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Response

LAPFF Response to the Competition and Markets Authority - Statutory audit market

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 79 local authority pension funds and four LGPS pools, based in the UK with combined assets of approximately £230 billion. It exists to promote the investment interests of the funds, and to maximise their influence as shareholders to promote high standards of corporate governance and corporate responsibility amongst the companies in which they invest. The Forum welcomed the announcement by the Secretary of State in March 2018 and welcomes both the CMA enquiry as well as the Kingman Review ('Kingman').

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Summary – competition and choice in the audit market

LAPFF agrees that there are problems with the market and that solutions are not obvious or easy - but there is also the need to focus on what auditors are required to do by way of standards and there are significant issues with the Financial Reporting Council. Andrew Tyrie has put this into context as such:-

"Sir John Kingman's independent review of the regulator is a big step in the right direction. And the CMA will now examine the market carefully to establish what contribution more effective competition could make to improving audit quality."

The LAPFF view is that there is an overlap between the two issues, in that the regulatory architecture is somewhat easier to capture with an oligopoly (four firms) in place, i.e. encompassing revolving door recruitment, secondments to regulators etc. However, the main focus of reforms should be on the standards and regulatory framework.

LAPFF has addressed each question and suggestion for reform separately.

Summary – framework of audit

The LAPFF position is that competition and choice are relevant issues, but for audit quality, the core issue is the standards auditors are required to follow, and the inadequacies of the regulator, the Financial Reporting Council (FRC). There is clearly some overlap in terms of oligopolistic behaviour from a concentration of four firms affecting both the standards framework and the regulatory framework, by means such as revolving door recruitment, alumni effects, and the sheer weight and global co-ordination of lobbying.

The FRC, International Auditing Standards, (which the USA does not use) International Accounting Standards (which the USA does not use), are still heavily influenced by the accounting profession. The latter two being private (not public interest) bodies and the FRC itself behaved like a private body by maintaining a pretence it was a private body, whilst actually being a public body.

The problematic position that the UK is currently in, is well summed up by the US regulator, the Public Companies Accounting Oversight Board (PCAOB), describing the pre-2002 US position:

"Self-policing didn't work well in the United States. Prior to 2002, the SEC looked to private organizations affiliated with the accounting profession to set auditing standards. Accounting firms or their representatives controlled or funded those organizations. As a result, standards tended to be written through the lens of the profession as opposed to the lens of investor protection."[1]

The PCAOB is describing regulatory capture.

There is an irony in that some of the flaws in the UK standards regime did have their origin in the USA, but that with pushback from stronger regulators in the USA, they were not then implemented there.

The issue of the profession setting and influencing standards that fail to deal with investor protection, is deeply rooted in auditor responsibility (and liability) driven goals. The FRC has run and supported a model that deviates from the law.

The former Senior Partner of Herbert Smith, Mr Edward Walker-Arnott published a paper in 2017 in which he stated "…*the FRC orthodoxy does not accord with the law and that it is based on opinions of Counsel which are flawed"*[2].

This revolution has occurred without the explicit authority of statute or case law. It has occurred while the primary responsibility of directors for annual accounts has remained unchanged.

*It rests entirely on an interpretation of the requirement that accounts give a true and fair view advanced in a series of opinions of counsel obtained by the ASC and the FRC between 1983 and 2013. In particular the expression of the FRC orthodoxy in its June 2014 statement "True and Fair" is explicitly based on opinions written for the FRC in 2008 and 2013. It is the argument of the next section that **all the opinions in the series are flawed**."*

LAPFF had engaged its own counsel on these matters in 2013 and 2015. What was most immediately apparent was that the FRC's divergence from the law was aided by the FRC not transcribing the most basic of statute properly.

[1] https://pcaobus.org/News/Speech/Pages/Harris-Audit-Industry-Concentration-12-07-17.aspx
2 Journal of Business Law, Issue 6 2017

1. Relevant issues from the LAPFF response to the Kingman Review ('Kingman')

Concerning the existing FRC structure, LAPFF said to Kingman that it saw at least three incompatible functions being run by the same body. These are

- standards (accounting, auditing and actuarial)
- enforcement (annual accounts of public companies, auditors and members of professional bodies of accountancy, actuarial discipline)
- the 'comply or explain' Governance Code

To address these failings, the Forum responded to Kingman with the view that it considers standards and enforcement should be in different bodies (as in fact was the case prior to 2004) and the following structures for a new regulatory framework are needed.

