“EXPERT” PUBLIC-INTEREST RESPONSE TO CMA INVESTIGATION OF AUDIT COMPETITION

Professor Atul Shah , Mr Brian Little , Mr Paul Moore and Professor Richard Murphy

We are a group of people who have had a long-standing concern for the impact of audit failures, and the power and excesses of the Big 4, with a strong research and policy record in these areas. We come from a public interest perspective and have no commercial interest in the outcomes of this investigation.

For example here is a sample of our reports and engagement:

SMALL “EXPERT” GROUP SUBMISSION TO THE HOUSE OF COMMONS TREASURY SELECT COMMITTEE RE KPMG AND HBOS AUDIT – TERMS OF REFERENCE - 7 DECEMBER 2015

OUR SUBMISSION TO THE TREASURY SELECT COMMITTEE RE KPMG AND HBOS AUDIT – 4 OCT.2017 DOCUMENTS INDEX AND INTERNET LINKS

OUR FINAL SUBMISSION TO THE TREASURY SELECT COMMITTEE RE FRC , KPMG AND HBOS AUDIT - JULY 2018 . FOLLOWED BY MR JIM SHANNON MP SUPPORTING LETTER TO TSC CHAIR MRS NICKY MORGAN MP ON 5 JULY 2018.

Our comments are presented; bearing in mind all the key concerns you have raised in your call, but laid out in our own structure and format.

1. **<u>TONE AT THE TOP, CULTURE AND ETHICS are</u> central to nurturing trust and accountability which, in turn, are the foundation of good corporate governance and auditing. We believe that the culture and ethics of auditing have failed miserably at too high a cost to society**.

   In particular, we suggest that the Big 4 have failed to make integrity, sincerity and transparency central to their culture, despite being given a state licence, and effective monopoly, to audit large corporations. This failure has been noted in FRC AIU reports but to no lasting impact or transformation.

   Instead these firms have become entirely profit-oriented commercial entities, helping clients to secure public contracts and assets whilst avoiding taxes on an industrial scale. In the process, they have also produced a generation or more of professional accountants who have gone on to run big corporations with this culture and values, so spreading the virus.

   <u>Background/Evidence</u>

   House Of Lords Economic Affairs Committee hearing – 23 Nov. 2010 (watch video *from 1 hour 2 mins* – Transcript Q.266 pages 29-46) **Banking crisis**, Going Concern audit statements, Balance Sheet audits / asset valuation and loss reporting, and financial reporting standards Mr Ian Powell – PwC UK : ; Mr Scott Halliday – E & Y; *Mr Griffith-Jones – KPMG*; *Mr Connolly – Deloitte* : Accountancy Age Video, Media coverage “**Lords accuse auditors of deceiving investors” , “Lawmakers attack auditors over bank statements”.**

The HOL committee published its report on 30 March 2011 – see Chapter 6 and para 145 re Northern Rock-

“**We are astonished that PwC appeared not to recognize an amber light that flashed so brightly**.”

PwC reported to accounting regulator after taking criticism of client from report

FRC – “Auditor Scepticism – raising the bar” *(para 17–25)* : August 2010
FRC written submission –Auditors Market Concentration and their Role - *(paras 2.7 - 2.11)* to the House of Lords.

This must stop, and the CMA and “new FRC / Accounting Regulator” (See point 3) should insist that there be cultural and ethical policing of large audit firms with the sanction that their audit licence might be withdrawn, with the option of personal punishments administered against leaders of these firms who create an adverse culture.

2. THE ECONOMIC BUSINESS MODEL FOR AUDITING IS BROKEN

Background/Evidence

(2A) The Guardian Phillip Inman Fri 8 Dec **2006**

KPMG’s £680,000-a-year partners round off Big Four’s bumper year

· Auditors thrive on boom in deals and regulation
· Profits likely to fuel calls for greater scrutiny

More than 500 partners at accountants KPMG have picked up bumper pay awards after a boom in City dealmaking and regulatory work in the UK and US.

The firm posted profits up 19% to £373m and awarded pay rises to 556 partners, taking their annual incomes to an average of **£680,000**. Staff shared a pot of £80m, up from £59m the previous year. *<£519,000 in 2017>*

Mike Rake, who stepped down as head of the UK operation in October, earned £3.6m including £800,000 as a reward for his job as the firm’s worldwide head.

KPMG is the last of the big four accounting firms to report its profits. The four collectively made more than £1.5bn.

Ernst & Young grew at a rate of 20% to rack up profits of £294m and profits per partner, the key measure of success in partnership firms, of **£686,000**. *<£677,000 in 2017>*

Deloitte registered profits of £489m, while PricewaterhouseCoopers, the largest of the big four, managed an average profit per partner up 5% to **£511,000.** *<£865,000 in 2017>*

The results are the second successive year of bumper returns for the major accounting firms and will fuel calls for more scrutiny from some backbench MPs and the small band of academics who closely watch the profession. *<PwC £652,000 in 2017>*

Regulators will also harbour concerns that large firms face an unhealthy oligopoly when looking for accounting services.

However, the profession is likely to escape censure from either the government or regulators who fear that any crackdown will only force one or more of the firms out of business and make the situation worse.

If anything they are bending over backwards to support the firms with extra legal protection and a light regulatory touch.

Last month, the Companies Act was passed with provisions protecting accountants from compensation claims by allowing them to sign contracts limiting liability. Some of the firms have also reopened consulting arms that only a few years ago regulators said were the cause of conflicts of interest.

