that is not one of the Big 4. It's not a majority at the moment but there is an increasing proportion of shareholders who would say they would be quite comfortable if a tier A firm were to be doing the audit of certain, say, mid-sized type of companies. But that information does not seem to be acted upon by audit committees or the board as a whole.

**Mr Jubb:** It is relevant to share with you that very little engagement takes place between audit committees and institutional investors about choice of auditors and audit matters. Last month the Institute of Chartered Accountants of Scotland published a document called *The Future of Assurance*. Declaring an interest, I was deputy chairman of the working group. In line

with the point made by my colleague, it has recommended that there should be included in the stewardship code for institutional investors a principle whereby institutional investors, for their part, will engage with companies and thereby audit committees about corporate reporting. But, equally, there is a suggestion in that report that every five years the audit committee should undertake a detailed evaluation of the service provided by its auditors and engage with its principal investors to discuss the findings of that so there is a forum for the dialogue to take place about the suitability of auditors and indeed the very quality of the service that is provided. That, sadly, is not taking place.

**Q413 The Chairman:** You expressed your concern about the dominance of the Big 4. How much evidence is there that that dominance is actually detrimental to investors?

**Mr Jubb:** The evidence is perhaps embedded in your opening remarks in terms of the common sense of the issues concerning what happens when you have the Big 4 and it then goes down to the Big 3 and the Big 3 then become the Big 2. There are inherent issues in terms of the issue of liability—which I know is a very important part of the equation and is part of the solution that needs to be considered—as to the attitude of regulators and others in terms of taking action which could bring down one of the Big 4, or indeed one of the Big 6 even, in a manner that would precipitate the consequences that judgement suggests is not going to be healthy for the capital markets and could undermine confidence in them.

**Mr Richards:** If I could add to that; I think that the other aspect that is significant for investors is the commoditisation of the audit and the reliance that we place on the audit to provide not just the internal discipline but the external signalling when it is appropriate. I think if you look back over the crisis and you look at signalling given by auditors and what happened to the banks, there has been a problem.

**Mr Lee:** I will take that slightly further. I think possibly we are seeing some complacency among the Big 4 firms. Iain has already referred to the work of the Audit Inspection Unit. A lot of what it discovered was the Big 4 pushing at the edges of the ethical standards, for example; trying to see what additional non-audit services they could squeeze in under the radar. These sorts of activities, I think, are a sign that the Big 4 are confident in their market position and don't feel the need to maintain standards quite at the height that we would wish them to.

**The Chairman:** We would like to come back to the point about the banks specifically on its own because, as you may have noticed, we have been having a lot of evidence on that.

**Q414 Lord Smith of Clifton:** Gentlemen, following on from the last set of questions, what would you say should be the minimum number of active audit firms needed to constitute a genuine competitive market for the audits of the FTSE 350 companies?

**Mr Richards:** It would be very easy to sit here and say that we would love to have the Big 8, the way we did back in 1987. The reality is that it is not particularly feasible. If you look at the largest firms, you would have to merge the next six firms in size just to equal the smallest of the Big 4. If you did that, you would then also risk leaving an even bigger gap between the then Big 5 and the rest. You may potentially raise issues, particularly if they are going to throw that resource at trying to capture large company audits, in reducing the choice for smaller firms. In terms of trying to tackle this issue, I would hope to see a range of packages that would see another Big 5 firm evolve and, if we are lucky, potentially a Big 6. But I think you have to be progressive about that not to have unintended consequences for the medium and smaller size companies.

**Mr Jubb:** Having been in complete agreement perhaps thus far, perhaps I may inject a bit of differential opinion. I am not quite so reticent about suggesting that one can have a larger

number of major networks beyond five or six. I do recollect and I did operate in the days of the Big 8 Plus 2. It is useful to remember incidentally there were Plus 2 in those days as well. In terms of the approach that I was articulating earlier in terms of where the major networks can organise their affairs and be given time to do that—that will obviously involve discussion, in part, with their clients—I believe it is in their gift to organise their affairs in a way that could have a larger number than just the five or six. I am not of a view that one should stipulate what the number should be but I would be entirely clear that eight was a comfortable number. When we had eight I felt that we had choice.

**Q415 Lord Lawson of Blaby:** The normal thing to do when you have lack of competition and a fear, which you have voiced, of excessive concentration is not to promote mergers among smaller companies but to split up—bust, trust-bust—the large ones. I am surprised, given the views you have generally expressed, that you have not commented on this. The other thing that is related to that is that obviously this is an international business. The United States is particularly important. The United States has a great history of being interested in trust-busting of one kind or another. Is there any movement, as far as you are aware, in the United States of concern about the concentration and a feeling that some kind of trust-busting might be in the interests of the economy?

**Mr Richards:** An in-depth study was done by the Government Accountability Office in the US—I cannot remember off the top of my head whether it was in 2000 or 2002—that identified all of the types of issues that are being debated today but it did not come up with any specific recommendations in the terms of the cost-benefit analysis. It didn't see the case being made and, in the absence of a sufficient problem with anti-competitive practices, didn't feel that intervention was warranted; though it noted that it was a situation that needed to be kept under review. I am not aware, other than a subsequent review by the American

Anti-Trust Institute, that there has been any other detailed examination in the US that has been published.

**Mr Talbut:** If I could come back directly on your point. My comment earlier on was very much along the lines that the organisations should be compelled to give up market share. That is not necessarily about splitting one of the Big 4 up but I think if you were to move down that road you could create a fifth or a sixth organisation over a reasonable period of time and that would have the effect that most of institutional investors would like to see.

**Mr Lee:** I am not sure whether, in the context of a dynamic such as we are talking about, you wouldn't see partners shifting from one of the existing Big 4 to the fifth or the sixth and leading to that effect without the need for trust-busting in any form.

**Mr Jubb:** The views on trust-busting were also inherent in my earlier remarks but it is perhaps the threat of trust-busting which may help to deliver the solution in terms of threatening to intervene in a way that causes the larger networks to move forward. In terms of the global and US aspects, we believe that this approach should be championed at the G8 or G20 levels in order to provide some leadership and indeed the requisite commitment. We would observe that a network is only as strong as its weakest link. Even if the UK, of itself, were to take a bold step in this regard, that could provide some form of catalyst for change that would otherwise have wider repercussions.