- Accounting Standard setting must be a free standing body, a **UK-Financial Accounting Standards Board**, with the objective of 'setting accounting standards that conform to both Company Law and Capital Markets Law'. It should be directly accountable to Parliament.
- Auditing oversight should follow the **US PCAOB model**. It should also be directly accountable to Parliament. The objective should be 'oversight of auditors to protect investors and the public'. Parliament should determine the public interest coverage of the "UK-PCAOB"[3]. Auditing standards should be totally separate from accounting standards as directors - to whom the latter apply - are not auditors, and to avoid the danger of a 'feedback loop' (where auditing standards become the 'tail wagging the dog').
- Auditing and director enforcement issues relating to company law breaches should be accommodated within the Insolvency Service as a '**Companies Commission'**. The emphasis should be on dealing with situations where there has been failure to demonstrably achieve justice and to enable the system to be corrected where necessary. That can only be a central government function. The Air Accidents Branch is a model where accidents are investigated wholly independently of industry interests. That should apply here too.
- The Companies Commission should also inspect accounts, a function currently delegated by the SoS to the FRC's Financial Reporting Review Panel/Conduct Committee.
- **The Governance Code** should be subject to consultation once the above issues are defined, to find a better home for that function. There are valid arguments that a 'comply or explain' system can't be run by government.
- In any transition period, senior roles must be recruited afresh.

3 i.e. which unlisted companies, charities, etc are important enough to also be under this oversight.

2. Problems with the CMA taking FRC pronouncements as authoritative

There are also carry-overs from some of the LAPFF response to Kingman on the following points.

- The irregularity of the FRC's own status [2000]. It has been and still is in breach of the Government Accounts and Resources Act 2000. By that Act, the FRC has been a public body since 2000[4].
- The position of the FRC on the legal framework for accounting and audit is flawed. Even some of the FRC's own material conflicts with its own status, and on the fundamental legal matter of writing down clear statute wrongly.

Irregularities with the FRC's own status

The FRC was classified by the Office of National Statistics (ONS) as **a public body from 1990** and that was also confirmed to apply to the new structure from 2004[5]. By then, that position had also been given a statutory basis[6].

Despite that, the FRC failed to apply the obligations required of public body status; with no evidence of ministerial knowledge or approval of that serious deviation in behaving like a market body whilst being a public body. Decisions were taken by officials rather than ministers, and during that period, both Mr Hadrill (the current FRC CEO) and Sir Brian Bender (a current FRC Board member) had line responsibility for the FRC, as Director General at the then DTI and as Permanent Secretary at the DTI respectively.[7]

The government also admitted the effect of this in May 2018 in terms of managing public money, as the FRC is still in catch-up mode, having tried to convince people that its status changed in 2014, which is not the case (but even if it were true doesn't explain why it is *still* in catch-up mode). A Parliamentary Question revealed the following:-

"*As such the full requirements of the managing public money guidance were not applied to the FRC*".[8]

And: "*The selection of [law] firms for enforcement cases was not the subject of a public tender. Since being confirmed as a public sector body the FRC has been working with the Department to review all internal processes and practices in order to ensure that they comply with managing public money guidance"*.[9]

Public body rules also require consent from the Treasury of salaries greater than that of the Prime Minister. The FRC Chief Executive earned more than 2.5 times that of the Prime Minister[10]. There is no evidence of that remuneration having been approved by the Treasury given the failure to apply public body status to the FRC.

Other issues where the requirements have not been followed are:--

- public money rules in general

4 PQ HL8591
5 Source Freedom of Information Act (FOIA) request`
6 PQ HL8591
7 Source: PQ HL5904 HL4991
8 PQ HL7591
9 PQ HL7589
10 PQ HL 4994

- conflicts of interest
- approach to procuring legal advice (in particular not demonstrably insulated from the professions' defence interests)
- procurement issues (including EU and Cabinet Office Rules rules for procurement of public contracts and recruitment, which has not been publicly advertised)
- setting of salaries
- freedom of information

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Statutory disconnect

Not only has George Bompas QC for LAPFF challenged the FRC orthodoxy, but so has the former Senior Partner of Herbert Smith, Mr Edward Walker-Arnott[11].

