House of Lords Select Committee on Economic Affairs – 11 January 2011

Written evidence from Iain Richards

The views and opinions expressed below are personal.

1. Does audit market concentration cause unease amongst investors? If so, why?

1.1 From an investment perspective, the potential risks that the current level of audit market concentration creates are apparent - the FTSE350 audit market is characterised by a tight oligopoly, a renewed emphasis on non-audit services, high barriers to entry and the problem of "too-big-to-fail". Although, the level of competition in the market has reduced compared to that seen in the 1980/90s that is not, of itself, necessarily a bad thing. From the early 1980s, audit firms came under tremendous pressure to lower their audit fees. Clients actively played the eight major audit firms against one another to lower their audit fees in bidding wars. As a result, audit fees became a "loss leader" and were not self-supporting. [1] According to Yale University professor Shyam Sunder, the auditors responded to competitive pressures "by lowering their audit fees, lowering the quality of audit services they provided, and by turning to more lucrative consulting services." Audits became a tool for attracting clients' business for management consulting, information technology, tax advice and other services.[2] It was not uncommon for the major accounting firms to under price ("lowball") their audit services to gain other business from clients[3] (see also paragraph 1.10 below).

1.2 The last major competition case that comes to mind was in Italy in 2000, when the Italian authorities levied fines on the Italian Association of Public Accountants and its members (i.e. the Big 6 firms) for violations of Italian antitrust law by concluding agreements that covered many aspects of competition between the auditing firms. The violations were of two distinct types: setting prices for the services offered on the market by the Association's members and, more generally, coordinating competitive behaviour.[4] Since around 2002 the Big 4 accounting firms appear to have been engaged in a milder form of competition for audit clients than was seen in the 1980s and 1990s, although Tier A and smaller accounting firms still face formidable barriers to entry in the larger company market. That is not to say, though that there are no extant concerns.

1.3 The principal interest of shareholders in a healthy audit market is on seeing the focus and dynamic squarely on robust and effective audits i.e. audit quality and I agree with the European Commission's starting point in their Green Paper[5] on audit:

"Robust audit is key to re-establishing trust and market confidence; it contributes to investor protection and reduces the cost of capital for companies."

1.4 The collapse of Andersen gave new impetus to concerns about the level of concentration in the audit market, around questions of competition, choice and the problem of 'too-big-to-fail'. A particularly good examination of the issues can be found in Bernard Ascher's (The American Antitrust Institute) working paper: "The Audit Industry: World's weakest Oligopoly?" (Aug 2008).[6] It is fair to say that investors have a particular concern over the theoretical risk of another big firm failure and the consequent disruption and uncertainty that could create. In that context, the consideration that is reportedly being given to the possibility of introducing arrangements equivalent to 'living wills', to ensure that if another firm were to fail, the situation could be managed and addressed promptly, is particularly welcome. In taking that forward it will be important for particular thought to be given to the question of how to ensure that any such arrangements do not further exacerbate the current levels of concentration.

---

[1] Berton, Lee, "Audit Fees Fall As CPA Firms Jockey for Bids," *Wall Street Journal*, Jan 28, 1985, p.1
[2] Shyam Sunder, "Collapse of Accounting: Causes and Cures", Yale University, PowerPoint slides
[3] Bazerman, Max H., Morgan, Kimberly P. and Loewenstein, George F., "The Impossibility of Auditor Independence," Vol. 38, No. 4, *Sloan Management Review*, Massachusetts Institute of Technology, Summer 1997
[4] Italian Authority Press Release, Proceeding Reference 1266, Number 4, February 21, 2000; also Proceeding Reference 97, November 25, 1998
[5] European Commission Green Paper, Audit Policy: Lessons from the Crisis, Brussels, 13.10.2010 COM(2010) 561 final (see http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf)
[6] Available from http://ssrn.com

1.5 Beyond that though, the issues for investors around the current state of the audit market are perhaps more nuanced than a focus just on concentration might allow for. It is certainly true that the growth in international operations of businesses created a rational pressure for consolidation amongst audit firms, to enable them to address the increasingly international or, indeed, global scope and scale of the entities they were auditing, as well as to enable them to maintain specialist resources, be effective and profitable. However, the current state of the UK audit market and the current levels of concentration in the FTSE350 cannot be justified on that basis (see answer to Q.2).

1.6 Oxera's report "Competition and choice in the UK audit market" (April 2006)[7] found evidence that higher concentration has led to higher audit fees (in line with economic theory and with several other recent empirical studies) and that, in addition, the audit fees also seemed to have risen as a result of cost increases, caused by factors such as changes in regulation and the accounting rules. Analysing the effects of the merger in 1998 between Price Waterhouse and Coopers & Lybrand, Oxera found the PwC merger led to a price increase which could have been in the order of around 12% from one year to the next - 8% for the market as a whole, and another 4% for the clients of the merged entity. Despite initial discounts being available though, actual levels of switching are low.

1.7 From a corporate perspective much emphasis continues to be placed on the wider range of non-audit, value-added services that can be obtained on top of the audit itself and this aligns with the overriding commercial priorities that seem apparent in audit firms (see answer to Q.5 and, in particular, paragraphs 5.9 to 5.12). In addition, bargaining on fees takes place during the annual audit firm reappointment process to, as one director put it, "ensure pricing remains keen" (see also the Rentokil example in the answer to Q.6)

1.8 Off-setting issues around increased audit costs (which perhaps more properly reflect the real cost of audits than has been the case in the past), in addition to the issue of discounting, there have been ongoing concerns over the practice of under-reporting time worked in the audit. Given that, US academics have again researched that phenomenon[8] and found that "staff reporting accuracy and managers' personal preference for the client interact to affect managers' performance evaluations of staff, with the highest evaluations going to staff who underreport when the managers preference for the client is high, and the lowest going to staff who accurately report that they have exceeded budget when the manager's preference for the client is high". They also found that "managers are more likely to request an under-reporter on a different engagement, regardless of their preference for the current client".

1.9 When I wrote my paper "Bringing Audit Back from the Brink (Auditor liability and the need to overhaul a key investor protection framework)" in 2004, I highlighted related findings by Otley & Pierce[9] (e.g. on the use of short-cuts) and Willett & Page[10] (quantifying the incidence and reasons behind 'speeding up of testing'), to emphasise the concerns that exist around this dynamic and from the increasingly formulaic audit approaches being used.

1.10 A key concern is that audit has to some extent become commoditized, in part for liability limitation purposes (e.g. helped by the auditing standards and development of related processes) and in part from being subordinated to wider commercial interests (e.g. higher margin non-audit work). Essentially there remains a real risk of the kind that led me, in 2004, to highlight the potential relevance of the Akerlof 'market for lemons' model[11] to the audit market, something that had not gone un-noticed by academics and not without reason. It only requires some 'bad' audit opinions to create the dynamic that forces high quality audit opinions out of the market:

---

[7] http://www.bis.gov.uk/files/file28529.pdf

[8] Agoglia, Hatfield and Lambert researched and published "When Do Audit Managers Prefer Staff to Underreport Time?" (Sept 2010)

[9] "Auditor time budget pressure: consequences and antecedents" D.Otley and B.Pierce (1996) Accounting, Auditing & Accountability Journal

[10] "A Survey of Time Budget Pressure and Irregular Auditing Practices Amongst Newly Qualified UK Chartered Accountants" (1996) C.Willett and M.Page, Britich Accounting Review, Vol 2, No.2

[11] "The Market for Lemons: quality uncertainty and the market for lemons" George Akerlof, Quarterly Journal of Economics 1970

"Consequently honest auditors are unable to compete in [the] market unless they decrease the quality of their own audit or supplement their (lack of) audit income with other revenue streams (e.g. non-audit services), which results in undermining auditors' independence."[12]

1.11 It remains notable that 17% of audits reviewed by the FRC's Audit Inspection Unit at major firms (including some in the FTSE100 and FTSE250) were deemed to require significant improvement (slightly up on the previous year), and a further 32% were rated acceptable but in need of improvement (a drop on the previous year). Given the purpose of the audit in protecting the company and its shareholders, this is an area of ongoing concern, particularly given the fact that the IFRS accounting and ISA auditing standards have de-emphasised prudence and substance over form in favour of a more process driven, compliance approach.