The accountants argued that soaring profits are a recent phenomenon. The Enron scandal and a series of corporate collapses hit audit practices at the big firms and led to the demise of Arthur Andersen.

KPMG has found it hardest to crawl out from under the weight of scandals. Its US arm admitted selling “unlawful” tax avoidance schemes that in effect deprived US public funds of billions of dollars. The firm was fined almost $500m (£253m). Several of its ex-partners face the prospect of criminal prosecutions.

John Griffith-Jones, the new UK boss, said the UK firm was unjustifiably tainted by these scandals and had only just begun to escape the opprobrium showered on its US counterpart. “It is not something that happened here and we should acknowledge that,” he said.

Prem Sikka, professor of accounting at Essex University, is a long-time critic of the accounting profession and has written several articles with Labour MP Austin Mitchell accusing them of profiteering and denouncing many of their practices.

He said the audit practices of the big four were under suspicion in the UK and not just abroad. He said they faced questions over their involvement in the collapse of several companies, including bus maker Mayflower, MG Rover and Christmas hamper firm Farepak.

Accountants have also come under fire for helping companies and wealthy individuals avoid paying tax on capital gains and corporate profits.

“They peddle a range of avoidance schemes in the UK, which are estimated to cost the state £100bn each year in possible tax revenues,” Mr Sikka said.

He points to a VAT avoidance scheme KPMG developed for a company operating 127 amusement arcades in the UK.

“The company employed 600 staff, but under KPMG ‘s scheme a complex corporate structure was created to show that it was controlled from the Channel Islands, and claim that, despite trading here, the business was not really established in the UK.”

Mr Griffith-Jones said he was happy to see the chancellor put an end to most complicated avoidance schemes last year when he demanded firms alert Revenue & Customs if they planned to sell packages with the express aim of avoiding tax.

“From our perspective our success is mostly a London story. There is lots of money flowing through the City and it’s our transaction services business that is benefiting from it,” said Mr Griffith-Jones.

Ernst & Young said avoidance made up only a small proportion of current work which was mainly focused on supporting firms that needed to conform with Sarbanes-Oxley reporting requirements in the US and transactions in the City.

Prof Sikka’s gloomier view of the profession and its benefits to the economy is shared, at least in part, by several other bodies. This year the Association of British Insurers said the creeping global dominance of the big four was in danger of compromising the independence of UK regulators and hampering disciplinary actions. It said the firms had a stranglehold on the market for auditing work and too much influence over regulators. **It has called for regulators and competition authorities to show their teeth.**

Transparency on a need to know basis

Accountants, along with lawyers, often fall off the radar in debate over corporate fat cats. Many now produce plc style accounts but they are more opaque than those of listed companies and without the details equity analysts have come to expect. Few give details of the pay and bonuses of senior staff and in KPMG’s case only the senior partner’s pay is outlined, and only then in the most obscure legalese. Their pensions are also obscured from view, which, given the furore over huge pensions awarded to the heads of big companies, is probably not an accident.

Mike Rake, the firm’s former senior partner, saw his pay rise from £2.4m to £2.8m for his UK work and from £600,000 to more than £800,000 for his job as worldwide chairman. Other directors are left out. The partnership status of accountancy and legal firms allows them to keep their pay, bonuses and pension arrangements secret. Equity partners own the firm and are deemed to be the only people who need to know how well it is doing.

KPMG was lauded as the first accountancy firm to produce annual accounts, but it refused, along with its rivals, to open itself up and mimic the format imposed on listed firms by the latest corporate governance rules.” *End of Article extracts*

and then A DECADE + ON

(2B) KPMG UK sees profits drop by almost a fifth - Economia

Danny McCance 18 Dec **2017**

The gap between KPMG and its Big Four rivals in the UK widened after it reported a 5% increase in revenues but a slump in profits of 19.5%

KPMG pushed its revenue from £2.06bn to £2.17bn for the year ending September 2017.

However, the gap between KPMG and its competitors is growing. This year EY posted a revenue increase of 9.2% in October and still remained behind both Deloitte, which posted revenues of £3.38 and PwC which posted revenues of £3.6bn. This trend is mirrored on a global level.

Average partner remuneration for KPMG fell for the second consecutive year, with a 11% decrease from **£582,000 to £519,000** after dropping from £623,000 in 2016, while the firm's profit before tax and members' profit shares fell from £374m to £301m.

Bill Michael, chairman of KPMG UK, said, "We are operating in a period of unprecedented change and this creates great opportunity for our firm. Our clients are navigating complex regulatory and geopolitical change, while technology continually reshapes and disrupts their markets. I believe KPMG has a pivotal role to play to help businesses through this period, helping them to adapt, evolve and grow."

……………… **KPMG UK's management consulting practice was the best performing service line, reporting growth of 11%.**

The audit practice also performed well, growing by 10%, while the firm became the number one auditor in the FTSE 250 and 350, securing contracts with BT, Legal and General and Micro Focus.

KPMG paid a total of £824m in tax to HMRC this year, while the firm's chairman was paid £1.4m. " *End of extract*

The Big 4 should be much more transparent in their own accounts, reporting in full contingent liabilities and litigation against them, their reserves and insurance arrangements, and the reward structures and incentives given to audit staff, including client gifts and entertainment. Conflict of interest policing and monitoring should also be transparently reported upon. Their efforts to promote public interest and a civic, responsible and ethical culture should be audited and reported on every year.