**Q416 Lord Lawson of Blaby:** You have not answered one of my questions. Do your opposite numbers in the United States share the concern that you have voiced today?

**Mr Jubb:** We and a number of my colleagues here do engage in informal discussions with other investing institutions in the United States. I am involved in and co-chair something called the Global Auditor-Investor Dialogue which brings together a number of investors in the United States with those in Europe in conversation with the Big 6 auditing firms. Two

years ago a working group that was derived from that developed some disclosure guidelines, which I shall gladly submit as evidence, which were designed to assist directors and audit committees. Among other things, it dealt with the issues associated with the rotation of auditors and the choice of auditors as well.

**The Chairman:** It would be very helpful if you could let us have that.

**Mr Jubb:** I would be very pleased to do that.

**Mr Richards:** If I could just add to that; the large focus in terms of action in the US in relation to auditors tends to be after the horse has bolted, in that they then sue them. That tends to be the focus of the way market investors decide in terms of their reaction to and interest in the audits. In terms of the engagement with auditors, I believe that the situation and access to the whole debate is much harder over there than it is here. Here we can, at least at times, get access to audit committee chairmen. It is not as easy in the United States.

**Q417 The Chairman:** In terms of the Big 5, I think one suggestion that has been put to us is that the Audit Commission might become one of the Big 5. Have you any comment on that?

**Mr Richards:** I am not aware enough of the Audit Commission and its work to have a well-founded view about that.

**The Chairman:** Fair enough.

**Q418 Lord Shipley:** Can I move us on to your views on the mandatory rotation of the audit firms—maybe five, maybe seven years or whatever—and whether you think that might improve independence and quality? Might it also encourage firms that are non-Big 4 to become more active in the large company audit market?

**Mr Richards:** I look around. “No”, I think, is a fairly common answer you will get from shareholders. We believe that it risks being detrimental to audit quality. If I can characterise this rather crudely; if you appoint a new auditor in a reasonable-sized company they have a period of learning. If that were to be, say, a year and a half before they were completely up to speed and then they would have a period in which they provided, if I can call it that, a full-service audit. Then they would have a period at the end where their commercial interest would be to rotate their best people on to new clients; so you would have, if you like, a wind-down period. What you might risk ending up seeing is three years of lower quality audits for every four years of full-service audits.

The other point I would make is that if you require mandatory rotation there is no reason why, if I were a company, I might not say, “This time I’ll have PwC and next time I’ll have KPMG and the time after that I’ll have PwC”, and so it goes on. So just mandating rotation would need to be thought through very carefully in terms of the potential impact to the quality of audit but, equally, just having rotation might not change anything. Indeed, if you took it down beyond the mid-250 it might give the Big 4 a greater opportunity to expand their current market dominance. So there is a whole series of issues that give people concern about the proposal. Where we looked at the issue, the next step we took was to consider whether there should be mandatory tendering of the audit. But, again, many of the issues were very similar and it wasn’t clear to us that we could make a strong case for it.

**Mr Lee:** We would actually disagree with the perspective that changing an auditor reduces quality. The main evidence that it might do so seems to come from a study by FEE, which is the profession’s own lobbying organisation in Europe. The evidence that we have from the Audit Inspection Unit in the UK is that audit quality improves in the first couple of years of an audit because the audit firms put in a lot more work to make it work. That is why we would be quite strongly supportive of mandatory tendering. We would not be supportive of



mandatory rotation. We think the discipline of going out to the market on a regular basis ought to be enough to drive people to look at audit quality, as well as looking at price.

**Mr Talbut:** Something else I would like to add in on that one is to refer to the fact that what we are looking for here is not only greater competition but we are also looking for greater choice. I think that simply looking for mandating rotation does not seem to me to be attacking the idea of how we introduce greater choice to the marketplace. By choice, what I am referring to is trying to break away from the homogeneity of audits that we have at the moment so that, prospectively, we have organisations trying to compete for the audit on slightly different criteria.

Coming right back to some of our initial responses to you, there does not appear at the moment to be the incentive or opportunity for organisations to come up with innovative approaches for how they wish to compete. We, as shareholders, have little or no information on the basis on which an audit is awarded. At the moment the prime criterion appears to be cost rather than incorporating a lot of other criteria that we as shareholders and other outside parties might like to see incorporated into that decision-making process.

**Mr Richards:** If I can add to that, I think it is not just cost. I think the term that is generally bandied around is the value-added services that can be derived from the audit firm. These are the non-audit services. One of the key interests from our point of view is putting audit committees much more on the spot; to make them much more accountable and transparent in the reporting they have to make in the audit committee report to explain what they have done in reviewing the audit relationship; in reviewing its quality; whether it should be put out to tender. A whole range of information around that provides shareholders with a much more qualitative insight into what is really going on and the fact that this is being addressed in a substantive and prudent way.

**Q419 The Chairman:** Would it not be likely that if you did that you would get the same response from the companies as you gave us in your first response? They would demonstrate all the reasons why you wouldn't want to have a change of audit in the same way as you said that mandatory rotation would not necessarily lead to a better result?

**Mr Richards:** We recognise that there is always a risk of boilerplates. That is what we have had to date, despite some very good efforts to try and instil a bit more life into audit committee reporting. Unfortunately there is always the influence of the lawyers in the process that always seems to get in the way. I think the more we create a framework that calls for it and articulates it effectively, the greater the opportunity for us to engage and pin people to the table about some issues that are important in this area.

**The Chairman:** I am bound to say I was a bit surprised at your first answer because it seemed to me to give a total justification for the situation we have at the moment.

**Q420 Lord Shipley:** Can we just be clear whether everybody agrees with the position that has been set out: there is mandatory rotation and there is mandatory tendering. Earlier on this afternoon there was mention—I cannot recall the precise wording—of the Big 4 getting too comfortable, or something like that. I am not clear how you think that issue should be addressed. Would mandatory tendering provide that extra spur to making the Big 4 improve quality and independence and so on?

**Mr Talbut:** From my perspective I don't think mandatory tendering would have any impact in diluting the power of the Big 4. I think you would simply find that the audit would just simply go around those organisations that are homogenous in terms of the service they provide. We need to think about other solutions if we are going to try and dilute the power of the Big 4. Our position was that we were comfortable with the idea that the audit partner has to be rotated because he has the prime responsibility for the quality of the audit within

the organisation. We are somewhat ambivalent about whether other aspects would have any meaningful impact.