1.12 Moving on from this, Oxera's 2006 report highlighted that reputation was a significant driver in the choice of auditor, "favouring the Big Four." Much emphasis is often placed on the apparent preference of markets and investors for the use of Big 4 firms and this needs some clarification. Investors and shareholders in particular, while attaching considerable value to having an audit, have very little true insight or transparency on the audit and its dynamics. It is often difficult for shareholders to form substantive views or make well informed decisions about audit firms, audit relationships, the audit itself or the routinely bland audit outputs (e.g. the audit report – see the answer to Q.8). As a result big becomes a proxy for safe, akin to the old adage that no one ever got fired for buying IBM (see, however, paragraphs 2.6 and 2.7).

1.13 The same is true of bankers and other market participants. The American Assembly, an influential public policy forum (associated with Columbia University), noted the effect of a more diffuse snobbery in a 2005 report[13] that said a 'patina of authority and confidence' surrounded the Big 4: 'Analysts and investment bankers are often concerned that the presence of a mid-tier firm as auditor will negatively impact a company's marketability, either by creating the perception that the company was shed by a big four because of high risk, or raising a spectre of doubt about the validity of its financial statements'.

1.14 In addition, despite the notional appointment of auditors by shareholders, this is in reality more a matter of form, rather than of substance. Auditors are recommended to Boards by audit committees and shareholders are then given a binary decision to address – 'here are the proposed auditors, appoint them' (see the answer to Q.6).

1.15 The lack of transparency and related substance in current disclosures is something that needs to be addressed, both in relation to disclosures by businesses (e.g. in relation to their audit committee reports and the types of fees being paid to audit firms) and by auditors in relation to the audit reports they produce for shareholders (see the answers to Q.s 4 and 8).

1.16 Looking at another of the factors that can create barriers to entry to non-Big 4 firms (see the reference to the American Assembly report in paragraph 1.13 above). Although the extent of the issue is not clear, credit agreements are emerging that put pressure either explicitly or implicitly on businesses to use a Big 4 audit firm. In this context we would note that research undertaken by Grant Thornton's US arm, conducted last year identified more than 450 restrictions applying to at least 220 companies in the Russell 2,000 index. While widely available on the public record in the US, in Europe such covenants are not transparent or easily recognised, although I understand from press reports that the audit firms have acknowledge to the OECD the existence of restrictive covenants in the UK[14]. I am also aware that other comments have been made to the effect that actors in this market do not actually stipulate the use of a Big 4 firm. A Spanish example highlighted by BDO International may add some colour to that, as the terms included the provision that: "The parent company, although not legally obliged to do so, undertakes to submit its individual and consolidated annual accounts to an annual audit by one of the four most solvent and internationally renowned audit firms (the Big Four)" - it may not be expressly stipulated but would be hard to ignore. Similarly I understand that the Loan Market Association, defines an

[12] "Audit Opinions or Lemons? Insights from Andersen and the Enron Audit" P.Roush and L.Thorne, University of Central Florida and York University Ontario.
[13] "The Future of the Accounting Profession: Auditor Concentration" (2005)
[14] See Accountancy Age - http://www.accountancyage.com/aa/news/1809171/audit-market-fiercely-competitive-deloitte-argue

"auditor" as one of either PricewaterhouseCoopers, Ernst & Young, KPMG or Deloitte or "any other firm approved in advance by the majority lenders." Again, this is not a stipulation per se.

1.17 Some commentators in this debate have suggested enabling Audit firms to raise external capital as a way to enhance competition with the Big 4. When the EU Commission published a summary of the replies[15] received to its consultation on control structures in audit firms and their consequences, which it had launched in November 2008 (IP/08/1727), most of the respondents considered that lack of access to external financial capital was not the most important barrier preventing emergence of new players. Bear in mind also, that audit firms are allowed to incorporate to move from the existing limited liability partnership structure to a public limited company one, list on the market and raise capital. RSM Tenon Group Plc is an example. The main reasons that this has not been used more are generally believed to be due the tax consequences and greater transparency obligations that would ensue. One might say that there are those who want the benefits of external capital (and indeed further liability protection) without any of the tax and other obligations that would normally go hand in hand with that. Indeed unless a compelling case was made that this would enhance audit quality (which has not been done to date), this does not appear to be a priority. This should be borne in mind alongside the other concerns that have been raised about potential impacts on audit quality (e.g. see the answer to Q.5 and Q.10).

1.18 Finally, it is worth touching on the question of auditor liability. Unlike the US, in the UK, this has not been a material issue. Audit firms already effectively have proportionate liability, as can be seen from the Barings case. Discussions with a number of QCs have confirmed that in settlement negotiations, drawing on the statutory provisions on relief[16] and other matters (see list below), proportionate liability does hold in practice. That is true even before, and as well as, taking account of the new provisions introduced in the Companies Act 2006.[17] Other arrangements include:

(i) The limitation imposed in the Caparo case, which means that any plaintiff would have to demonstrate: (a) forseeability - that the loss would result from a failure of the duty; (b) proximity - a tangible (contractual or special) relationship with the auditor other than just their role as auditor; and (c) fairness - that it is just and reasonable to impose the duty in that case.

(ii) Linked to (i), the fact they only owe their duty of care only to the conceptual body of shareholders as a whole, and not to individual shareholders or others and, in the absence of any contractual or other special relationship with an investor, potential investor or other third party, no duty of care will be owed.

(iii) The introduction of Limited Liability Partnerships (offering the protections of limited companies without the same transparency and disclosure obligations).[18]

(iii) The principle of contributory negligence, which enables auditors to make a defence based on the negligence of other parties.[19] The ICAEW itself has acknowledged that this would have "a dramatic effect on limiting the effect of negligence".[20]

(iv) The right of action by auditors against other parties (e.g. in the Wallace Smith Trust or Sound Diffusion cases).

(v) The use of formulaic guidance and processes, such as on risk models,[21] to leverage defences off the back of legal concepts articulated in the likes of Lloyd Cheyham & Co. v Littlejohn & Co. [1987] BCLC 303[22], as well as compliance orientated standards.

---

[15] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/09/1139&format=HTML&aged=0&language=EN&guiLanguage=en

[16] See section 1157 of the Companies act 2006

[17] See sections 532 to 536 of the Companies act 2006

[18] See the 'Limited Liability Partnerships (LLP) Act 2000' and associated regulations.

[19] See House of Lords Judgement in Banque Bruxelles Lambert v Eagle Star Insurance (1997) AC 191

[20] The Accountant, August 1996 (page 11)

[21] See paragraph 8.6

[22] In this case, although the Statement of Standard Accounting Practice were accepted as not being rigid rules, they were held to very strong evidence as to what was the proper standard to be adopted. While a departure from them might be regarded as a breach of duty unless there was some justification, conformity to them might be used as a defence that the duty of care was satisfied.

(vi) Other operational tactics (selection of jurisdiction, limitation statements[23] etc..).

1.19 Back in the 1990s, again as a result of the large accounting firms lobbying to change and reduce their liability, the Law Commission undertook a feasibility study[24] for the Government on whether joint and several liability should be replaced by proportional liability. The Law Commission described the accounting firms' claims about the catastrophic unfairness of unlimited liability as "misleading". This view was re-confirmed in a report[25] by The Alberta Law Reform Institute in 1998, which concluded that the profession's claim was "notable more for its audacity than its accuracy as a description of either the theory of joint and several liability or its likely effect" (page 35). In the words of the Managing Partner of one of the UK's leading audit firms: "It should … be noted that no major accounting firm has collapsed because of unlimited liability".[26]

2. What would you say would be the minimum number of active audit firms needed to constitute a genuinely competitive market for the audits of FTSE 350 companies?

2.1 Although it would be easy to refer to an ideal scenario, such as the position we had up to 1987 with the Big 8+2 firms, it is by no means clear that it would be feasible (particularly given the international dimension of the audit firms/networks), even with aggressive intervention to restructure the market, to achieve that today. Nor, given the problems and risks involved, has a case been made as yet to warrant that level of intervention. More practically I would hope that, supported by a range of reforms and pressure, over time, we might see the market change, resulting in the emergence of a fifth and maybe even a sixth 'big' firm.