Their corporate governance is a sham – there must be independent non-executives on the Board. As Professor Richard Murphy has campaigned for years they should also publish accounts for the global groups of which they are a part, including country-by-country reporting data.

Through judgements like Caparo and legal structures like LLP, the audit firms have built a culture of minimising responsibility and accountability for themselves, and maximising fees and revenues. The CMA needs to work with other regulators to transform this errant culture which has resulted in billions of losses for employees and the state. The laws should make them responsible and accountable, and going back to a partnership unlimited liability structure would make auditors much more careful.

(2C) AUDIT QUALITY

(2C1) Audit Inspection Unit: Annual Report 2010/11 – and a decade ago

https://www.frc.org.uk/getattachment/adf01122-7b6b-4db3-92e3-4be586c7e2af/AIU-Annual-Report-2010-111.pdf

1.3 Key issues and concerns

Inspection results are as good as, or slightly better than, those of last year. In particular, the improvement. While this is encouraging, the AIU cannot confirm that this is a positive underlying trend until it is replicated more consistently across all types and size of engagement.

Set out below are a number of key issues and concerns arising from the AIU's Inspection activities which it believes should be addressed in order to improve audit quality. These matters are discussed further in Section 3.

Professional scepticism

• **The AIU's findings continue to identify the need for firms to ensure that both partners and staff exercise appropriate professional scepticism, particularly in respect of key areas of audit judgment such as the valuation of assets and the impairment of goodwill and other intangible assets.**

• A number of actions have been taken, or are in the process of being taken, by firms to address the AIU's concerns in respect of professional scepticism. Since many of these actions were taken subsequent to the completion of the audits reviewed in the 2010/11 inspections, any improvements that might be expected are, therefore, not reflected in the AIU's findings.
Focus on audit quality

Given the current economic climate **which has led to a decline in fee income.** When seeking to grow their businesses and obtain further efficiencies in the conduct of audits, firms must ensure that this is not at the expense of audit quality. The importance of audit quality should be reinforced, and its achievement appropriately rewarded at all levels within audit firms.

A Decade of FRC Audit Inspection Unit extracts for reports for KPMG

FRC : AIU DECEMBER 2008 FRC: AIU JULY 2011 FRC: AIU May 2014 FRC : AIU JUNE 2017

The words 'competition' and 'market' do not easily apply to large audits. Audits are not tradeable commodities, nor is there evidence of strong interest from 'ownerless' corporations in purchasing a good independent audit. To the contrary, just as these companies see regulation as interference, corporations see audits as a burden.

In Professor Shah's research (*and Book the Politics of Financial Risk, Audit and Regulation: A Case Study of HBOS)*, he discovered that not once throughout its short life did KPMG have a meeting with the entire Board to ask them whether they were satisfied with the accounts and culture of the organisation. That company, like so many others only 'bought' an audit because they had to. From our submission to the TSC on 4 October 2017 please also see the link between (and conflict) consulting work and subsequent "audit"……

"2.20.4 It should also be noted that, even if the accounting standards were appropriate, there must still be serious doubts as to whether the judgements made by management and KPMG were appropriate, in particular, in relation to bad debt provisions and the opinion that HBOS met the "going concern" test which, by its very nature, must be forward looking.

2.20.5 It is also crucial to note that, in relation to KPMG signing-off bad debt provisions (a fundamental element of the ability to signoff the 31/12/2007 accounts), KPMG itself, in 2004,having been engaged to conduct an "independent" review of credit risk management in the HBOS corporate division signed off HBOS's "atypical approach" to credit risk management. (Para 1181 of FCA/PRA report : Nov 2015 and Paul Moore book Crash, Bank Wallop) This can be proved by viewing the Board minutes of the relevant meeting. In particular, KPMG (under pressure from HBOS management) agreed that the CEO of the HBOS Corporate Division could sit as the Chairman of the Corporate Credit Risk Committee. It is absolutely obvious that a credit risk committee whose primary role was to exercise independent oversight of credit risk policies and decisions, should never have been Chaired by the Chief Executive of the same operating division, especially as that CEO was remunerated on the basis of the growth of assets in that division. The Auditor is formally accountable for identifying control weaknesses that may affect the financial reporting. A control weakness such as the absence of rigorous independent oversight of credit risk policies or decisions effectively means that it is impossible for the auditor to sign off loan loss provisions or an opinion as to whether a firm met the "going concern" test. HBOS should not have done so at the end of 2007, especially given the critical importance of doing so without conducting much more rigorous testing and not relying on management assurance.

2.20.6 The PRA / FCA final report into the failure of HBOS also makes it abundantly clear that HBOS relied almost entirely on management assurance relating to bad debt provisions and only undertook a specific review of loans that HBOS itself had already identified as having incurred a loss and only conducted a cursory review of other impaired assets. They also accepted management's view, without adequate challenge, of the actual amount of loss on impaired assets recognised by management.

This was never going to paint a true and fair view of the financial position of HBOS as a going concern. They were also aware of other control weaknesses as pointed out by the Group Risk Director who they simply ignored.

We recommend that the TSC also read the entire section in the PRA / FCA final report 2.11.3 and 2.11.4 (page 170 to 192) and following relating to financial reporting (document 9). Reading this narrative no investigation or credible tribunal could arrive at any other conclusion than KPMG were fully aware of the auditing problems and chose inappropriately to rely on management assurance of key financial indicators which were fundamental to their duty to report on HBOS's financial status as a going concern without performing the requisite independent checks."