**Q421 The Chairman:** Mr Richards, you referred to the fact that it was a benefit to the Big 4 in terms of their audit that they could provide non-audit services as well. I know there are certain qualifications around that but, nevertheless, most of them do in some form or another. Looking for something that would help to break up the monopoly, would you make that mandatorily impossible?

**Mr Richards:** I wouldn't make it impossible but I think that there needs to be a much more rigorous look at the area. The UK, in my view, has a relatively permissive regime. Just by way of example, if you compare it to the French system or the US system, you see the average ratio of non-audit fees to audit fees in the FTSE 100—this would be 2009—was a little over 40%. In France it would have been about 5%. In the US it was just over 26%.

In the UK the largest ratio of non-audit fee to the audit fee was 380%. In France it was 44%. So there is a very significant economic interest in higher-margin, non-audit services. The Big 4 have very clearly stated their intention to maximise that. This rolls back into our concern about the commoditisation of the audit; the comments that have been made about loss-leading and issues that exist around the use of shortcuts and managing timesheets, discounts and so on.

**Q422 The Chairman:** I don't know what the statutory position is in France and the USA. Perhaps you could enlighten us as to why they have a different situation.

**Mr Richards:** In the US Sarbanes–Oxley was very strict in prohibiting a whole range of non-audit services that had been major revenue generators for the accounting firms. In France the model is slightly different. You can provide only very specifically audit-related services

unless there is some great compelling reason. I can't remember the precise wording of the structure but, again, it is quite prohibitive about non-audit services; whereas the UK system encompasses all sorts of areas in terms of corporate finance; IT and HR; internal audit, where they are a little, "You can't do that little bit of it but you can do all sorts of other parts of it".

The whole area just seems obfuscated. From our point of view the one that has been of particular concern has been tax advice. Obviously as shareholders, when it comes home to roost, we are the ones left picking up the tab. Where you see FTSE 100 companies facing actions for recovery of billions of tax that has been unpaid due to whizzy tax schemes, we would like to think that the one person in there being sure that prudence is being applied is the auditor. Obviously if they have been providing tax advice, tax management and planning advice, there is a conflict.

**Mr Lee:** I am sure the Committee would not expect me to agree wholeheartedly with what Iain has just said, not least because I have been a member of the Auditing Practices Board throughout the period that we've just been considering the issue of non-audit services. What has come out of that process is a much greater understanding of what is audit, what are audit-related services—I suspect that when we look at reporting out of the US and out of France and other markets we see the audit bundled together with these audit-related issues—and a much clearer breakdown of what the genuinely non-audit services are.

The conclusion that we reached on the board was that many of the non-audit services were appropriate to continue to be provided by the auditors. We tidied up a number of areas and removed certain aspects. But the big change that has come out of that review of the regulations is a move to generate much more disclosure on the nature of non-audit services provided by the auditors and that greater disclosure, going forwards, will be very useful to us as shareholders in calling the audit committees to account.

I would agree with Iain that the one area where there remains a question mark—that is a personal question mark in my own mind—is on the issue of tax. Certainly looking at the statistics that we have, that is the one very sizeable remaining area of non-audit services. That will, in time, be looked at again.

**Q423 Lord Hollick:** Several of you suggested that the company's annual report should include a more informative and direct report from the audit committee, which could cover the reasons for choosing an auditor and the reasons for going to a tender. It could also possibly lift the veil a little on the discussion between the auditors and the audit committee and shed some light in your cave on what were the particular issues of concern. What would you like to see in this audit report, if indeed you think there should be one?

**Mr Richards:** I think you have hit the nail on the head with what you say because you have raised the one point about the key issues discussed between the audit committee and the auditors that I would add to the list of recommendations that the Scottish Institute has set out in its report that my colleague Guy Jubb referred to, which is quite fulsome in articulating what people would like and I think is extremely welcome. The one point that I would have added to it is the one you make: that it needs to include perhaps a summary of the key issues discussed between the audit committee and the auditor.

**Q424 Lord Hollick:** Would that not spook investors?

**Mr Richards:** This is a very interesting point. It's one that is thrown out repeatedly. It is one that we have had thrown in our face in questioning going concern statements over the past few years. When the going concern statement was first introduced it was the common assertion, "This will force companies into liquidation; you will ruin them". The ACCA did a study of it in the years that followed and found that exactly the opposite happened. It

allowed issues and problems to be addressed earlier and, whether it was by way of an emergency rights issue or a restructuring of the company, the survival rate increased. Regrettably, we slowly drifted back into, “Let’s keep a lid on everything; sweep it under the carpet and hopefully everything will be okay”, and the going concern statement, in my view, has been slightly debased.

**Mr Talbut:** I don’t think it would spook investors. It would help redress the balance somewhat in that the report and accounts are starting to become marketing documents on behalf of management rather than necessarily providing the type of objective and, dare I say, prudent view as to how that company has been managed over the previous period and what they believe the outlook to be.

**Mr Jubb:** Shareholders would rather know the truth and, in terms of how it is communicated to the market, if there is a particular aspect that has the potential to spook the market and spook investors—this can be very critical in financial services companies and the confidence that pertains in those sectors—then a great deal of care and thought has to go in as to how the communication of these issues to the market and to shareholders is handled.

**Q425 Lord Lipsey:** As parliamentarians we are held to account by a website called *theyworkforyou*, which analyses our voting records and so on and holds us to account. In theory you would think the auditors should have a site called *theyworkforyou* where you as shareholders—the people who, after all, are supposed to be getting benefit from this operation—find out what they are up to. Instead of which what we find is very short audit reports and a group of people who seem to be in an extremely intimate relationship with the finance directors, directors, the audit committee chairman and so on of the firms they are auditing. Isn’t there something wrong here?

**Mr Lee:** There is indeed something wrong. Possibly the most useful thing that I have done as a member of the Auditing Practices Board is to change the word “client” in the ethical standards, which was the term that was used for the company being audited, to the “audited entity”. But that use of the term “client” for the company being audited is what every single auditor does and that is just the term for it; whereas, in fact, shareholders are the underlying client and yet we have no relationship and no real opportunity, as yet, to have that relationship. There is an opportunity to change that. With audit firm governance shifting, we may now have some non-executive directors on the audit firms with whom to have a dialogue. We are certainly eager to have that. The firms are moving slowly in that direction.