2.2 It has been suggested that Tier A firms should be merged to create a new Big 5 player. I do not, however, believe that it would sensible or beneficial to force this issue. In terms of total UK fee income, based on 2010 data, it would require the merger of the next six Tier A firms (In the UK: Grant Thornton, BDO, Baker Tilly, Smith & Williamson, RSM Tenon and PKF) to create a firm large enough to equal even the smallest of the Big 4, which would leave the market with an even greater deficit in choice between the Big firms and the rest. The same is true for the second Tier global networks (see table below). Even were those firms (or networks) to merge, they would still face the prospect of having, at least in the short to medium term, limited opportunity to make in-roads into the large company market, given the low turnover levels seen.[27]

2.3 Picking up on the point made in paragraphs 1.7, 1.12 and 1.13, it seems to me that one of the key hindrances to increased choice (and competition) derives from the perceptions and attitudes (e.g. a default preference for the Big4) that I've referred to. Coming back to the point that there are some businesses, which due to their size and scope and type of business, need to use a Big 4 firm, that does not provide a reason or justification for the situation found by Oxera in its 2006 report[28] in terms of the dominance of the Big 4 in the FTSE 100 or, even more to the point, the FTSE Mid250, which is neither warranted nor in any way really justified on that basis.

2.4 Looking at the top 15 accounting networks provides a quick snapshot of the international capacity that is currently available:

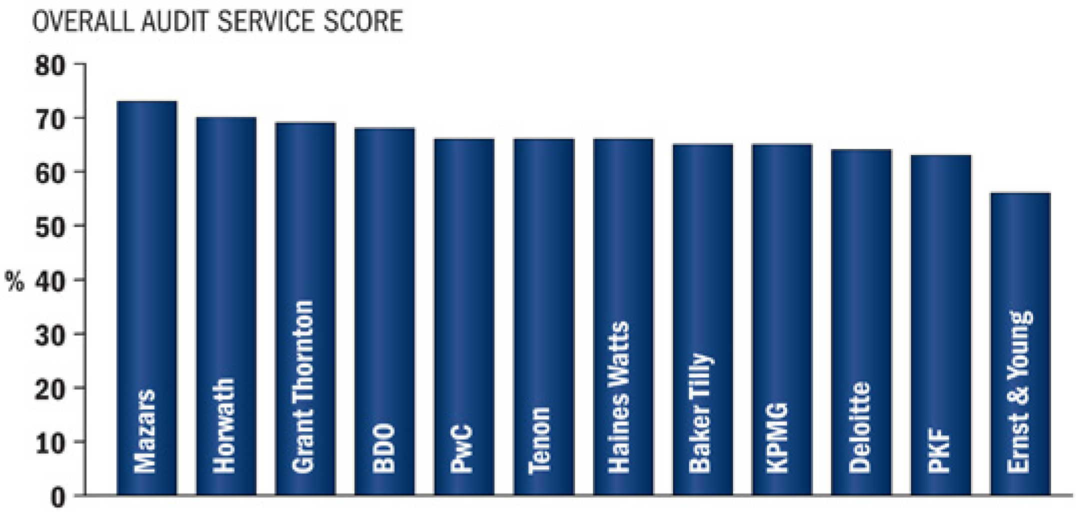
Rank	Firm	Annual Turnover ($ms)	No. Countries	No. Partners	No. Prof Staff
1	PwC	26,171	151	8,552	123,548

[23] See ICAEW Technical Release: Audit 1/03 'The Audit report and Auditors' Duty of care to Third Parties' on the recommended wording to use to in a disclaimer in the audit report to avoid the effect of the Bannerman judgement (see paragraph 9.3)
[24] DTI, Feasibility Investigation of Joint and Several Liability (1996), page 35
[25] "Limited Liability Partnerships and Other Hybrid Business Entities" (March 1998)
[26] "Liability of Auditors in light of Parmalat" RREV newsletter (Feb 2004)
[27] According to Oxera's 2006 report switching rates are low (around 4% on average for all listed companies, 2% on average for FTSE 100 companies), and competitive tendering does not occur frequently.
[28] "Competition and choice in the UK audit market" April 2006

2	Deloitte	26,100	140	9,555	130,208
3	E&Y	21,440	140	8,715	114,536
4	KPMG	20,110	145	7,953	106,973
5	BDO	5,027	115	4,098	34,156
6	Geneva Group	4,052	79	1,795	14,612
7	RSM	3,876	77	3,150	23,262
8	Grant Thornton	3,592	100	2,654	30,369
9	Praxity	3,272	84	2,401	19,962
10	Baker Tilly	3,130	114	2,813	17,728
11	Crowe Horwath	2,779	103	3,359	17,683
12	Leading Edge Alliance	2,420	92	1,615	15,185
13	Nexia	2,110	105	2,272	14,353
14	Moore Stephens	2,078	98	2,236	14,557
15	PKF	1,905	125	1,827	12,493

Source: Accountancy Age's International Networks Survey Results 2010

2.5 Clearly there is real scope outside the very largest companies, for a more open minded approach by Audit Committees to the choice of auditors that is available and that would be welcome. The results of the Autumn 2009 study[29] undertaken by Accountancy Age and Financial Director of audit firms' service to their clients offers encouragement in this regard that needs to be built upon. That study encompassed 635 financial directors, CFOs and financial controllers – a representative cross-section of UK plc – and graded firms on five distinct aspects of service as well as drawing out qualitative comments. The results, illustrated in the overall ranking below, highlight the scope for and merit in more audit committees actively considering Tier A firms:



2.6 There is also academic evidence that questions the suggestion that Big4 firms provide higher quality audits (as opposed to markets preferring and responding more positively to them). A recent example is Boone, Khurana and Raman "Do the Big 4 and the Second-Tier Firms Provide Audits of Similar Quality?" (2010)[30], which examined audit quality for Big 4 and Second-tier auditors during 2003-06 around the issue of going concern. Amongst other things, they confirmed the investor bias towards the Big 4 and concluded that: "Overall, our findings suggest little difference in actual audit quality but a more pronounced difference in perceived audit quality."

---

[29] See: http://www.accountancyage.com/aa/feature/1809503/audit-services

[30] *Journal of Accounting and Public Policy, Vol. 29, No. 4, pp. 330-352, July-August 2010*

2.7 Similarly Lawrence, Minutti-Meza and Zhang's study "Can Big 4 Versus Non-Big 4 Differences in Audit-Quality Proxies be Attributed to Client Characteristics?"[31], compared Big 4 and non-Big 4 firms in relation to discretionary accruals, the ex ante cost of equity capital, and analyst forecast accuracy. They found that the effects of Big 4 auditors were insignificantly different from those of non-Big 4 auditors and that the differences largely reflect client characteristics and, more specifically, client size.

2.8 In terms of the issue of the perceived market/investor bias towards the use of Big 4 firms, to address this, in addition to a more open minded approach by audit committees, a key reform that is needed, is the provision of more meaningful transparency and visibility on the audit committee and the audit, as well as more substantive audit outputs/reporting, which would be a prerequisite for enabling effective shareholder engagement (see the answers to Q.4 and Q.8).

3. Would investors welcome mandatory rotation of audit firms, perhaps every five or seven years, to improve audit independence (perceived or real) and audit quality, and possibly leading to non-'Big 4' audit firms becoming more active in the large company audit market?

3.1 No. Mandatory rotation of auditors over a short time horizon, of the kind envisaged, might create risks for audit quality. Even if, for instance, rotation were required every nine years, you risk creating lower quality audits for the first two years, as the firm goes through its learning curve, as well as potentially for the last two years as the best quality audit staff are rotated off onto new and ongoing audit relationships. This would give you a cycle of four years of potentially lower quality audits, for a five year period of "full service" audits. Better disclosure might be considered around audit partners' identification, audit partners' rotation, the duration of the audit relationship and tendering etc. More informative Audit Committee reports around these and other issues needs to be provided (see the answer to Q.4).

4. How do you react to the suggestion that companies' annual reports should include a more informative and direct report from the audit committee (not merely the board's rather boilerplate report on its audit committee, as at present); and that this report should include the audit committee's reasoning on the audit tendering and auditor choice decisions?