(2C2) Miscellaneous / internet links

Extract from PwC written evidence to the House of Lords Economic Affairs Committee – at para 24 **"Professional scepticism is fundamental to what auditors do. It is defined in auditing standards as** "*an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence*."

and at para 25 **It is the job of the auditor, as established by internationally agreed auditing standards**, to **challenge management's assertions and ensure that they are backed with evidence that is appropriate, supportable and capable of independent verification**. It is not the auditor's job to develop alternative views and then try to persuade management to adopt them in preference to theirs**."** and then read this

example of **A340 pricing** – "management's assertion" – PwC para.8.62b – maths wrong/untruthful: **A340 quantities** – "management asserts" – PwC para 8.72/8.76 – untruthful/ industry PwC logic+maths wrong …

FRC/APB – " Audit is essential to public and investor confidence in companies… The application of an appropriate degree of professional scepticism is a crucial skill for auditors. **Unless auditors are prepared to challenge management's assertions** they will not act as a deterrence to fraud nor be able to confirm, with confidence, that a company's financial statements give a true and fair view."
Mr Paul George – FRC /POB Director : Daily Telegraph July 2011 "Biggest audit firms hit by scathing regulator's verdict"

You may read the PwC letter/public response to the FRC "Auditor scepticism …" Discussion Paper …*(by Mr Sexton in the above PwC Trust in Business Video)*

(2C3) FRC publishes thematic review of auditors' materiality judgements

https://www.iasplus.com/en-gb/news/2013/12/frc-materiality-review 16 Dec 2013

The UK Financial Reporting Council (FRC) has today published the findings from its review of auditors' consideration and application of materiality. The report sets out a number of observations on the application of materiality by the six largest UK audit firms, as well as the reporting of identified errors to audit committees. It also sets out some key messages for audit firms and audit committees to consider.

In 2013, for the first time, the FRC's Audit Quality Review (AQR) team have begun conducting Audit Quality Thematic Reviews. From 2013 onwards, thematic reviews will supplement their annual programme of audit inspections of individual firms. Two reviews have been conducted in 2013:

- A review of the auditor's consideration and application of materiality; and
- A review of the auditor's identification of and response to fraud risks and relevant laws and regulations.

The report on materiality considerations has been published today, with the report on fraud risks, laws and regulations expected in January 2014. The report is based on data from a cross-section of audits conducted by the six largest UK audit firms - BDO LLP, Deloitte LLP, Ernst & Young LLP, Grant Thornton UK LLP, KPMG LLP and KPMG Audit plc and PricewaterhouseCoopers LLP. The report identifies a number of findings:

- Several of the firms have recently made changes to their materiality guidance which may lead to higher materiality levels being set.
- **Some firms have significantly higher acceptable percentage ranges than others for determining materiality.**
- **Auditors did not always appropriately explain and justify their judgments in completing templates for setting materiality.**
- **In the majority of cases materiality levels set were the maximum permitted under the firm's guidance, irrespective of the risks identified.**
- **Auditors did not always appropriately consider revising materiality levels when actual performance was significantly worse than forecast.**
- **In a number of instances, not all of those errors that should have been reported to the audit committee were communicated by the auditor.**

The report also identifies some key messages for both audit firms and audit committees to address these findings. In particular, firms should ensure that appropriate judgement is exercised in setting materiality and that the judgements made are fully documented. Audit committees should seek to understand the materiality level set by their auditors and why it is considered to be appropriate, including the impact that it will have on the audit procedures. The FRC's press release can be found on their website here and the report itself can be downloaded here.

(2C4) and then A DECADE + ON

FRC Press Release - Big Four Audit Quality Review results decline 18 June 2018

The Big Four audit practices must act swiftly to reverse the decline in this year's audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council (FRC). Overall results from the most recent inspections of eight firms by the FRC show that in 2017/18 72% of audits required no more than limited improvements compared with 78% in 2016/17. Among FTSE 350 company audits, 73% required no more than limited improvements against 81% in the prior year.

Across the Big 4, the fall in quality is due to a number of factors, including a failure to challenge management and show appropriate scepticism across their audits, poorer results for audits of banks. 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. As a result, KPMG will be subject to increased scrutiny by the FRC.

Stephen Haddrill, CEO, FRC, said, **At a time when public trust in business and in audit is in the spotlight, the Big 4 must improve the quality of their audits and do so quickly. They must address urgently several factors that are vital to audit, including the level of challenge and scepticism by auditors, in particular in their bank audits.** We also expect improvements in group audits and in the audit of pension balances. Firms must strenuously renew their efforts to improve audit quality to meet the legitimate expectation of investors and other stakeholders."

The increased FRC scrutiny of KPMG includes inspecting 25% more KPMG audits over its 2018/19 cycle of work; and monitoring closely the implementation of the firm's Audit Quality Plan. KPMG agrees that its efforts in recent years have not been sufficient; the FRC will hold KPMG's new leadership to account for the success of their work to improve audit quality.

The FRC has also reported on the results of its inspections of four other firms, BDO, GT, Mazars and Moore Stephens. These reports show general improvements in the quality of inspected audits.

Other actions taken by the FRC include:

- Setting out to firms earlier in the year concerns over various aspects of bank audits, including their challenge of management and provisioning against loan losses and PPI mis-selling claims.

- Reviewing the effectiveness of Root Cause Analysis by the firms to identify the real causes of audit shortcomings and whether their action plans will effectively address the FRC's concerns.