**Mr Richards:** If I can come back. It’s true that there is a focus towards the shareholder and the audit but I think we need to be realistic about what’s implied by what Paul says. It is a duty owed to the body of shareholders as this ephemeral concept. It is not a duty owed to individual shareholders. So there is no real direct duty of care to an individual shareholder. It is to this nebulous concept of the shareholder body as a whole and that creates a bit of a fudge in terms of our ability to lean on them. The more specific issue that comes up as investors is that many of the types of conversations we might want would give us access to privileged inside information and clearly that would create issues for us that we would need to be very careful about.

**Mr Pitt-Watson:** Yes, I think you are getting to the heart of some of the difficulties here because fundamental to this is that the auditors are working for the shareholders to help in the good governance of British companies. Actually the auditors are appointed by the audit committee and with very close relations to the finance director.

Your question was: why don’t the shareholders create something called *theyworkforyou*? Well, we don’t have that for auditors. We don’t even have that for directors, which you might think was even more important. In part that is because most of what shareholders are

doing has to do with the buying and selling of shares rather than the owning of companies. The five people that you see here today are a very substantial proportion of the resource of the investment industry that takes any interest at all in what it is that auditing standards and accounting standards are.

Therefore, as one thinks about that, clearly that may not be the way that we want the world but it means that the audit is even more important, because there aren't going to be the thousands of people who work in the fund management industry calling companies to account every time they hear a piece of news that is problematic. We absolutely depend on the auditor who does have substantial resource going in there and making sure that they are presenting a full and fair picture so that people behave in the right way without the shareholders having to come in, rather than because that report shows something that's problematic. But your question is as much a question about the problems of the fund management industry as it is about the audit industry, I think.

**Q426 Lord Lipsey:** I was going to say if you think of the sort of thing that might happen—if shareholders determined that they were going to change the nature of the relationship—one thing would be, as I understand it, that the appointment of the auditors has to be confirmed at the annual general meeting. If there were more revolts against that then you would find quite different sets of practices developing among the auditors and the companies that employ them.

**Mr Talbut:** I suppose the point about that is that we don't have the information on which to make a decision about whether we should reappoint them to be auditors. It could be seen as just a purely arbitrary or spiteful decision, "We've just chosen you as a test case. We're going to boot you out". Whereas I'd like to be in a position to have the information, to have



the dialogue and then make a decision as to whether I would wish to have that auditor continuing to audit that particular company and producing the audit report.

**Q427 Lord Lipsey:** You might have to be rather robust in the examinations if there's something arbitrary about it and just give it a go on a few occasions, particularly where there is some obvious piece of evidence that the work hasn't been done right.

**Mr Richards:** The problem is that we do; the difficulty is not enough of us do and we vote against a notable number of audit appointments during the year. It can be for a variety of reasons relating to the audits and to the accounts. But I think companies know that we are in such a small minority that they shrug their shoulders. We did have some discussions and raised the issue that maybe shareholders should be involved in the selection and appointment of auditors, using a model similar to Sweden. I have to say that the reaction among the investment community was less than enthusiastic. I think there is a certain element of truth that currently the investment industry doesn't have the resources, time or the skills or indeed inclination to do that but it's certainly something that might be thought about in the future.

**Mr Jubb:** This relates to the suggestion, as previously mentioned, that as the Stewardship Code evolves—because auditing is central to good stewardship—there should be a principle in the Stewardship Code that provides that those institutions who sign up to it do adopt a higher duty of care and engagement on audit and corporate reporting matters.

**Q428 The Chairman:** I'm very anxious that we shouldn't take up recommendations that will lead, as in the past, to nothing happening in practice. If I could just explore this one a little bit further. I think it would be fair to say that the item at the annual general meeting dealing with the appointment of the auditors is the one that goes through fastest and

without any questioning in practically every case. Would recommendations along any of these lines make any difference?

**Mr Jubb:** I believe that they would in terms of the engagement and the understanding that goes into the decision that shareholders make to approve or otherwise and, as you will be familiar with the way in which corporate governance and stewardship operates in the UK, part of the role of the institutional investors is to exercise influence so that when it comes to the AGM it does meet with the approval of investors. At the moment, as colleagues have indicated, we do not have sufficient information. By putting a principle that we subscribe to, it gives our clients and others a basis on which to hold us to account as time goes by. That hook of accountability is not currently there and if it were adopted, in that way or some other way, it would enable progress to be achieved.

**Q429 The Chairman:** Would that be a general view of the other four or other three institutions?

**Mr Pitt-Watson:** Yes. I was in Deloitte for a number of years. I work for Hermes now and I speak very much here in a personal capacity. I think there are things that you can do—it's really important that they are done—that nudge the audit towards doing what it says on the tin. But these are quite difficult to bring about. Some of them are structural with the involvement and shareholders and all the rest of it. I think probably many more of them have to do with the role of the audit and the regulator, which I know Lord Lawson has taken a great interest in, and also what the audit is and the insistence that the audit is, for example, for the shareholders.

What Paul did at the FRC is extremely important: that the Big 4 don't think that the client is the company but they do think that it's the shareholder; that the principles are true and fair and all those sorts of things are there. We've talked a lot about prudence, but prudence is a

principle that's been changed for neutrality. We want to watch out for those sorts of things and I think that your Committee might want to focus on those as well as just obviously on structural things.

**Q430 Lord Moonie:** What, if anything, do you think can or should be done to promote shareholder engagement in the appointment and reappointment of auditors?

**Mr Jubb:** It has been suggested in this Institute of Chartered Accountants of Scotland report that every five years the audit committee should engage with its principal shareholders about the quality of service and other aspects surrounding the auditors and the relationship that subsists. If that approach were adopted as a matter of good practice, it should enable a sensible dialogue to take place and enable shareholders to exercise influence, consistent with their responsibilities, either to institute change or otherwise. At the moment, sadly, that dialogue, as we have represented, doesn't take place.

**Q431 Lord Best:** You think that UK corporate governance is too light in this regard. What changes would you wish to see; aspects of the UK Corporate Governance Code becoming mandatory; in particular the question of whether every FTSE 350 company should have an audit committee? I am just picking up various points that you were making on audit committees. Mr Jubb was saying that they don't consult and talk to the investors. The audit committees don't add that line of communication and Mr Richards was saying that they sometimes are the ones that insist on the Big 4, on continuing the concentration. I didn't get the impression that you felt very strongly that audit committees, as such, would make a huge difference to anything; a mandatory requirement for them.