4.1 Current 'boilerplate' disclosures do need to be revisited and improved and in that regard the Institute of Chartered Accountants of Scotland's (ICAS) report: "The Future of Assurance" (2010), which both goes into further detail, expanding on the FRC's current headline recommendation for change, is a welcome contribution on the kind of reporting needed in this area:

The following guidance should be enshrined in the FRC's *UK Corporate Governance Code* and its associated *Guidance on Audit Committees*:

[*Addition based on the FRC's headline recommendation*: The Audit Committee should produce a (fuller) report on how it has discharged its responsibilities for the integrity of the Annual Report and other aspects of their remit (such as their oversight of the external audit process and appointment of external auditors), [including]:]

In relation to risk management the audit committee (or risk committee) report should include:

- Confirmation it has received sufficient, reliable and timely information from management to allow it to discharge its duties;
- How it has satisfied itself that the risk and control processes are operating effectively. This should include a matrix-style report which maps the key risks disclosed by the Board in the corporate report to the assurance processes used to gain comfort over those risks;
- Confirmation that action has been taken where appropriate to address any significant weaknesses in the risk and control framework;
- How it satisfied itself of the appropriateness of management's significant judgements – this

[31] Accounting Review, forthcoming - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1640111

should include a substantive discussion of those significant judgements (for example how the audit committee satisfied itself that the models used to value financial instruments are appropriate or how it determined that the value of a decommissioning provision was a reliable estimate of future costs).

In relation to the appointment of the external auditor the audit committee report should include:

- The date the audit firm was first appointed as the external auditor;
- The date the external audit appointment was last subject to a full tendering process;
- The policy on the expected timescale after which the company would normally expect to re-tender the audit appointment;
- Where the auditor has been subject to the normal annual review of effectiveness – the process by which the audit committee concluded that the external auditor was effective or otherwise and the conclusions of that review;
- Where the auditor has been subject to the extended 5 yearly review process – the process by which the audit committee concluded that the external auditor was effective or otherwise, in particular how it engaged with the shareholders during this process; and the conclusions of that review process;
- The reasons for any decision to re-tender the audit other than simply compliance with the policy;
- The circumstances of any resignation or dismissal of the external auditor before the end of their term.

In relation to the external audit process the audit committee report should include:

- Details of the key areas discussed between the audit committee and the external auditor during the audit process, including the main areas of audit challenge.

4.2 In addition, the APB itself has concluded that Audit Committees should exercise greater oversight over other services that auditors provide to the company they audit which are not audit-related (see the answer to Q.5). Disappointingly though, only minor (albeit welcome) changes to the rules on non-audit services are proposed (re: contingent fees). Nevertheless, they have announced changes to the reporting regime to reinforce Audit Committee responsibility for such services and improvements are proposed to the regime for reporting on the fees in the Annual Report, which is something else that is clearly welcome.

5. Since the audit is an audit of the directors' financial statements principally for the shareholders, do you consider auditors to be sufficiently aligned with shareholders and sufficiently independent of boards and managements? If not, what do you suggest?

5.1 I would highlight three perceived issues in this area:

1. Companies' effective control of auditors' appointment and dismissal – see paragraphs 1.7, 1.14, 2.3, 2.5 and the answers to Q.s 4 and 6.
2. the dynamic around and extent of non-audit services – see below
3. The constraints imposed on auditors as a result of IFRS and ISAs - addressed further under Q.10 and in Appendix 3.

5.2 On point 2, considerable emphasis is given by companies to the wider range of value-added services in their choice of audit firms, (i.e. non-audit services). While recognising the potential for conflicts to arise from non-audit work (either due, amongst other things, to the type of work undertaken or the economic interest in the revenues, giving rise to self-interest threats, self-review threats, management association threats and advocacy threats), a total prohibition of non-audit services would not be welcomed either by companies or their investors.

5.3 There are clearly ‘audit related’ services[32] that are appropriate for the auditor to provide, which are compatible and can be expected to enhance the knowledge and insights of auditors and the overall quality of the audit. Equally, there are areas of work that are undertaken that do raise concerns and can lead to conflicts. These include areas of potential concern, including around tax advice, corporate finance, internal audit and ‘consultancy’ (IT, HR etc).

5.4 In passing I should also note that during the many discussions we have had with directors, anecdotally, a number have highlighted instances in which the accounting firms offer pro-bono services to companies (with, presumably, an expectation that chargeable work will ensue).

5.5 Recently much emphasis has been placed on the supposed fact that fees for non-audit services have decreased both in absolute terms and when expressed as a percentage of audit fees. I would note however, that this has gone through cycles in the past and, after the low point between 2004 and 2005, non-audit fees have been increasing again, albeit this slowed in 2009 presumably as a result of the economic downturn.

Big 4 Growth Rates	**2008-9**	**2007-8**	**2007-7**	**2005-6**
Total Fee Income	+1.0%	+6.1%	+10.1%	+14.2%
Audit Income	+1.5%	+2.2%	+6.8%	+9.6%
Non-audit income	+0.8%	+7.4%	+11.3%	+15.9%

Source: Professional Oversight Board - “Key Facts and Trends in the Accountancy Profession” (June 2010)

5.6 To offer some further granularity on these growth rates, Appendix 1 offers some additional observations on a firm by firm basis around 2009, 2007 and 2003.

5.7 I would also note that the UK’s framework in this regard is relatively permissive compared to some. By comparison, harder lines have been taken in the US and in France:

- In the US, Sarbanes Oxley imposed broader prohibitions on non-audit services, which academics have found to have reduced perceived conflicts.
- French legislation prohibits the auditor from providing all services other than reporting on prospectuses and those that are directly relevant to the audit (The "Loi de Sécurité Financière" of August 2003; codified under article L 822-11.r of the Code of Commerce). In addition, services that are directly relevant to the audit can only be provided if they are performed in accordance with approved standards.

5.8 To contextualise this, in 2009 the Big4’s average UK ratio of non-audit fees to audit fees was around 40%[33] (and higher in the FTSE100). By comparison, in France the share of non-audit fees was decreasing every year after 2003 and has fluctuated between an average of 4% and 5% of total fees since 2005, although in 2009 they did rise above the 5% level.[34] Looked at another way, in 2009 the highest single example of the ratio of the non-audit fees to the audit fee in the CAC 40 was 44%, which compared to 380% in the FTSE100. In the US the introduction of Sarbannes Oxley has seen the average ratio of fees for non-audit services fall from over 100% in 2003 to just around 26.6% in 2006, 2007 and 2008[35].

[Note: In 2010 the UK ratio of non-audit fees to audit fees rose to 54% for the FTSE100 and 84% for the FTSE Mid250.]

[32] We would count these, principally, as categories 1 to 3 in paragraph 2.2 of the Auditing Practices Board’s Consultation on audit firms providing non-audit services to listed companies that they audit (Oct 2009)
[33] Derived from the Professional Oversight Board’s “Key Facts and Trends in the Accountancy Profession” (June 2010)
[34] Autorite Des Marches Financiers (AMF) annual studies of fees paid by French companies listed in the CAC40 index to statutory auditors and their networks.
[35] Audit Analytics, Audit Fee and Non-Audit Fee Report

5.9 The Audit Inspection Unit (AIU) has repeatedly highlighted related issues arising around audit firm priorities since its first public report in June 2005[36], when it noted that, in relation to non-audit services:

"*The basis on which candidates for promotion to audit partner level are assessed was generally found to focus primarily on leadership skills and the ability to generate new business. Quality considerations did not appear to feature prominently*."

5.10 Although firms have clearly adapted their approach given the AIU's inspections, it is notable that the AIU's 2009/10 Annual Report, still notes that:

"*Firms need to embrace more fully the principles underlying the Ethical Standards which require threats to be mitigated by appropriate safeguards if the work is to be undertaken. Firms are perhaps too ready to conclude that existing procedures, required in any event in the audit, provide that necessary degree of safeguard. They must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence*."