- Agreeing actions with firms on all audits where shortcomings were identified.

- Taking enforcement action under the Audit Enforcement Procedure where appropriate.

- Implementing a new audit firm monitoring approach, focusing on five key pillars of leadership and governance, firm values and behaviours, business models and financial soundness, risk management, and evidence of audit quality.

(2C5) When UK Regulators are found wanting they typically complain they don't have powers – the FRC are no different and were given the opportunity / inputs in 2010/2011

Economic Affairs Committee - Second Report Auditors: Market concentration and their role

https://publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/11902.htm

106. **The FRC is keen to gain more powers**. It would firstly like to introduce an additional licence for auditors of listed companies. This would give the FRC the power to impose a range of sanctions against individual auditors which it currently cannot do. At present, the FRC's only option is recommending the relevant professional body remove the licence of the entire audit firm—not just the individual auditor(s). Removing a firm's licence is "a nuclear option", according to FRC chief executive Stephen Haddrill. But even if the FRC recommends such a drastic step, it cannot enforce the action. Mr Haddrill said: "We would expect [the professional body] to enforce it but we don't have that power."[140]

107. After gaining a licensing role the FRC wants "a wider range of sanctions to address shortcomings in audit quality and for use in disciplinary situations".[141] These would include being able to set conditions on how an erring audit firm does business in future and to set fines.

108. The FRC also wants more power to conduct preliminary investigations. Mr Haddrill said: "At the moment it's quite difficult for us to conduct a comprehensive investigation into whether or not there has been an audit failure, if we don't have some real hard evidence of that being available. We have very limited powers to call into account and to question directors, for example, unless they happen to be accountants. So we find it quite hard to get a thorough review of whether something has gone wrong and would like our investigatory powers to be strengthened in that respect."[142]

109. The FRC argues for these changes on the grounds that too many audits seen by its Audit Inspection Unit (AIU)—which monitors the audits of all organisations in whose financial condition there is considered to be a major public interest—are substandard.[143]

110. **The regulation of accounting and auditing is fragmented and unwieldy with manifold overlapping organisations and functions. This is neither productive nor necessary. Other professions have only one regulator—medicine for example under the General Medical Council. The wider powers sought by the Financial Reporting Council would go some way to simplifying and streamlining matters for audit. But further impetus needs to be given to rationalisation and reform. We hope and expect that the profession will provide that impetus. In the absence of rapid progress, we recommend that the Government stand ready to impose a remedy.**

BIS/FRC Consultation on the "Reform of the FRC" - submission by Mr James Shannon.MP

BIS/FRC Consultation on the "Reform of the FRC" – submission by Professor Stella Fearnley

(2D) "Beancounters"

Can we also commend the "Beancounters" book by Richard Brookes which , in our view, includes many interesting facts including for example the extent of the change in audit fee income to consulting income over the last few decades.

SO HOW DO BIG 4 PARTNERS SUSTAIN THEIR EARNINGS WHEN AUDIT FEE CHALLENGES to REDUCE OR IS THIS REALLY SUSTAINABLE? -the only route to date is selling other tax and consulting services or face a continuing reduction in audit quality.

Our research to date and extensive anecdotal evidence is that the accounting/audit firms are exposed to enormous conflicts of interest which have become routine among the Big 4 , especially where they have financial institutions as clients.

It is our view that the only way to create an environment in which HMG can create a competitive situation whilst also providing the framework to improve audit quality and performance is to

1. Split away the audit work for the Statutory Audit in to AUDIT only firms. That is they have NO tax or consulting fee work at all therefore reducing the opportunity for cross subsidy and conflicts of interest in to other fee work.

2. For the Big 4 firms split the remaining Audit businesses in to two – in effect create eight Audit only firms.

The result of 1 and 2 is that audit fees for UK firms are likely to increase reflecting that cost /income reality in the short term while over the medium to long term the framework opportunity to improve the cost of audits and audit quality should improve if audit firms are rotated every seven years.

3. In the selection of auditors by publicly quoted firms the Audit Committee should continue to take the lead in selecting the audit firm but the "new FRC" should have a competent and experienced person attend such selection meetings, perhaps with AIU type experience. Where there are future "audit" problems in relation to "material" professional scepticism points then the audit firm an approach that "new FRC" member as a conduit to the Regulator.

4. Furthermore the CMA and HMG should consider whether the audit of systemically important Financial Services organisations e.g. banks should be taken into public hands and away from the private audit firms. Should an arm of the PRA or FCA conduct these audits, giving them direct first-hand information on what these firms are up to and the risks they are taking?

3. REGULATION AND THE FINANCIAL REPORTING COUNCIL (FRC)

PAUL MOORE , BRIAN LITTLE, PROFESSOR ATUL SHAH AND PROFESSOR RICHARD MURPHY : TEAM SUBMISSION TO THE FRC ENQUIRY BY SIR JOHN KINGMAN – AUGUST 2018 ….

Full submission at Link, Sections 3 and 4 of our Submission to the Kingman Enquiry begins below.

Recommendations for a new regulatory system

3.1 **The crucial importance of the right leadership and personnel -** Before setting out our proposals for an effective and credible regulatory system for auditing, accounting and corporate governance, it is important to emphasise that, without the right leadership and other personnel, no new system will be effective. And, this is a very difficult "nut to crack" as has been seen with other regulators. For example, appointing the ex-Senior Partner of KPMG as the chairman of The Financial Conduct Authority, when KPMG have failed in its auditing responsibilities of many of the banks, was bound to cause criticism and to ensure that the authority was on the back foot when it came to inspiring confidence in its stakeholders.