**Mr Richards:** To the best of my knowledge I can think of only one company that doesn't have an audit committee, which is Daejan Holdings, which is effectively a family-controlled

company even though it's listed. Four of the five directors are family members. There is not even a single independent director and they've decided that the whole board shall act as the audit committee.

**Q432 Lord Best:** Is this the whole 350 you're talking about? Only one in the whole of the 350?

**Mr Jubb:** In 1979 I wrote an article for the *Journal of Accountancy* called *The Objectives and Advantages of Audit Committees* and I was informed regarding that by Sir Brandon Rhys-Williams, who was a member of the House of Commons. At that time audit committees were not prevalent in the United Kingdom and he made particular representations in the House of Commons that were encouraging of that. To a large extent, following Sir Adrian Cadbury's report on the financial aspects of corporate governance, we now enjoy audit committees being, as we have indicated, throughout the 350. What we are lacking is the communication and dialogue regarding the work that the audit committee does on behalf of the board but on behalf of shareholders as well. That is very important to the future.

**Mr Lee:** When the European Commission, a few years ago, proposed making audit committees mandatory across the EU we opposed it simply because introducing mandatory requirements into corporate governance in some way absolves shareholders of the responsibility to get involved and to change things that they don't like. We'd far rather that the responsibility sat very clearly on the shoulders of the shareholders to seek the governance structures and frameworks that they want. That would be our perspective on any move in that direction.

**Q433 Lord Smith of Clifton:** The problem is that one reads countless articles in the financial press of shareholder passivity, which you gentlemen represent presumably, and you

can't have it both ways. Either you are going to be active or some other check has to come in.

**Mr Lee:** My colleagues have already suggested that there is an appetite among shareholders to be more active on these issues around audit. The problem historically has been that investors simply don't have the information, either about individual companies or frankly about the market as a whole. That means that the individuals who might become more active in particular institutions feel uneducated, under-informed and, therefore, unable to make difficult judgements. That is now changing. We hope it will change further as audit committee reports improve and as audit reports also improve. Once we have the basis to take judgements and decisions, those judgements and decisions will be taken and they'll be taken actively.

**Mr Pitt-Watson:** But even at that, Paul, the point that you make about investor passivity, I'd have to say I would excuse my four colleagues here; these people in the investment industry that devote their lives to trying to be proper active investors and hold people to account. But I think if the Committee is thinking about how much you can place on investors picking up the baton and running with it, I think you need to have a degree of scepticism about just how much will be done.

I think the story that Mr Richards told you about an audit appointment would be one that I would bear in mind in thinking about this. It's not that all of us in this room wouldn't want to see more of this. It is just that the fact of the matter is the structure of the market is mainly about the trading of shares rather than about the owning of shares and it's in that owning governance part that the audit is fundamental to the integrity of the capital markets.

**Q434 Lord Lawson of Blaby:** I absolutely agree with you and agree with Lord Smith. Investor passivity is the rule and activity is the very small exception. My very dear friend,

Alastair Ross Goobey, who used to work for me before he went on to higher things, blazed a trail in investor activism. But although he blazed that trail, and this was a long time ago now, very few followed him. Therefore, I have to say I am not optimistic of anything happening on that front although it would be very desirable if it did.

**Mr Lee:** A few of us had the privilege to work with Alastair.

**Q435 Lord Lawson of Blaby:** Perhaps I may move on to the issue of the banks, which is certainly the area that concerns me most. We have been through a real banking disaster and although there is no evidence at all to suggest that the auditors were responsible for the disaster, there is equally no evidence that they, in any way, reduced the disaster. What is to be done to prevent a similar disaster in the future? I'd like to start by referring back—I hope I've not misunderstood or am misquoting—to something that Mr Richards said in this very context. He said that there should have been some signalling by the auditors. I should like to know exactly what he meant.

**Mr Richards:** If you look at banks, and many people have, there were a number of issues that were very apparent in the banking system that were of concern. Some of those were the result of imprudent standards and so on. I highlight specifically loan loss provisioning as an example of that. Some of them were slightly harder to put your finger on around things like going concern.

I think the issue has been that the audit has been rather compromised in terms of the impact that IFRS has had on what scope the auditor has to play. Just using the loan loss provision example, if the standard says, "You will not make any provision until the loss occurs", which is ultimately what IFRS IAS 39 says, there is very little that the auditor can do to say, "Listen management, you're not being very prudent about it".

Having said that, I noticed in the *Daily Telegraph* yesterday there was a very interesting article about Santander finding its way around IFRS to ensure that it remained prudent. I suppose technically they may have been in breach of the standards; good for them. The other issue within that context is that the standards specify a process that shall be followed and then allow huge discretion in the assumptions used. I'm thinking fair valuation here on the marked model basis. I will give an example.

We had a company chairman come in to see us—a company we held more than 10% of—about a very significant valuation and he wanted our view about it. It was very quickly apparent to us that the valuation was not one we could agree with. The numbers and valuation had been agreed with the auditors and the brokers. The assumptions used in it were aggressive, with a capital A, particularly around the volatility put into the model. The actual final number that we agreed on was slightly over a third less in terms of the valuation of the instruments.

But it highlights the issue and, having spoken to members of the profession about this, you get—and I will characterise it slightly—a finance director will approach the auditor and say, “What’s the range of fair values that would be acceptable under the standards?” The auditor might say, “Well, it’s between 70 and 140 and we think the reasonable prudent number would be about 95”. The FD says, “Thanks, 140 is just what I was looking for. Thank you very much”, and it’s compliant with the standards. I’m exaggerating slightly but the auditor is then in an invidious position of having very little leverage under the way that the standards work to push back on that.

I know there are many auditors who have done a very good job in some circumstances in trying to do that but the auditor is operating in a system and is somewhat constrained by the standards framework and the way it has developed. Clearly the process-orientated model

helps them with their liability exposures and every time there is an audit failure, “At all material times we complied with the standard”, is the first thing they will say.

**Q436 Lord Lawson of Blaby:** That is interesting, but may I come back to the more general point? If there is any signalling, if there is any querying of the going concern—and it is suggested that this, in general terms, should be nothing that shareholders should worry about—or if the accounts are qualified in any way—the Big 4, in their evidence to us, in fact, said, “We couldn’t do that because banks depend on confidence and the confidence effect would be so damaging to the banks”—do you believe that that is the whole truth or do you believe that they did not spot what was amiss?