Even without a QC's opinion, a review of the content of the FRC's 2011 'True and Fair' paper when compared to the statute, shows that in no part of that document is the actual text for the relevant statute (s393 CA 2006) transcribed properly.

Whereas the True and Fair View standard applies to the specified <u>numbers</u> <u>in</u> the accounts, the FRC paper refers to 'accounts as whole' and other variations of that.

Disconnecting the 'True and Fair View' from the specified numbers then paves the way to disconnects from the core requirements of Company Law, without Parliamentary or judicial sanction for departing from this model.

The accounting model of the Act is that the numbers in the accounts (by a profits test and a net assets test) set an upper limit on what can be distributed, 'distributable profits' and what cannot be distributed 'undistributable reserves'.

The operation of this model can be seen in at least three places in the Companies Act:-

- s836, the general requirement for annual accounts being the basis for lawful distributions.
- S837, the specific requirement for when an auditor has qualified his opinion. In such circumstances the auditor has to make a statement on the effect of that qualification on the ability of the company to make any distribution.
- S92, the specific requirement for the auditor to ensure that a company meets the additional distribution test for a public company when it re-registers from a private company. (It is of note that Patisserie Holdings plc (Patisserie Valerie) was required to file such a statement in 2014).

The robustness of the numbers in the accounts, and the going concern position on those numbers, are clearly relevant to whether distributions can and should be made.

The auditor, by the law, is therefore a gatekeeper for lawful distributions, unfortunately the FRC has opened the gate and propped it open.

[11] See footnote 2

In the light of the collapse of Carillion, and the problems with banks, the impact of the FRC deviating from this model becomes a clear public interest issue.

The FRC in dealing with criticism created a red herring, stating that the law 'did not require disclosure of a figure for distributable profits. LAPFF had never said it did. The law sets two tests to calculate the number based on the numbers in the accounts. Clearly if the result of the calculation was already in the accounts, the Act wouldn't need to prescribe calculations to arrive at it.

3. The use of law firms

LAPFF made the point to the Kingman Review that no regulatory body should use private sector law firms that undertake any defence work for companies or auditors; and that 32 years is too long for one person to be part of a regulatory system

[ ] of Herbert Smith was at the FRC or the predecessor subsidiary body, the Auditing Practices Board, from 1986 until leaving the Financial Reporting Review Panel at some time in Spring 2018, 32 years.

Given that length of time and that he was advising firms during this period (PQ 7046)12, we find the tenure unacceptable.

[ ] progressed from being a member of the Accounting Practices Board (APB), chair of the ABP, Chair of the Conduct Committee, Chair of the Financial Reporting Review Panel (FRRP) and then a member of the FRRP after having been Chair. He was also the chair of the FRC Conduct Committee.

He also co-signed the FRC's True and Fair View paper based on the series of opinions that Mr Walker-Arnott referred to.

4. The 'auditor expectation gap' - regulatory capture has to be addressed

The 'Expectation Gap', the difference between what an auditor is expected to do and what an auditor actually does, is essentially synthetic. It could be described as an auditor defence tactic. It is clearly given some credence if the regulator itself (the FRC) has deviated from applying the law properly.

The construct of an 'expectation gap' has pervaded the highest levels in the FRC. Mr Haddrill FRC CEO said in a speech at the PCAOB 19 November 2013.

"The increased transparency, in both audit and Audit Committee reports will help investors, should they want to, ask relevant and pertinent questions of the board as well as help manage the audit expectation gap."

For a regulator to refer to 'the expectation gap' seems to diminish their own regulatory position by admitting and excusing failure of the party they regulate, and entrenching it as the norm.