5.11 As reported in the press[37], the Audit Inspection unit found that, for example, PwC changed its bonus criteria to emphasise business growth, which jumped from 25% to 40% as a proportion of its KPIs. Meanwhile, the audit quality portion dropped from 25% to 20%. In relation to KPMG, it found that audit quality was not significantly represented in performance assessment:

"*We concluded from our review… that the achievement of audit quality objectives does not have as significant an impact on partners' overall performance assessment as their achievements in other roles*,".

5.12 Adding context to this, in August 2009 The Times reported on the plans of the Big4 firms to expand their consulting services:[38]

"PricewaterhouseCoopers (PwC), the UK's largest professional services firm, plans to treble its fees from management consulting to more than £1.3 billion within the next four years and hire 2,000 staff, including more than 100 partners.

Three of the Big Four accounting firms — Ernst & Young, KPMG and PwC — sold their consultancy arms at the start of the decade after their growth led to clashes over business strategy. The Enron scandal also aroused concerns over conflicts of interest. Only Deloitte kept its consulting practice.

However, the big accountancy firms have been rebuilding their consulting arms and want to capture some of the market from strategy advisers, such as McKinsey, and providers of technology-oriented and outsourcing projects, such as Accenture and IBM.

PwC is counting on aggressive growth in its consulting practice to help it to keep its lead as the UK's biggest professional services provider."

5.13 Although the debate about the extent to which the provision of non-audit services effects independence and audit quality, is often characterised by references to the fact that the evidence is mixed, the working paper by Paul Griffin and David Lont "Non-audit Fees and Auditor Independence: New evidence based on going concern Opinions for US Companies Under Stress" (Jan 2010), examines this problem. Noting that much of the confusion stems from studies of the US market, as opposed to those relating to the UK or Australian market, they specified and applied a potentially more powerful examination of the US data to shed light on those discrepant results. Their revisiting of the US market found a reliable negative relation between non-audit fees and auditors' propensity to issue a going concern opinion, which is consistent with the results of certain prior studies on U.K. and Australian companies.

[36] "Audit Inspection Unit 2004/5 Audit Quality Inspections – Public Report" - http://www.frc.org.uk/pob/audit/reports.cfm
[37] Accountancy Age "Audit quality under pressure as firms cut costs" (12 Nov 2009)
[38] PwC aims to treble its fees from consulting (4 Aug 2009) - http://business.timesonline.co.uk/tol/business/industry_sectors/support_services/article6738036.ece

They also found that in the period after Sarbanes Oxley this had been mitigated to some extent. There are several studies of the relation between non-audit fees and auditors' opinions for UK and Australian companies (e.g. Wines 1994[39], Sharma and Sidhu 2001[40], Firth 2002[41], Pe et al. 2006[42], Rosner et al 2007[43], Basioudis et al. 2008[44], and Fargher and Jiang 2008[45]), which challenge the confusion found in the US market research, reporting a significant negative association between non-audit fees and the quality of financial reporting or auditing.

5.14 Finally, I note that the AIU's inspections in 2009/10 confirmed that major firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base, although it also noted that, "nevertheless, improvements to these policies and procedures have been recommended at all firms." (the reports produced by the US Public Company Accounting Oversight Board (PCAOB)) have also highlighted the ongoing need to improve audit quality).

6. What should be done to promote shareholder engagement in the appointment and re-appointment of auditors?

6.1 Improved disclosure as suggested in the answers to Q.4 and Q.8 would be critical factors in enabling shareholders to engage effectively in this area.

6.2 Picking up the points noted in paragraph 1.14, about the notional appointment of auditors by shareholders being more a matter of form rather than substance and that from a corporate perspective the focus can be on non-audit, value-added services that can be obtained on top of the audit itself, the example of Rentokil was notable:

Rentokil's 2009 Change of Auditor

Rentokil's appointment of KPMG, mid-year, was a particularly contentious one, initially understood to have been initiated not by shareholders or the audit committee but by management, in a process which saw the auditors appointed by shareholders (PwC) forced to resign mid-year.

The precise origins of the proposal and nature of the deal struck with KPMG remain unclear, given the limited disclosures made by the company, which initially indicated that the proposal was attractive to them as it offered "a more integrated financial assurance process extending external audit coverage to some work undertaken by internal audit" and that as a result the combined internal and external audit costs would reduce by approximately 30% (reportedly making savings of £1million).

Although PwC apparently did reluctantly tender against KPMG, it expressed public reservations, while KPMG's UK head of audit was promoting the new package as a way for companies to cut costs, which they planned to discuss with others as well.[46]

Mixing internal and external audits has the potential to cause serious conflicts of interest in the audit, as well as reducing the effectiveness of internal controls and the management of risk. Internal audit is seen by shareholders as an important part of the management and the

[39] Wines, G. 1994. Auditor independence, audit qualifications and the provision of non-audit services: A note. *Accounting & Finance*, 34 (1), 75-86
[40] Sharma, D., and Sidhu, J. 2001. Professionalism vs. commercialism: The association between non-audit services (NAS) and audit independence. *Journal of Business Finance & Accounting*, 28 (5-6), 595-629
[41] Firth, M. 2002. Auditor-provided consultancy services and their associations with audit fees and audit opinions. *Journal of Business Finance & Accounting*, 29 (5-6), 661-693.
[42] Pe, Y., Carson, E., and Simnett, R. 2006. Threats to auditor independence: The impact of nonaudit services, tenure and alumni affiliation. Working Paper, University of New South Wales
[43] Rosner, Markelevich, Ariel and Rebecca 2007. Auditor Fees and Fraud Firms
[44] Basioudis, I., Evangelos, P., and Geiger, M. 2008. Audit fees, non-audit fees and auditor going-concern reporting decisions in the United Kingdom. *Abacus*, 44 (3), 284-309.
[45] Fargher, N., and Jiang, L. 2008. Changes in the audit environment and auditors' propensity to issue going-concern opinions. *Auditing: A Journal of Practice & Theory*, 27 (2), 55-77.
[46] See for example: http://www.accountancyage.com/aa/news/1756317/cut-price-rentokil-kpmg-deal-raises-ethical-questions-auditors or http://www.ft.com/cms/s/0/bee07652-7fc9-11de-85dc-00144feabdc0.html#axzz1Acj3VJD3

board's own internal controls and governance frameworks, whereas the audit is undertaken for the members to ensure accurate financial information is being produced, so as to protect the company and provide its members with reliable intelligence.

The Financial Reporting Council itself warned that audit clients "may want to be cautious before entering into arrangements which stretch the internal/external audit boundary" (The Audit Inspection Unit had also, previously, raised concerns about the inverse practice, where internal audit staff are used in the audit process to cut costs).

The move also drew warnings from the Institute of Internal Auditors that highlighted the concerns that auditors risked becoming mired in ‘serious conflicts of interest’ if they fuse internal and external audit roles and pointed out that "Internal auditors answer to management and the non-executive directors… external audit reports to shareholders." Mixing these two important, but distinct functions has "the potential to cause serious conflicts of interest and reduce the effectiveness of internal controls and the management of risk."

After all the furore, in engagement the company clarified the situation to argue that in fact the external auditors were not undertaking any internal audit work, the savings were to be made by reducing outsourced internal audit services being used on overseas control checks and relying instead on data collected during the course of the audit as a basis for prioritising the work of the internal audit department. Although this does not on the surface appear to impact the auditor's independence or necessarily create conflicts that may depend on how the 'relationship' is being operated.

6.3 Although the initial and significant concerns that arose around potential audit conflicts at Rentokil were somewhat mitigated, some concerns about the way the auditor switch took place and residual uncertainty about the potential impact remains.

6.4 For investors, it remains essential that auditors are not and are not perceived to be losing their independence from the management infrastructure. In addition, given the nature of audits, their focus and auditors’ reliance on sample testing, a company's shift to relying on audit derived data as a basis for managing internal audit raises some potential concerns in its own right. Added to this must be a recognition of the shortcomings that can arise in the audit processes (e.g. see Appendix 3 or, for example, the UK Audit Inspection Unit's 2009 report on KPMG as well as that of the US PCAOB).