**Mr Pitt-Watson:** There’s a sort of circular thing in this as well. I made a point about information. The fact you know that this information is going to be declared changes the way in which you behave. If you are a bank and you think there’s any difficulty about your loan book and that that’s going to be declared, you would change what you would do in your business practice. That is what we, as investors and what we as society, I think, are looking for; not something where somebody says, “Oh, you’re not the going concern any longer. You’re bust and the shareholders have to dive in”. So I would just think about that element. If you ask the auditors about this, particularly if you ask them privately, and you say, “Look, I thought we had this true and fair view that was supposed to be the override”. In fact this weekend I was emailing one of my former colleagues who is a very senior auditor. He said he would agree that the true and fair view should override the rules but it’s difficult to put into effect when a general rule is laid down so emphatically by the standard setters. If you set that together with the point that Iain has made about the behavioural situation that you’re in, where somebody wants this valued highly on their books, perhaps because their bonus might be based on that, you’ve got yourself a really difficult issue. The importance of



being able to make sure that anything that we do is reinforcing professionalism and reinforcing principles and that the rules are there to help the principles is, I think, something that this Committee might want to focus on.

**Mr Richards:** The FSA has admitted that there was a problem here. There are areas that are proper accounting and the difficulty with them in saying that something is true and fair is that it doesn't necessarily reflect the risk involved. This is where the concern around the relationship between the auditor and the regulatory authorities becomes so important, particularly in relation to things like prudential risk.

IFRS is extremely procyclical. It facilitated and exacerbated the credit bubble and then brought it home to roost in the crash and crisis. The issue then is that there were some very clear risks inherent in what was going on in bank accounts. They may not have justified a going concern statement at a given point in time but the risks were extremely material. There were valuations that frankly I'm not sure were necessarily rigorously carried out on some instruments where reliance on netting off against credit default swaps was fictional given that the CDS markets, which hit US\$66 trillion at its peak, was 80% naked and the counterparties could never meet their exposures. Reliance on an instrument like that to support a toxic instrument that you are carrying on your balance sheets is imprudent, in my mind, but it's acceptable and allowed under the standards.

The difficulty is, as these issues emerge, how they are addressed and just looking at a going concern statement isn't necessarily the solution. There needs to be a much earlier stage of involvement where the prudential regulators can be involved. Equally, we would look to see the prudential regulators being much more forthright and open to talking to the auditors about their perception and awareness of risks that are relevant to the audit.

**Mr Talbut:** From my perspective I think effectively what I would guard against is the situation whereby we are afraid to alter anything because in a crisis situation there will be a

problem. We would like to see changed behaviour in more normal circumstances that makes it less likely that we will end up in a crisis situation. Therefore, we think that the emphasis upon prudence and taking a conservative approach has been considerably lost in the way in which the accounting standards are operating and in which managements want those accounting standards to operate.

**Mr Richards:** If I could add an extra point; in terms of sweeping everything under the carpets, that has had a material cost to the taxpayer and to shareholders. By sweeping some of these issues under the carpets, distributions have been made and bonuses had been paid that were imprudent. The gap and the hole, in terms of cash, that resulted has had to be plugged and double-digit billions of the money pumped into the bank went to plug the gap created by both the bonus distribution and the dividend distributions that were made just preceding the crisis and some fairly significant capital raisings.

**Lord Lawson of Blaby:** Everything you say seems to me to be absolutely fair and accurate and you have, in fact, said that there was clearly some degree of audit failure and yet nobody has been sued. It's true that in the United States Ernst & Young have been sued over the Lehman Brothers auditing but that's an isolated incident, so far as I'm aware, on the banking front and it is in the United States. So maybe you accept the view and indeed Mr Jubb did suggest that there is a particular sensitivity in the financial services sector and, of course, that sensitivity is highest in the case of the banks.

I do understand there is a point here about what would be the effect on confidence and on the share value and on the viability of the bank if there were to be a negative auditor's report. So we come back, as a sort of fall back, to something you, Mr Richards, referred to a moment ago and something which I have been very concerned about, as you know, over a number of years—I think I introduced the requirement in the 1997 Bank Act—private

discussions between the auditor and the regulator if the auditor has concerns about a bank, but he feels, for the reasons I have just indicated a moment ago, he should not qualify the accounts in any way but he will go and speak to the regulator. That means that the auditor is saying to the regulator things that he is not telling you, as shareholders.

I hope that does not give you cause for concern. I don't know what conclusion we will come to but it is very important that we should be satisfied that if we do think that this dialogue needs to be beefed up—it was rather watered down, so far as I can see, when the change of regulatory authority from the Bank of England to the FSA occurred; there was still an obligation but it was a weaker obligation and, indeed, very much less happened in the way of dialogue—that you would not be at all concerned as investors.

**Mr Lee:** We would not be concerned by such dialogue. We would welcome it.

**Mr Pitt-Watson:** Indeed, I think there might be more to your proposal as well, Lord Lawson, both in terms of what the issue is and what we might do about it and also I think it is something on which we might be able to get political consensus. In the first half of last year I was part of the Future of Banking Commission. It was sponsored by *Which?*, but it was chaired by David Davis. Vince Cable was one of the members, as was John McFall. So it was a cross-party commission and, like you, we were investigating the role of audit; although not in as much detail.

I noted and we were concerned by the managing director of the FSA who told us that, in thinking about the audits of banks, it is not the purpose of the audited accounts to forecast potential losses on loans. It seemed to us that if that was what the regulator thought a year ago, after the crisis, we have a problem here. Because it means that absolutely safe loans and absolutely unsafe loans, in the mind of the regulator as well as in the mind of everything else, could conceivably have been put on the balance sheet at the same value and, therefore, have generated the profits and, therefore, have generated the bonuses.

It seems to me, therefore, if we're thinking about what we do—I was reminded of my old textbook on that auditing and accounting term: “There seems to be no limit to the optimism of businessmen”; it's a very old textbook, and politically incorrect—the first line of defence for investors and creditors is the vigilance of the practising accountant. How is it that we manage to get that vigilance back? I should have thought a huge focus on principles over rules. We got into this really ironic debate, “If we do this on principle and then we get one of these things wrong, then you'll come back and we'll sue you”. So instead of doing what it is that the shareholders and the governance system need, which is the rules helping the principles, “Well, we'd rather do just the rules”, and that was the quote that you had from my former colleague. That would be one.