On the one hand, it is vital to have personnel with the requisite technical knowledge but, on the other, it is even more important that conflicts of interest are avoided. In these circumstances, it is better to appoint leadership who understand the principles and values and culture required as regulators rather than those who have the greatest technical knowledge in auditing, accounting and corporate governance. Indeed, a good deal of what is required to be effective from a technical standpoint is as much about common sense as it is about current technical knowledge. It is often the case that those who have been steeped in the status quo of the technicalities of the subject are, in fact, unable to "think out of the box" and set the appropriate rules and standards which the ordinary stakeholder would consider obvious.

In these circumstances, we would strongly recommend that the leadership of any new regulator knows more about regulation (i.e. setting the right principles, rules and standards; carrying out rigorous risk-based oversight and assurance; conducting forensic investigations in the face of wrongdoing; enforcing and disciplining actual wrongdoing) than the technicalities of auditing, accounting and corporate governance. A leader with this type of regulatory expertise can be supported by a broad range of technicians, including academics, as well as individuals who represent all key stakeholders as set out in the 1975 paper as referred to above who can provide input that specifically relates to the needs of the various stakeholder groups.

3.2 **Auditing, accounting and corporate governance now needs statutory regulation -** So far as the constitution of any new regulator is concerned and the legislation under which it is set up, we see no other choice but that it should be statutory in the same way as The Financial Conduct Authority or The Prudential Regulatory Authority. The legislation should be similar to the enabling legislation for The FCA and PRA. It should set out specific broad objectives for the new regulator and give it the powers to set rules, standards and guidance subject only to preliminary work setting out a cost benefit analysis. So, for example, the statutory objectives for the FCA are to maintain market confidence, protect consumers, educate consumers and fight financial crime. A new auditing, accounting and corporate governance regulator (The AACG Authority) would certainly have an objective to protect the stakeholders as set out in the 1975 paper referred to above as well as to maintain market confidence.

There are arguments to remove responsibility for regulating corporate governance from the same regulator that oversees auditing and accounting. However, in our view, auditing and accounting is, in fact, a crucial part of corporate governance, the aim of which should principally be to ensure a proper separation and balance of power between the executive and all other constituents of the organisation which are responsible for the "checks and balances" i.e. internal control functions (risk, compliance and internal audit), non-executive directors, external auditors, shareholders and regulators. In these circumstances, we recommend that any new regulator, along with auditing and accounting, is also responsible for both setting the rules and standards relating to corporate governance as well as to supervising them.

3.3 **The new regulatory system must ensure personal accountability of senior managers to act in accordance with high-level standards of conduct -** We recommend that any new regulator of auditing, accounting and corporate governance implements a similar set of "Principles for Business" and "Senior Managers and Certification Regime" to ensure personal accountability of those in positions of responsibility for wrongdoing and failure e.g. audit engagement partners as well as the managing partners of the relevant audit firm. For ease of reference for the review team, we copy below three sections that explain the FCA Senior Managers and Certification Regime in summary:-

FCA objectives

ENTERPRISE LEARNING

"Firms' senior managers have a crucial role in demonstrating that they are accountable and responsible for their part in delivering effective governance. This includes taking personal responsibility, being accountable for their decisions and exercising rigorous oversight of the business areas they lead. **We want all firms to develop a 'culture of accountability' at all levels** and for senior individuals to be fully accountable for defined business activities and material risks."

"The SM&CR aims to:

- encourage staff to take personal responsibility for their actions
- improve conduct at all levels
- make sure firms and staff clearly understand and can demonstrate who does what"

FCA
FINANCIAL CONDUCT AUTHORITY

Regimes in overview

1. **Senior Managers Regime**
   a) Prescribed Senior Manager Functions and responsibilities
   b) All SMF holders will need prior approval from FCA
   c) All SMF holders should be "suitable" to do their jobs and 'certified' by firm annually
   d) All SMF roles to have a Statement of Responsibilities provided to FCA on appointment and on any "major change" to responsibilities
   e) Requirement to submit Responsibilities Map to FCA regularly
   f) All SMF roles to be subject to "Duty of Responsibility"
   g) Handover Procedures to cover transition when senior manager leaves or changes role
   h) NEDs: all covered by Conduct Rules, Fit and Proper Checks and Regulatory References. Some will be SMFs.

2. **Certification Regime**
   a) Covers roles not included in SMR whose jobs mean they can have a big impact on customers, markets or the firm.
   b) Requirement to certify "at least annually" that they are suitable to do their job

3. **Certification Regime**
   a) Covers SMF and Certification roles and all other roles (except ancillary jobs)
   b) Code of Conduct and responsibilities
   c) Role holders need to understand be educated
   d) Poor conduct must be notified to regulator
   e) More prescription around provision of 'regulated references'

More prescription; increased duties for firms; very wide coverage of people

Conduct Rules

	First Tier – Individual Conduct Rules
1	You must act with integrity
2	You must act with due care, skill and diligence
3	You must be open and cooperative with the FCA, the PRA and other regulators
4	You must pay due regard to the interests of customers and treat them fairly
5	You must observe proper standards of market conduct
	Second Tier – Senior Manager Conduct Rules
SC1.	You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively
SC2.	You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system
SC3.	You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively
SC4.	You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice

3.4 **The new regulatory system could adopt many of the approaches which have already been developed by the FCA and PRA -** Whatever many commentators may say about the operation and effectiveness of the FCA and PRA, in our view this is much more about implementation than it is about strategy, structure, process or powers. For example, the FCA's approach to The Principles for Business and the new Senior Managers Certification Scheme as well as the risk-based approach to day-to-day supervision and oversight (referred to by the FCA as the ARROW process which results in a firm specific RMP (Risk Mitigation Plan), if carried out appropriately, is highly effective. Thus, there is no need to reinvent the wheel.