6.5 Once again I would point to the Institute of Chartered Accountants of Scotland’s (ICAS) report: “The Future of Assurance” (2010), which picks up the issue of the resignation or dismissal of an external auditor before the end of their term, recognising that it is potentially of particular concern to shareholders when it does happen. Company law[47] provides for a statement of the circumstances of the resignation or dismissal to be provided to shareholders, but in practice these often shed little light on the real circumstances. As a result they recommend that audit the committee report should disclose sufficient details of the circumstances to provide that understanding. That would be useful and welcome.

6.6 More specifically on the point about promoting shareholder engagement, the ICAS report also proposes that an additional principle be added to the UK Stewardship Code, which I would endorse.

6.7 Going beyond the points noted above on audit related reporting and the Stewardship Code, if consideration was to be given to requiring a more active involvement of shareholders, then the experience of greater shareholder involvement in Sweden merits examination (if the option of introducing shareholder nominations committees were ever to be considered for auditors, it might consider (i) limiting it, initially at least, to a small defined group of companies and (ii) structuring such a committee to include, say, 3 shareholder representatives, 1 bondholder representative and 1 representative of the key regulator).

[47] Companies Act 2006 s.520

That said, it is not clear to me that the investment community as a whole currently has the resources, time or inclination to take a more hands on role of this kind.

7. Do you think UK corporate governance is too light touch, and would you welcome aspects of the UK Corporate Governance Code being made mandatory – for instance, should there be a mandatory requirement for FTSE 350 or all listed companies to have audit committees?

7.1 No. As a practical matter, I am only immediately aware that, in the FTSE 350, Daejan Holdings Plc does not have an audit committee, although they assert compliance on the basis that the entire board fulfils the role of the Audit Committee (The board has a joint Chairman/CEO, one other executive director and three non-independent NEDs. Four are family members).

7.2 As previously indicated, the Institute of Chartered Accountants of Scotland has made a series of recommendations for improvements across a number of areas (two of which I have referred to above), which do merit being taken forward in this context. I would, however, note some reservations about its references to ISAs (see Appendix 3) and its assertion about the "true and fair view" being supported by the framework of International Financial Reporting Standards (IFRS) (both points are discussed further under Q.10).

8. Do investors place significant reliance on the audit report, and could it be made more useful?

8.1 Investors attach considerable importance to audit and do value it. However, the audit report is largely boilerplate and rarely provides any timely or useful signaling of the kind envisaged by the Law Lords in the Caparo case.[48] The experience over the crisis is renewed evidence of its limited use at present. The requirements for the audit report should be reviewed to remove boilerplate statements and with a view to introducing something along the following lines:

1. Include an Opinion that:

   a) the accounts <u>have been prepared on a prudent basis [requires acceptance that this principle is enshrined in Law]</u> and that, <u>notwithstanding anything else</u>, provide a True & Fair View of the state of affairs of the business and its assets.
   b) proper Accounting Records have been kept.
   c) following the review of the assumptions made by the Board in their assessment of the going concern, the conclusion and disclosures of related judgments and contingencies are complete and reasonable.
   d) distributions have been properly made in accordance with the Act, out of realized, distributable profits and reserves.
   e) the accounts have been prepared in accordance with the Companies Act 2006.
   f) the accounts have been prepared pursuant to relevant standards.
   g) the (enhanced) Audit Committee report is complete and reasonable (incl. confirmation that it is an appropriate reflection of the key issues discussed between the audit committee and the external auditor).
   h) the annual report is balanced, reasonable and consistent with the audited financial statements.

2. Provide information:

   a) on items that are the subject of significant accounting judgments or estimates (or confirm there were none)
   b) on accounting judgments or estimates that are the subject of significant uncertainty or risk (or confirm there were none)
   c) on any areas or matters that the auditor has not obtained all the information it required (or confirm there were none)

[48] Caparo Industries plc v Dickman, House of Lords (1990)

3. Notwithstanding anything arising from 1(h) report by exception on Remuneration and the relevant Governance Code provisions

4. State any matters of emphasis that the auditors <u>should reasonably</u> draw attention to given the purpose of the audit (as per Caparo) or in relation to any of the above (or confirm that there are none)

9. Would you welcome an extension of audit scope into aspects of corporate reporting outside of the financial statements?

9.1 The priority and focus of the audit should be on the core role and purpose of the audit and in ensuring audit quality. However, the work and recommendations produced by the Institute of Chartered Accountants of Scotland's (ICAS) report: "The Future of Assurance" (2010), in relation to the provision of 'assurance' on the corporate annual report (other than the financial statements) do merit being considered in this debate.

10. In your experience have IFRS hampered the exercise of prudence in financial reporting, especially of banks, and have ISAs made the audit more a matter of following a complex but routine box-ticking process with lessened judgement on whether the financial statements are true and fair?

10.1 Although IFRS may seem a diversion from the issue of the audit, it is not. The concerns underpinning the lobbying that was done in the run up to the Companies Act 2006, to reassert the unencumbered 'True & Fair View' basis of accounts and auditing have been borne out (e.g. in relation to loan loss provisioning). IFRS are pro-cyclical and did play a role in facilitating and exacerbating both the credit bubble and subsequent crisis.

10.2 Despite a common assertion that is made by some, that IFRS are just presentational, in reality they have real world effects, such as on pensions, capital management, behaviours & risk taking, executive remuneration, valuations, profit recognition, loss provisioning, financial product innovation and I could go on. They also impact significantly on the audit and to provide context for that I have touched upon some aspects of the effect of IFRS below

10.3 IFRS has muddied the waters both as a result of how it has been implemented and its effects on accounts. Let me start with the observation that in practice critical concepts like prudence and accounting conservatism have been superseded in IFRS by process and compliance to standards. Aspects of the model seems more targeted at short-term trading (decision usefulness) rather than stewardship accountability. As a result concepts like the 'true and fair view' have been diluted and subordinated to that dynamic and other Companies Act accounting requirements have been obfuscated. Increasingly the True & Fair View has been characterised as being evidenced by compliance to the standards, particularly by standard setters. This is evident both in the standards themselves and in the approach to them taken by the standard setters:

- It has frequently been asserted that IFRS embraces the principle of the True & Fair View. However the extent to which it actually embraces the principles of the True & Fair View and substance over form (compared to, say, the old FRS5), as opposed to seeking to re-define by reference to compliance with the standards, needs to be considered carefully. We went to great effort to get the move made by proponents of IFRS (to change company law to explicitly encumber the true and fair view as being in accordance with the standards) reversed, which it now is in the Companies Act 2006. There is a question mark, however, as to whether this is currently the case (clearly at least) in the EU framework. In particular the emphasis in IAS1 on fair presentation and both the related constraints and emphasis that "In *virtually* all circumstances, an entity achieves a fair presentation by compliance with applicable IFRSs" and the process and rules orientated nature of much of the subsequent standards, clearly calls the claims in relation to the overriding true and fair view principle, into question. The emphasis on compliance is continued in relation to deviations from standards only being 'allowed' "in the *extremely rare circumstances* in which management concludes that compliance with a requirement in an IFRS would be *so misleading* that it would conflict with the objective of financial statements". In that context it is worth noting that under IAS 1, "The objective of general purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions." The paragraph continues in a more general way around other underlying elements, but without providing any more that might mitigate the restrictions outlined above.

- In relation to standard setters, their reaction to the commendable decision by Société Générale and its auditors (E&Y) to use the accounting override so as to reflect the emergence in January 2008 of the Kerviel fraud in the December 2007 balance sheet, to show the weakened balance sheet with the recognition of a significant post-balance sheet event, is notable.[49] We considered the action taken to have been appropriate, both in relation to IAS 10 (Events after the Reporting Period) and the true & fair view principle (even IAS1). The 'fraud' existed at the balance sheet date and it is worth noting that had the adjustment not been made that would have has an inflationary effect on the bonuses and potential dividends, requiring additional increases in the capital that had to be raised, given the hole that existed behind the 'illusory' paper profits. In that context I am minded of the Barings case (Kerviel's £3.6billion fraud dwarfed the Leeson's £827million fraud at Barings), where the Court held that the auditors, in light of the facts and events that had emerged, "were in breach of the duty of care that they owed to BFS concurrently in contract and in tort. As a result, they negligently certified BFS' accounts for 1992 and 1993 as giving a true and fair view of the affairs of BFS in those periods of account. They thus failed to alert BFS and BSL, its controlling shareholder, to the unauthorised trading of Leeson." The Barings analogy is particularly powerful given the Court's application of the 'true and fair view' principle, even though the auditors had failed to detect the fraud.