I think, also, you could question the principles themselves, particularly the balance of what I learned on accounting, which was that it should be prudent and objective rather than neutral. Again, prudence we have talked about and I think most investors would say, “Gosh, prudence and objectivity; that would be something that we would want to see”. Then the final thing is the reinstatement of discussions. If I was advising this Committee, I think you might think about how extensive you want these discussions to be.

I think they could be quite extensive. Not just simply the auditor going and seeing the regulator and saying, “I'm a bit concerned about this”, but something that is reasonably formal; that should perhaps include the auditor's entity, the chair of the audit committee of the auditor's entity. It used to in the past, for example, include commissioning by the regulator of the auditor to do things that were specifically for the auditor. I don't think that many investors would object if the regulator was to say, “Look, the auditor is going to charge up but we're going to make sure that this system is stable”. As I say, those were the sort of things that we were discussing in what was a cross-party group and I think they may have some relevance for the sort of issues that you are thinking about.

**Q437 The Chairman:** On that last point, just to be clear, these discussions that you are talking about, between the auditor or the chairman of the Audit Commission and the regulator, would be in private.

**Mr Pitt-Watson:** Would be in private, yes.

**Q438 The Chairman:** And you were quite happy with that as investors?

**Mr Pitt-Watson:** Yes.

**Mr Jubb:** There is one supplementary, if I may, however. The institutions represented here are long-term investors. When a bank is failing, other than the exceptional circumstances, it is our clients who have to provide that additional capital to support the entity going forward. One of the aspects of the discussions that has to be contemplated, as well as being bilateral between the regulators and the auditors, is that there should be some understanding of the mechanism as to when institutions in a regulatory compliant way—long-term institutions—can also be brought into that dialogue to help formulate the solution if additional capital is required to enable the company to continue forward. Most of the institutions here, I am sure, will have capability to deal with such information in a regulatory ring-fenced, compliant basis to enable that to happen.

**Mr Richards:** If I may add one extra thing to this dynamic that we are all supportive of. In the Equitable Life case, Lord Penrose, even though the standards were not within his locus, went to great pains to point out that the standards set the threshold so high that, for all material purposes, it was very hard for the auditor to ever justify talking to the regulator. The report is quite revealing and I think Lord Penrose made a rather tart aside at the end of his recommendations to note that it seems that the auditors can say they complied with the standards at all material times. I think, in looking at this, we have no insight in terms of what

dialogue did take place between the auditors and the regulator. But I think, in looking at this area, it is important not to take for granted that the obligations on the auditor at the moment are necessarily correct and it is something that is worth examining to ensure that they would be effective and were effective.

**Q439 Lord Hollick:** There is quite a degree of unanimity among you about the emphasis on prudence in terms of accounting and re-examining the rules. Is that unanimity expressing itself in dialogue with the audit firms, with the banks that you are continuing to be a shareholder in? Is your enthusiasm for this change of direction, change of emphasis, re-examining the rules, shared by the banks and the financial institutions in which you invest? Have you had discussions with the FSA about these matters?

**Mr Jubb:** Just yesterday I had a sandwich/working lunch with the chairman of one of the major British banks and the aspect of prudence and the importance of prudence was emphasised in that. If I could take this further into the market conditions, one thing that markets do not like is when the audited accounts come out and you then have further provisions that are made on a drip-feed basis thereafter. We were emphasising the importance, to the chairman of the board, to ensure that appropriate prudence was put into place. So I use that as timely evidence that this is more than rhetoric; it is in fact put into practice.

**Mr Talbut:** From my perspective, we certainly have, when we have spoken to the regulator and also to many other financial organisations—I suspect others have as well—expressed our scepticism with the issue of fair value accounting and the part that it played in the lead-up to the crisis and then in the crisis and even after it. We are still dealing with the crisis. So our scepticism—this is not allowing us to get to what we think is the correct answer in terms of the valuation of these organisations—is something that we have expressed.

**Q440 Lord Lawson of Blaby:** Following on from that, the emphasis on prudence and the move from neutrality to prudence, as Mr Pitt-Watson said in the very interesting evidence he gave a little while back, I think probably most of us would think that is right. But how do you square that—and maybe this is what you are getting at—with mark-to-market accounting? Because at the height of the financial boom, at the height of the financial bubble, nothing could be less prudent than mark-to-market. So how do you square that circle?

**Mr Talbut:** That one is exactly true. You couldn't square the two and that was a significant element, we would suggest, behind the troubles that led up to the crisis.

**Q441 Lord Lawson of Blaby:** So what is the solution?

**Mr Lee:** The one regulator that Lord Hollick did not ask whether we were having dialogue with was the International Accounting Standards Board—as was, now the IFRS Board—and we are certainly having dialogue with that board. They were, historically, very much in favour of fair-value accounting, mark-to-market. That is changing and they have, in recent years, become much better at listening to investors. Investors, frankly, have become much better at talking to them and that dialogue is leading to a change in the sorts of standards that are coming forward. They are changing the way in which financial instruments will be dealt with; the way in which loans will be dealt with in the books. So, over time, those concerns are evaporating but we are continuing the dialogue with the board.

**Mr Pitt-Watson:** I think one must recognise, however, that it has to be the principle that has the override—objectivity says mark-to-market is pretty good; prudence says there may be some circumstances in which you want to be thinking about whether that is sensible or not. I think the danger, at a fundamental level, of hundreds and hundreds of rules is that you encourage innovation to go around the rules. So rules in a system don't prevent people who

are unprincipled within that system. I don't mean that in a negative way, but they encourage people to try and go around them.

The only way that you can overcome that, I think, is with principles and with professionalism. That is why the statement that I gave from my former colleague seems to me to be so informative; that if you have too much weight on the rules so that there is not an encouragement for the professional override of that, whether it is on banking loans or anything else that we are looking at in audit, then we will give ourselves a problem. We don't have shareholders that are going to hold companies to account. We desperately depend on auditors being able to do that for us. We desperately depend on their judgement.

**Q442 The Chairman:** Of course, also the judgement of the chairmen, chief executives and boards of the companies concerned, which we are not dealing with at the moment.