The speech was also at odds with the real issue for investors and the public which is whether the auditor has delivered the correct opinion. How talking to the board of the company about the audit

[12] https://www.frc.org.uk/document-library/frc/2013/speech-by-stephen-haddrill-at-the-pcaob-s-internat

report once signed could make any difference to that is difficult to understand. The auditor should be discharging a statutory function, not providing tools for further analysis by providing parallel information. Whether he knew it or not, Mr Haddrill's statement actually creates an excuse for failure of the opinion.

5. Responses to specific consultation questions

Consultation questions

A) Issues

1. How well is the audit sector as a whole serving its stakeholders?

Problems have been apparent during and after the banking crisis exemplified at HBOS, Bradford & Bingley, Co-op Bank, then Quindell, and now Carillion. For the relative size of the market, the UK seems to be suffering from more accounting problems than the USA. By the FRC's own statistics there is a particular problem with KPMG[13]. The FRC stated: "*There has been an unacceptable deterioration in quality at one firm, KPMG. 50% of KPMG's FTSE 350 audits required more than just limited improvements, compared to 35% in the previous year.*" .

Theme 1: The audit framework

2. How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

LAPFF believes that the legal framework is robust, as set out by Company Law. The problem flows from international standards (accounting standards 'IFRS' and auditing standards 'ISA') being grafted in that don't fit with the model of the law.

The IFRS model isn't, the ISA model is at best incidental to it. LAPFF notes that the UK adopted both IFRS and ISA in 2005. The legal framework is based on first order creditor and shareholder protection. The genesis of both systems would seem to suit the Big Four oligopoly, through standardization as well as setting barriers to entry due to the complexity of the standards. One set of standards may be of benefit to them, even if not – as has occurred – to the public interest. It is of note that the USA whilst having influenced the global standardization project, has chosen not to become a user of those standards itself.

Theme 2: Incentives and governance

3. To what extent do the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?

It may be the case that companies will have poor audit committees precisely when they need strong ones, i.e. well run profitable companies will have good directors, and those with problems will not. In those situations, auditors do not seem to be the last line of defence that they ought to be.

[13] "Big 4 Audit Quality Reviews" FRC https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline

4. How has this changed following the Competition Commission's intervention?

Little appears to have changed. There is clearly more retendering, but at the same time, even the FRC is now concerned about systemically weak auditing. There is clearly a particular problem with KPMG.

Theme 3: Choice and switching

5. Is competition in the audit market working well? If not, what are the key aspects hindering it?

It certainly is not working well. One hindrance to the supply side may be the entrenchment of large firms with the experience of operating overly complex accounting standards, and defensive auditing standards.

6. In particular, how effective is competition between the Big Four and between other firms and the Big Four?

We see no evidence of effective competition.

7. How has this changed following the Competition Commission's intervention?

There is little evidence of any change since that intervention.

8. What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?

LAPFF believes it may be incorrect to see competition as a solution to problems with audit quality.

9. In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

From engagement with companies, and also from first-hand experience of LAPFF members, there are significant problems. For example if the current auditor of a company is not to be chosen by rotation and a company sponsored pension fund is audited by another firm, then that leaves at best two other Big 4 firms to choose from..

10. What are the key factors limiting choice between auditors?

As stated in Q9, the issues are an additional lack of choice due to conflicts of interest, when the starting point is seen as four firms.

11. What are the main barriers to entry and expansion for non-Big Four audit firms?

LAPFF considers there to be barriers and perceived barriers. A perceived barrier is that one firm needs to audit a whole group globally. That was not always the case and there may be arguments for the firm auditing the holding company and the firm auditing the consolidated accounts not being the same auditor as all (or material) subsidiaries of . With a greater focus on the statutory objective of creditor protection, then group-wide audits may in fact have conflicts of interest as different groups of creditors are present in different subsidiaries. Some elements of these inter-group conflicts have been dealt with by bank ring-fencing in the UK, though not the audit aspect.

Theme 4: Resilience

12. Is there a significant risk that the audit market is not resilient? If so, why?

Defining resilience in terms of the failure of any one of the large four firms could occur, and that must be a significant possibility. For the UK, large civil actions against auditors – which will tend to require a liquidator as the party instigating action - are relatively unusual given that there will need to be the rare circumstance of a liquidation with the liquidator having the resource to see proceedings through. However, adding that risk to similar risk of failure in other countries, may mean that the risk is already significant.