10.4 In terms of the standards themselves, they obfuscate the separation of realised items from unrealised ones. There also appears to be some confusion, in practice at least, with other Companies Act provisions, such as in relation distributable reserves and dividends. It would certainly be possible to characterise a significant proportion of bank capital raising and tax-payer funds as having been necessary to redress precisely the results of the problem created by both bonuses paid on unrealised profits (that disappeared) and imprudent dividend distributions. In terms of prudence the point should be obvious.

10.5 If it is not, IAS39's approach to loan loss provisioning should make it obvious. Although IFRS seems all too ready to recognise unrealised profits given its commitment to, amongst other things, the layers of so called fair valuation (admittedly it also accepts the reversals), in contrast it is imprudently opposed to recognising real, anticipated expected losses to enable provisioning against them.

10.6 Even though the old UK GAAP SORP approach to loss provisioning may have been far from perfect, it still allowed scope for more reasonable and prudent provisioning than has been possible under IFRS (For illustrative purpose I have attached the comparative language from each in Appendix 2). As the December 2002 Bank of England article on dynamic provisioning[50] noted:

"While in practice some banks have established provisioning policies with forward-looking elements that attempt to cover some expected losses over the life of a loan, general provisions are only a relatively small part of total provisions. This is probably in part because general provisions are not tax deductible, and the Basel Capital Accord (1988) limited the inclusion of general provisions in regulatory capital to 1.25% of risk-weighted assets."

10.7 Nevertheless, the introduction of IFRS removed even that limited ability to make prudent general provisions by imposing a model that strictly limited incurred losses to those that had occurred. The result of that was that some loss provisions had to be unwound and, for example, PwC advised in its 2004 Financial Services Bulletin CP04/17 - Implications of a changing accounting framework, that "it is expected that many banks and building societies

[49] NY Times "Société Générale invokes special accounting rule to absorb Kerviel losses" (2008) - http://www.nytimes.com/2008/03/06/business/worldbusiness/06iht-norris07.1.10762430.html
[50] Financial Stability Review: December 2002 – Dynamic provisioning: issues and application

will be required to release some of [*general bad debt provisions*] that they currently hold as a result of the tougher tests under IFRS for establishing provisions."

10.8 Of the models I've looked at for loan loss provisioning, perhaps the Spanish one (dynamic provisioning) has been most notable in terms of the positive benefit it has offered and it is also, generally, well perceived by investors. In the Spanish model, loan loss provisions are fully transparent, with banks having to publish details of their general provisions so that investors and shareholders and others can easily factor in their impact. Moreover, the system is robustly structured, and there is a cap on the amount of the dynamic fund being built up, limiting any scope for the bank to use these provisions to game their numbers. Indeed the occasional discussion with analysts has highlighted no concerns about the use of the Spanish model of dynamic provisioning for earnings management. Given the clearly damaging effects of the IFRS approach it is notable that those coming from more prudent environments, appear to have sought to be prudent despite IFRS, as the recent Daily Telegraph article "Santander prudence highlights IAS risks" (10 January 2011)[51] reports. By allowing earlier detection and coverage of credit losses in loan portfolios, the Spanish model allows banks to build up a buffer in good times against recognised problems and times of stress. The anti-cyclical nature of dynamic provisions enhances the resilience of individual banks as well as the banking system as a whole. That said they are no panacea, but still clearly help even in the kind of systemic crisis we have experienced.

10.9 Essentially IFRS places far too much emphasis on process, rules and compliance with the standards. Although enough has been said by a great many well regarded commentators about the shortcomings and issues with fair value accounting that I don't propose to repeat them here, it does help illustrate a wider issue with IFRS. Either rules allow no leeway, such as on loan loss provisioning, inhibiting the ability of auditors to be robust despite the imprudence and risks associated with the IFRS model, or they set out process such as on fair valuation but leave very significant discretion to management, making it potentially extremely difficult for auditors to push back on imprudent or aggressive assumptions.

10.10 That problem with the standards has played into a wider dynamic (see points made about auditor liability in paragraphs 1.18 and 1.19). The cornerstone of the process by which auditors decide on the scope of their work is a risk model.[52] There are questions on the effect of this in terms of ensuring a quality audit and the use of a formulaic model approach as a defence against the need to undertake fuller due diligence.[53] Although the regime has changed since the imposition of ISA in the UK, there have been concerns in the past[54] about whether some of the approaches to risk assessment used by large audit firms have been fully compatible with the, then applicable, SAS 300 risk model. The same might be said about the apparent approach taken to going concern in the recent crisis. This links to broader concerns that the profession uses formulaic guidance to leverage defences[55] off the back of court cases such as Lloyd Cheyham & Co. v Littlejohn & Co. [1987] BCLC 303. This trend in the profession away from the use of judgement towards a formulaic rules orientated approach remains disturbing.

10.11 In light of the crisis and what has been seen over the last few years, it would seem that similar points might be made about the apparent impact that IFRS and ISAs have had on going concern assumptions and the audit of them.

10.12 Despite recognising that the standard setter is seeking to address individual concerns (e.g. accounting for own debt, incurred loss provisioning to name but two), the fundamental structural problems of IFRS remain. To address the problems seen here, action needs to be taken at EU level, although some of the steps could be taken in the UK:

[51] See: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/8249406/Santander-prudence-highlights-IAS-risks.html
[52] See Appendix 3
[53] e.g. of the kind required, say, of a reporting accounting in a Class 1 transaction under the Financial Services Authority's Listing Rules, where proximity vis-à-vis individual shareholders and hence liability, is clearer.
[54] "Developments in Audit Methodologies of Large Audit Firms"(2000) W.Lemon, K.Tatum and W.Turley.
[55] "Auditor Liability: The Other Side of the Debate" J.Cousins, A.Mitchell and P.Sikka

- The objectives of the audit should be explicitly define in legislation, which should build on the two principal purposes of the audit that was articulated in the Caparo case (Caparo Industries plc v Dickman, House of Lords (1990), 1 All ER 568 [1990] 2 WLR 358). Namely that it is the auditor's function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order,

  "first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital)" and

  "secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to reward or control or remove those to whom that conduct has been confided."

- Within the European framework, the True & Fair View Principle needs to be unencumbered and overarching (although this is the case in the Companies Act 2006, the effects of the various EU provisions are not so clear and appear to undermine that), which will require changes to the EU's 2nd and 4th Company Law Directives and related Regulations.

- The True & Fair View principle needs to be reinforced with an additional principles, such as on prudence and substance over form.

- Each standard considered for adoption by the EU should be reviewed and assessed in relation to these overarching principles.

- Just as was seen after Terry Smith's publication of accounting for growth, a review (by fresh and independent eyes) of both the accounting and auditing problems encountered during the crisis, might be considered.

- The Audit Committee Report and the Audit Report arrangements should be overhauled in line with the recommendations set out in the answer to Q.s 4 and 8

11. One suggestion to improve banking regulation has been to restore two way dialogue between regulators and auditors of banks. Does this raise any concerns for you as investors in banks?

11.1 In the UK, it has been acknowledged that the relationship between auditors and the regulators was not as effective as it might have been. This was particularly true in relation to the dialogue between the regulators and the auditors of major banks.

11.2 Although auditors do have a duty to report certain matters to the FSA (see below however), there is no reciprocal duty of the FSA to report matters to auditors. There is no logic in a regulator being aware of potential issues affecting the accounts and audit by virtue of its role (e.g. suspicions of serious fraud or criminal activity or, indeed, material risks), but not making the auditors aware of them. We understand that in the US, under the Federal Reserve system, banking supervisors are required to confirm to bank auditors that they are not aware of any matters that might impact upon the audit.