**Mr Pitt-Watson:** Exactly. It is right through the system, isn't it? And the role of the auditor within this system is to be able to be like the inspectorate, the eyes and ears, who, in extremis, reports back to the shareholder so that the shareholder takes action and changes things on the board of directors. But because the board of directors knows that this report is going to come out telling the truth, the whole truth and nothing but the truth, they will therefore run their company, naturally, in the way that they ought to, which is in the interests of the shareholders, taking into account wider society.

**Mr Richards:** It has always fascinated me that the purpose of the audits isn't defined in legislation. There is no defined purpose for it and it is articulated, or it was articulated, by the Law Lords in the *Caparo* case and the auditors have two, if you like, objectives. The first one is to protect the company itself from errors, omissions or wrongdoing and the example that was given was improper distributions from capital. The second is to signal to the shareholders to enable them to enable them to carry out their, if you like, stewardship



duties of the company. It was rather well articulated and, alongside adopting the necessary principles to support the true and fair view. Having a clear articulation and effective purpose for the audit would be very useful as well because it's often obfuscated in debates and its absence often leads to standards being interpreted in its particular way.

**Mr Jubb:** To take that one stage further, the *Caparo* judgement was the judgement that enshrined the responsibility of the auditors to the shareholders as a body of the company in that regard. If there were to be better articulation of the role and purpose of the audit, there should be also better articulation of to whom the auditors are accountable, because as we are currently sitting, it is in relation to the shareholders taken as a whole. In terms of litigation, this is one reason why in the United Kingdom it is primarily in relation to rights issue documents where the audit report is enshrined that litigation arises, rather than in relation to the individual audit reports on individual sets of accounts. The *Caparo* judgement is something that needs to be considered within that wider review.

**Q443 The Chairman:** I do not want to prolong this too long but this has been a very interesting session for us. Can I just ask a couple of questions to be absolutely clear about the last part of the discussion we have been having and particularly to Mr Richards? In terms of the position of the auditors in relation to the banks at the end of 2007 and the end of 2008—I am summarising very briefly and probably inadequately—the evidence we were getting from the auditors on that was that in 2007 they were working according to the accounting rules and looking at the situation as it was before the end of 2007, at the end of the year-end. In terms of 2008, they were able to get comfort from the fact that they had discussions with certain Treasury Ministers who indicated to them what the Government would be prepared to do. Would you be criticising the auditors in both cases on that score?

**Mr Richards:** You touched on a number of issues; if I take them in reverse order. I think it is very dangerous to create a situation where going concern can be contingent on all sorts of unrealised discussions. Ultimately, what you might end up with is, “We are going to need a rescue rights issue but we reckon there’s a possibility the market will support it. Therefore, it’s a going concern”. I’ve replaced the taxpayer with the market in that case. I think we saw a couple of banks that ran into trouble trying to get their rights issues away and I think it’s very dangerous to start accepting implicit contingencies within the going concern concept.

Going concern is already limited to a 12-month period. It’s quite an important one. There are a lot of other things that going concern is important on and feeds into, not least distributions. I think if you start creating flaws within the going concern statement, we are looking for trouble. That is not to say that it is necessarily improper for prudential regulators and the authorities to be taking a more strategic view about issues. We don’t know what went on; so it’s very hard for us to comment.

Coming back to the point-in-time position, this is one that is always very interesting. Let’s take fair value: mark-to-market as opposed to mark-to-model. This is something that can go terribly wrong and I think in the banking scenario we saw this, particularly around some of the toxic assets that were around. If we take just a simple one, the CDO; a lot of the values that were attached to that were not ones that could ever be realised in full when there was a problem and reliance was placed, as I mentioned before, on credit default swaps and you get a mismatch. Fair value is, “Yes, you may be able to sell some of it in the market but if you tried to shift any significant amount, that value doesn’t apply”. You have a very notional value, but you’re not looking at the depth and liquidity that underpins it. So I think there were question marks about whether some of the valuations of instruments were really substantive and true and fair.

**Q444 The Chairman:** Is that not also criticism of the rating agencies?

**Mr Richards:** I think the criticisms of the rating agencies are well-known. There was a very big problem; worse than a big problem. They were bloody awful, if you'll forgive my French.

**Mr Pitt-Watson:** Lord MacGregor, this is a cumulative thing, isn't it? Actually, if we'd had more conservative accounting then the profits and the equity of the banks would have been lower; the bonuses wouldn't have been so big; they wouldn't have loaned out so much more money. I am intrigued that when HBOS was taken over by Lloyds that, of their £432 billion loan book, Lloyds said £186 billion of that was not business that they would've wished to do. It would have been helpful, maybe it did happen, if whoever was auditing HBOS had said, "Your loan book seems to us to be rather different from the loan books that we're finding in other banks".

Perhaps there should be some provision behind this. But, of course, if the regulator was saying that the purpose of audited accounts is not to forecast potential losses on loans, you can see how it is that the auditor might prefer not to have that awkward conversation. And if that awkward conversation is not had, you then end up finally with collapse, rather than with having this sand in the machine that slows things down before you get to having to consider going type issues, which come at the very end in 2008.

**Q445 The Chairman:** Normally, with some of our witnesses, we have asked them at the end a sort of all-embracing question, "If there was one measure that you would want this committee to recommend, what would it be?" I think as a result of this conversation, it is quite difficult to answer that but if any of you would like to try, please do.

**Mr Richards:** If I can, it's a package that involves the reference that was made earlier about setting a clear ultimatum to the Big 4 that is time-defined in terms of output. I think by making it an ultimatum, you have to sort of look at tangible actions that would be taken if

the outcome sought wasn't achieved—whether that would be the introduction of joint audits, mandatory tendering of audits, rotation or some other direct intervention—and supports that ultimatum with a package of measures that I hope we have tried to outline in terms of seeking greater transparency in audit committee reports, more enhanced audit reports and increased governance arrangements, including changes to the Stewardship Code.

**Q446 The Chairman:** Anyone else, or are you happy with that?

**Mr Jubb:** I couldn't have put it better myself.

**Mr Pitt-Watson:** I think, pragmatically, just thinking about how we get the principles and the professionalism back into this—and also I would follow up on some of the questions that Lord Lawson was asking about the reporting of the audit to the regulator—those two, I think, are pertinent and important issues where a push from the House of Lords would make a difference to the outcome of the debate.

**The Chairman:** Gentlemen, I think the length of the session demonstrates how helpful you have been to us. Thank you very much indeed.