However, the approach to investigation, prosecution and enforcement is currently ineffective. There are inadequate resources both in terms of quantity as well as quality, the process takes too long, too many documents are reviewed and too many interviews are conducted. The unlimited financial resources of the firms under investigation and their "magic circle" lawyers currently run rings around the regulators and are given the opportunity to do so by the process. It is also absurd that such investigations and enforcement actions are subject to the Maxwellisation process. This doesn't happen in civil or criminal judicial processes. It should not happen in regulatory investigations and enforcement actions. Either the investigation was comprehensive and fair in the first place, in which case a successful "conviction" will be obtained or it wasn't and won't be. Why should a "defendant" be entitled to control the process of investigation and enforcement by effectively running its entire defence during the course of the investigation process as opposed to during the trial process? This does not happen in criminal or civil proceedings. The current process permits the defence to "swamp" the regulator with papers, delay the process by engaging in complex rebuttal process during the course of the investigation and have yet another "bite at the cherry" during Maxwellisation. For example, the final report by The Prudential Regulation Authority and The FCA into The failure of HBOS published in November 2015 ws required the FCA to review whether senior executives at HBOS should have been subject to enforcement and disciplinary actions. This work has still not been completed almost three years later and The FCA has stated that it has been provided with "millions of documents" to review. This is simply an inadequate process.

3.5 **The new statutory regulatory system must separate / ring-fence policy, standards, rule-setting and day-to-day risk-based supervision and oversight from investigation and enforcement -** We have seen the problems that occur when day-to-day operational regulatory activity (policy setting and day to day, risk based, supervision) are carried out within the same organisation as investigation, enforcement and disciplinary action. Understandably, those who work at the regulator and who have to deal with member firms on a day-to-day basis need to develop close working relationships with those that they regulate even though they must always retain their independence and objectivity. However, those who conduct investigations and work on enforcement actions not only do not, but must not, have such close relationships. It is their job to get to the bottom of the evidence irrespective of whether it upsets the regulated firm or its leadership and staff.

Naturally, when day-to-day supervision and investigation and enforcement are mixed together in one organisational structure, there are natural tensions between what one might call the "community police" and the "fraud squad". The "community police" will wish to be more lenient given their need for good ongoing operational relationships but those who do investigation and enforcement should have no such objective.

In these circumstances, we strongly recommend that these two crucial aspects of any new regulatory system are separated either divisionally or constitutionally and have their own operational executive leadership teams, boards and appropriately qualified and experienced staff even though they may ultimately report in to a Minister of State. This will mean that those who work in the policy and day-to-day supervision setting side of the regulator must be legally obliged to refer any matter where there is a case to answer of a material regulatory breach or other wrongdoing to the investigation and enforcement division.

3.6 **Regulatory enforcement tribunals must also be separate and entirely independent of both the regulatory policy-making/day-to-day supervision unit as well as the investigation and enforcement unit -** Currently, all regulatory systems combine law-making, day-to-day policing, investigation and enforcement, prosecution and trials within the same organisational structure. This is tantamount to giving one organisation executive, legislative and judicial powers. In our view, this is inappropriate and the three functions should be separated. So, policy / rule setting and day-to-day supervision should be separate from investigation / enforcement / prosecution and both these functions should also be separate from the ultimate judging tribunal.

3.7 **The need to conduct regulatory enforcement tribunals in public -** Currently, all regulatory systems hold their formal enforcement and prosecution “trials” in private. This allows for no public (including media) scrutiny of the process. Regulatory wrongdoing is often tantamount to criminal activity. It is certainly as serious as civil litigation. In these circumstances and, as justice not only must be done but must be seen to be done, we recommend that regulatory “trials” which are held after a rigorous investigation and independent prosecution process are held in public.

4. The need for a complete review of all policy, rules, guidance and day to day supervision and oversight

4.1 The Kingman Review is focused on the regulatory system itself rather than the actual policy, rules, guidance etc that should apply to auditing, accounting and corporate governance. Accordingly, that is what our submissions relate to. But that should not be taken to mean that we, in any way, accept the current rules that apply are, in any way, adequate. Indeed, we take completely the opposite view and, at the appropriate time and after the new regulatory system has been set up, will feed into that debate vigorously. In our view, the entire system needs a fundamental review. We recommend that the Kingman Review acknowledges this.

4.2 Having said that, there are a few important pointers which we would like to bring to the attention of the Review team even at this early stage.

4.3 Auditing and effective corporate governance is crucial in any developed economy. It is a public good. The depth, breadth and rigour of auditing needs to be substantially improved so the quality and effectiveness of these "general-purpose financial statements" achieve what they are supposed to achieve i.e. the protection of the stakeholders as set out in the 1975 paper referred to above. Any change must include a revised "true and fair view" opinion along with the prescriptive rules and standards that apply to arriving at it. This may well require a change to company law as set out in The Companies Act 2006 (see relevant extracts in our preliminary submission). Where the audit in question is of a regulated firm (as so many are), the terms of engagement of the audit (including the audit work plan and resourcing) should be agreed with the relevant regulator on the basis of the risk that the regulator considers that the firm poses to its regulatory requirements. The auditor should have private meetings throughout the audit with the regulator and must be required under new and much broader statutory duties to disclose to the regulator any matters of relevance to the regulators objectives or the production of financial statements.