11.3 In relation to the auditors' duty to report certain matters to the regulators, although there is no visibility for investors on how they worked over the recent crisis, I believe that they would be worth reviewing to ensure that the kind of situation apparent at Equitable Life did not and could not be repeated. In his report on Equitable Life[56] The Rt. Hon. Lord Penrose highlighted the very real deleterious effect of a compliance orientated approach to standards. While Lord Penrose was clear that it was not for the inquiry to enter into the debate on the formulation of appropriate standards, he nevertheless deemed it appropriate to comment on some of the problems standards can create. One example of this related to SAS 620:

[56] "Return to an order of the Honourable House of Commons dated 8 March 2004 for the: Report of the Equitable Life Inquiry" The Rt. Hon. Lord Penrose, HMSO ISBN: 0-10-292688-3

"The auditor's independent obligation to report to the regulator could, in appropriate circumstances, involve investigations into the reserving policies and practices of the actuary. But the obstacles in the way of the auditor have at all material times been significant."

11.4 In the preceding and subsequent paragraphs,[57] Lord Penrose set out how the prescriptive drafting of the applicable standards and their thresholds and tests meant that the circumstances enabling an auditor to 'justify' reporting to the regulator were likely to be "extreme". Lord Penrose (perhaps slightly tartly?) also noted in his final comment to his 'Key Findings'[58] that "It is also significant to note that at all material times …. the auditors are able to claim that the discharge of their duties met all applicable standards." Although standards have changed since then, given the recent financial crisis there would be merit in reviewing them.

11.5 Investors would positively welcome reforms to ensure that effective two-way dialogue between audit firms and the regulators happens and it should be a explicit objective for both.

12. If there were one measure you would propose that would most assist in widening choice in the audit market, what would it be?

12.1 Leaving aside the option for aggressive intervention and restructuring of the market and firms, for which the case is not completely clear, I believe the various proposals suggested or outlined above should be taken forward to help enhance the audit market and audit quality. This should be done alongside a clear commitment by the authorities that, unless clear defined progress in made in opening up the FTSE Mid250 and to a lesser degree the bottom end of the FTSE100, they will make tangible interventions, such as the adoption of the joint audit model or mandatory rotation.

[57] Ch.11, paras 71-77, pages 375-7
[58] Ch. 19, page 727

Appendix 1: UK Big 4 Audit & Non-Audit Fees

These Figures have been extracted (quickly), from survey's undertaken by or for Financial Director, Accountancy Magazine, Accountancy Age and, for total fee income, the Financial Reporting Council. Given differences in the data sources and dates used within these surveys and differences in firm disclosures, the comparison should be taken as indicative.

FTSE100	Audit fees (£ms)			Other fees - from audit clients (£ms)			Highest NAF ratio/ Highest Non-audit fee **			Total UK Fee income (£ms)		
	2009	2007	2003	2009	2007	2003	2009	2007	2003	2009	2007	2003
Deloitte	99.8	54.4	42.31	80.7	72.2	66.1	242% / £31.6m	450% / £11.2m	875% / £15m	£1,969m	£1,802m	£1,187m
E&Y	68.4	71.8	25.92	56.4	39.9	73.6	380% / £15.1m	150% / £7.6m	1146% £37.1m	£1,383m	£1,226m	£812m
KPMG	121.7	90.2	66.91	81.3	59.6	96.5	308% / £27.2m	333% / £12.1m	747% / £18.9m	£1,626m	£1,607	£1,008m
PwC	248.6	186	99.37	180.6	140.7	216.2	249% / £44.8m	833% / £16m	933% £24.5m	£2,248m	£2,107m	£1,505m

UK	2009			2007			2003		
	Tax Income	Consultancy	Corporate Finance	Tax Income	Consultancy	Corporate Finance	Tax Income	Consultancy	Corporate Finance
Deloitte	£523m	£737m	£321m	£557m	£430m	£307m	£374m	£299m	n/a
E&Y	£392m	n/a	£289m	£335m	£60m	£255m	£288m	n/a	n/a
KPMG	£375m	£352m	£253m	£400m	£292m	£364m	£267m	n/a	n/a
PwC	£650m	£737m	n/a	£667m	£493m	n/a	£495m	a/a	n/a

Note: the Big Four now organise themselves into service areas that do not exactly match with each other, or with smaller firms.

Appendix 2 – Loan Loss Provisioning (UK pre/post introduction of IFRS)

Unlike the IFRS's backward looking incurred loss rules, the UK's comparable 1997 Statements of Recommended Practice (SORP) on Advances were not as rigid in only allowing losses to be recognised when they could effectively be said to have actually occurred (a strict incurred loss model). The SORP model did allow for an element of forward looking provisioning and the difference in the wording of the provisions. Extracts from the SORP and IAS 39 (emphasis added) are included below:

Statement Of Recommended Practice (SORP) on Advances (November 1997)	**IAS 39 - *Financial Instruments: Recognition and Measurement***
[This old model looked at incurred losses that are 'inherent' to a loan, allowing for example, forward looking statistical models to be used – emphasis added] 10. The methods for calculating the level of impairment inherent in a portfolio and, consequently, the appropriate provision are constantly evolving and are becoming increasingly sophisticated, with greater use of statistical and other modelling techniques. Such methods are compatible with the accounting framework established by this SORP. 12. A loan is impaired when, based on current information and events, the bank considers that the creditworthiness of a borrower has undergone a deterioration such that it no longer expects to recover the advance in full. In these circumstances, it is necessary to consider whether a specific provision should be made against the advance. Such advances are described in this SORP as 'impaired'. A provision is generally only needed when the position deteriorates to an extent not foreseen when the advance was made, ie when recovery of the outstanding amount in terms of principal and interest due but unpaid at the balance sheet date, is no longer likely. Although it is often an event of default that serves as trigger, a provision should be considered whenever the information available to the bank suggests that the advance has become impaired. 17. Experience shows that portfolios of advances often contain advances which are in fact impaired at the balance sheet date, but which will not be specifically identified as such until sometime in the future. There will not usually be sufficient information to hand at the review of advances to be certain that all impaired advances have been identified. To cover the impaired advances which will only be identified as such in the future, a general provision should be made. 18. It is emphasised that the general provision relates to impairment already existing in the advances portfolio at the balance sheet date. It does not relate to advances which at the balance sheet date are subject to no more than normal credit	[*This model looks strictly at incurred losses that have occurred, not allowing statistical models override that rule resulting in PwC advising in its 2004 Financial Services Bulletin - CP04/17 - Implications of a changing accounting framework that "it is expected that many banks and building societies will be required to release some of [general bad debt provisions] that they currently hold as a result of the tougher tests under IFRS for establishing provisions."*] 59. "…impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that … has an impact on the estimated future cash flows … that can be reliably estimated……. Losses expected as a result of future events, no matter how likely, are not recognised." AG89 Future cash flows in a group of financial assets that are collectively evaluated for impairment are estimated on the basis of historical loss experience for assets with credit risk characteristics similar to those in the group. Entities that have no entity-specific loss experience or insufficient experience, use peer group experience for comparable groups of financial assets. Historical loss experience is adjusted on the basis of current observable data to reflect the effects of current conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist currently. Estimates of changes in future cash flows reflect and are directionally consistent with changes in related observable data from period to period (such as changes in unemployment rates, property prices, commodity prices, payment status or other factors that are indicative of incurred losses in the group and their magnitude). The methodology and assumptions used for estimating future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience. AG90 As an example of applying paragraph AG89, an entity may determine, on the basis of historical experience, that one of the main causes of default on credit card loans is the death of the borrower. The entity may observe that the death rate is

risk, but which in the nature of things may become impaired in the future. [*note the double negative*] 19 Assessment of the appropriate level of general provision is the responsibility of the directors and is inevitably subjective. Past experience will provide some guide, but <u>current economic and other factors affecting the business climate should be taken into account</u>...specific and general provisions together represent the amount by which a bank considers that it needs to write down its loan portfolio in order to reflect <u>bad and doubtful</u> debts.	unchanged from one year to the next. Nevertheless, some of the borrowers in the entity's group of credit card loans may have died in that year, indicating that an impairment loss has occurred on those loans, even if, at the year-end, the entity is not yet aware which specific borrowers have died. It would be appropriate for an impairment loss to be recognised for these 'incurred but not reported' losses. However, it would not be appropriate to recognise an impairment loss for deaths that are expected to occur in a future period, because the necessary loss event (the death of the borrower) has not yet occurred.