Theme 5: Regulation

13. What is the appropriate balance between regulation and competition in this market?

LAPFF sees the two issues as separate. The need to improve audit quality should be driven by improvements to the regulatory and standard setting systems. A regulatory risk from having an oligopoly of four large firms is the ability they may have to distort the standard setting and regulatory environment towards professional self-interest, exactly the situation that the PCAOB described (see Summary).

B) Potential measures

14. Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented.

The items are:

- Restrictions on audit firms providing audit only services (see Q16 below)
- Market share cap (see Q19 below)
- Joint audit (see Q23 below)
- Incentives and governance (see below).
- Insurance firms taking on responsibility (below)

The insurance firm option was not seen an attractive option when put to LAPFF members. However, an interesting thing about the proposal was the focus on what the insurable risk would be, which is given in the consultation as the capital of the audit company. However, as that is in fact already the focus of the Companies Act model of accounts and audit – which the standards have deviated from – then a near equivalent effect could be generated by a proper adherence to the full statutory model of the law.

15. Are there any other measures that we should consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.

Nothing over and above what is already in Section 3.

Restrictions on audit firms providing non-audit services

16. One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?

If the proposition is audit only firms, then there may be a cost issue that would need to be borne by higher audit fees. However, if that were to have a positive effect on audit quality that should be a cost worth paying. The wider impact of audit failure can be seen in certain banks, and more recently the collapse of Carillion.

17. How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?

Given that firms tend to have an affiliate relationship, rather than common international ownership, then audit only firms in one jurisdiction doesn't seem to create barriers. Some jurisdictions already have tougher requirements than others.

18. What should be the scope of any measures restricting the provision of non-audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audits of large companies and PIEs?

At first sight, a market share cap may appear to be a solution, indeed some form of cap has been mooted from within the Big Four firms. However, if the Big Four collectively are restricted to some cap lower than 100% then there would need to be a mechanism for telling some companies that they can't appoint any of them because they are all at capacity. Depending on the company and the expertise needed to do its audit, this might have unintended consequences. Over time one would expect the Big Four to gravitate to the biggest or most lucrative contracts, with other companies effectively shut out from appointing them. Seen from those companies' standpoint, this would therefore appear to be an anti-competitive outcome.

Market share cap

19. How should the market shares be measured? - number of companies audited, or audit fees or some other measure?

To achieve an economic effect, at first sight it would need to be based on fees, as setting the criteria of the number of companies' audits alone would create anomalies given the difference in size between e.g. the five largest and the five smallest FTSE companies, and likewise for the FTSE 250. However setting a cap based on fees could potentially create fee distorting effects, such as lowballing to avoid breaching fee based quotas.

20. Could the potential benefits (greater choice, and resilience) of a market share cap be realised?

There are too many uncertainties to be able to answer this question.

21. What do you consider to be the relative scale of the costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits?

Again, there are too many uncertainties at this stage to be able to make a reasonably informed comment.

22. What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%?

Again, too many uncertainties at this stage to be able to recommend one or the other levels.

23. Could a joint audit be an effective means of implementing a market share cap?

When put to LAPFF members, this suggestion met least resistance and raised few difficulties. It is clearly the norm in France, and may be a way of building proven capability for firms currently outside of the current Big Four.

Incentives and governance

24. Should the auditors and those that manage them (e.g. audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?

When put to LAPFF members there was support for this in the context of parallels with directors' s172 duties. In particular in terms of looking at the long-term health of the company, as a longer time frame makes non-financial considerations more relevant. There also may be special cases where creditors (banks) and government contracts (e.g. Carillion) are particularly relevant in the context of a broader definition of stakeholder interest, as indeed some sponsors of large pension funds may be.

25. If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?

When put to LAPFF members there was a general view that this could result in too much work for any regulator. Notwithstanding that, there was a view that there could be some limited use of this approach in cases related to the wider public interest issues in Q24 above.

26. Please describe the benefits, risks and costs of such an independent body replacing audit committees.

See Q25, the main risk being the scale of work involved.

27. Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What would be the costs and benefits of this?

See Q9 above. There is a practical difficulty with retendering with only four firms.