There should be a mandatory requirement that no statutory auditor can be removed from their office by the organisation which they audit without the approval of the regulator and without setting out precisely and fair reasons. A provision of this nature will enable and facilitate auditors to speak up and report regulatory and other risks (i.e. to blow the whistle).

In order to implement new requirements for broader, deeper and much more rigorous statutory auditing, it may be necessary, at the same time, to review the maximum legal liabilities that should apply to auditing firms.

4.4 Professional firms that provide statutory auditing services **must be banned** from providing any other advisory services at all, whether these be called "consultancy services" or "assurance services". The fundamental problem with this is that the business models of the large firms of accountants that do provide auditing services will not work unless they provide the more profitable other types of advisory services. This creates obvious and systemic conflicts of interest because, if the firm does not sell other non-audit services, it will make an operating loss.

In these circumstances, if the business models of the large firms that have, hitherto, been able to recruit the brightest and most competent young professionals will not work without the right to provide other advisory services, this will inevitably lead to further poor auditing work. This means that it will have to be accepted that the scope and cost of audits of large publicly quoted companies will have to increase substantially. Having said that, the additional cost, even if it was to increase twofold or more would still be de Minimis in the operating expense of these large companies. For example, how could a professional firm be expected to audit a bank the size of HBOS, for example, about £5 million? And, even if you multiply that by two, it would only represent a miniscule percentage of the HBOS annual operating expense.

4.5 The whole approach to setting accounting standards needs to be reviewed. It needs to become wholly separate and independent of the big firms of auditors and the finance directors of large companies. If, the CFO of HBOS until the end of 2007, took the view that some of the key accounting standards that applied to the calculation of the P&L and balance sheet of that bank were "accounting standards designed for a different purpose", the point is made. The setting of accounting standards needs to involve a broad range of stakeholders including academics, shareholders, regulators, independent think tanks and well-informed members of the general public.

4.6 There are many other areas, especially of corporate governance, the need to be reviewed. Executive pay and remuneration is one of them. As The Parliamentary Commission on Banking Standards concluded, in relation to HBOS, "…corporate governance of HBOS at board level serves as a model for the future… It represents a model of self-delusion, of the triumph of process over purpose." This statement could probably be applied to most large companies. It is purely a tick box exercise which doesn't achieve the purpose of creating an adequate separation and balance of power in the boardroom. Powerful "alpha male" executives run rings around the finance function, the control functions, the non-executive's and the auditors. This has to be changed if we are to achieve control of huge societally important corporations with balance sheets the size of sovereign governments and who put profit before principles, public good and people. A good start would be to make the fiduciary duties of directors include mandatory three "public duties" by making a simple change to section 102 of The Companies Act 2006.

Paul Moore has written extensively on this subject and submitted detailed papers to The Walker Review as well as to The Treasury Select Committee on the personal request of the then Chairman, Mr Andrew Tyrie MP. At the appropriate time, of these papers can be made available.

4.7 There are numerous other specific areas where new rules and standards will be required. These can be identified when the new regulatory system has been set up." *End of extract*

4. INTERNATIONAL ACCOUNTING FIRMS

Where the Firm is listed in London financial markets then the Audit lead should be from the separate audit entity. Any other services for consulting or tax should be from other firms on a competitive basis.

Where the lead is from London then the Audit firm should engage an appropriate firm from the relevant jurisdiction to carry out the local audit. The Lead Audit firm will be wholly responsible for ensuring that the local audits are carried out effectively.

Where the firm is listed or headquartered in another jurisdiction then the local audit may be carried out by the aligned firm or alternatively an alternative firm. Again the Lead audit firm is wholly responsible for ensuring that the local audit firm carry out their audit effectively.

5. ICAEW Role

The role of the Institute of Chartered Accountants in England and Wales and other such institutes **should be doing much more to** promote strong ethical culture and professional standards and ensure the integrity of the profession.

Furthermore the ICAEW **should substantially increase its investment** I n encouraging better processes and technology to improve audit quality at all levels in these new Audit firms whilst optimising the cost base for execution of audits in the UK.

6. HM Government Corporate Audit Risk Research

A fundamental review and overhaul of Audit in the UK is essential – underway?

We believe there ought to be huge benefits and economies of scale for a central government body conducting regular industry research study to expose risks and financial problems in specific industry sectors which can then be utilised by auditors in devising audit strategies. In our view the National Audit Office is pretty good at doing this kind of work for local authorities and would make a good role model for this kind of public interest research. It would also help significantly in reducing audit costs overall.

The CMA and HMG should consider whether the audit of systemically important Financial Services organisations e.g. banks should be taken into public hands and away from the private audit firms. Should an arm of the PRA or FCA conduct these audits, giving them direct first-hand information on what these firms are up to and the risks they are taking?

Professor Atul Shah, Mr Brian Little, Mr Paul Moore, Professor Richard Murphy

30 October 2018

This document can be treated as a Non Confidential response and therefore published on CMA website as one of the Responses to the Statutory Audit Market Survey.