Competition and Markets Authority - Statutory audit market
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Local Authority Pension Fund Forum

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Response

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

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 79 local authority pension funds and five 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.

Summary – competition and choice in the audit market

LAPFF was pleased to have been invited to meet with the review team in November 2018 and is supportive of the recommendations in the CMA's Update paper dated 18th December 2018 for structural reforms of the market and LAPFF has answered the questions in detail.

LAPFF is also pleased at the recognition of issues with the 'Auditor Expectation Gap' that require exploring further. LAPFF has been clear that the standards regime the FRC has set and endorsed not only is not addressing the statutory regime, but it is positively going against it. We further add that as well as Part 23 (Distributions) that Part 18 (Acquisition of own shares and financial assistance) where s712 CA 2006 sets out in statute the auditor duty in respect of solvency and going concern reporting.

There is a risk with the forthcoming 'Brydon Review' that the auditing profession will continue to cloud the issues and lobby for a 'statement of solvency' with the explicit duty on directors; despite there already being both implicit and explicit requirements under the existing statutory regime with a significant responsibility also falling on the auditors.

The concept of going concern (essentially whether a company will continue to be funded, by shareholders, creditors and profits) is therefore at risk of being clouded by the more nebulous concept of 'viability'.

There is precedent here. An example is the auditor duty over the adequacy of 'accounting records' in law which extends to all internal accounts. The FRC's model of 'Internal control' downplays auditor duties under the law and then shifts the responsibility to directors; representing both a **downgrade and a buck-pass**. LAPFF sets out other examples relevant to the scope and outputs of the Brydon Review.

[ ] That Review's reference to the Expectation Gap appears to have a narrow focus on fraud rather than the deeper problem with standards and the law.

In addition, Lord Tyrie chaired the Parliamentary Commission for Banking Standards Enquiry into the failure of HBOS. That concluded that the Banking Crisis was caused by capital deficiency and recognised that liquidity was an symptom of that not a cause. Accounting standards and problems with audits compared to company law feature in that analysis.

That contrasted to the FSA's review into the collapse of Royal Bank of Scotland Group plc 'RBS' (which was done by PwC for the FSA) which put the emphasis on 1) liquidity 2) global Basle Standards. Any analysis that avoids dealing with capital deficiencies being the problem - i.e. the numbers were wrong - plays into the "Expectation Gap" position as it misses out auditor's statutory objectives on capital maintenance. Basle is a red-herring in that it only applies to systemically important banks to protect the interbank market.

Company law applies to all banks and other companies. That being particularly relevant in the context of the KPMG audit of Co-op Bank which was not subject to the Basle Regime and exhibited parallels with HBOS and RBS, and had similar problems from the same period, but took until 2013 to identify.

The Walker Review (2009) had also put the emphasis on liquidity. However the former Governor of the Bank of England, Lord King has said: "*Right through this crisis from the very beginning ... an awful lot of people wanted to believe that it was a crisis of liquidity," Sir Mervyn said. "It wasn't, it isn't. And until we accept that, we will never find an answer to it. It was a crisis based on solvency ... initially financial institutions and now sovereigns."* (Financial Times, 24th June 2011).

A cursory review of the civil liability regime based on the requirements of company law where there is a capital problem with a bank explains why auditors and directors of failed banks, have a direct interest in arguing liquidity, rather than their management of lending, audit and the presented balance sheet were the causal events of a defective business model trending towards insolvency unchecked.

The civil liability regime deals with unlawful distributions and consequential loss, both of which are invoked if the accounts and audits are defective. Given that PwC had audited Icelandic banks which failed and Irish banks which failed, as well as Northern Rock, it could clearly have created difficulty for them if they drew attention to deficiencies in the RBS audit that could be "read across" to their own audits.

This response therefore also makes a brief comparison between the two analyses, HBOS vs RBS. LAPFF also notes that the moderators of the RBS report, before Parliament saw it were Sir David Walker and the Chair of an FRC constituent board.

We are already picking up soft lobbying against the proposals for joint audit on the basis of auditor liability issues. However, that seems to further undermine the concept of an expectation gap. If the expectation gap existed then there wouldn't be a liability issue to complain about.

1. The balance sheet and going concern

The LAPFF position on Part 23 Companies Act 2006 (capital maintenance) was 'dividend' and 'profits' focussed in the October 2018 CMA response. However LAPFF has also covered balance sheet and going concern aspects in the legislation. This is even more definitively set out **in Part 18 CA 2006** (which deals with reductions of capital).

This is relevant to any debate trying to deal with 'viability' as the existing legal standard is already rigorous. s714 CA 2006 sets a solvency requirement and a going concern requirement with an explicit requirement for the auditor.

2. The Expectation Gap and 'Internal Control'

The 'Expectation Gap' has also been used to distract from the auditor duty (s498 CA 2006) as to whether the company has kept adequate accounting records **at all times** as required by s386 CA 2006. The statutory requirement is sufficiently worded to ensure that the company keeps records so that the directors can know where the company is at **any point in time at that time**, and that the auditor has to investigate to reach **an opinion** that standard has been met, and report by exception where that has not been the case. That would be expected to be useful for boards themselves, if for example, employees or individual directors are running 'two sets of books'.

Not only does the FRC not have a standard to deal with that objective, but the FRC instead has guidance on Internal Control, which achieves a different set of responsibilities, whereby the auditors merely **review the process** by which the directors concluded whether 'internal control' (by the FRC's model of 'internal control') had applied. That approach is not an investigation, it is essentially starting (and finishing) with the answer that the directors give the auditors in the first place. Given that most directors don't have the proximity to the records that the auditors do, it can amount to a case of the blind leading the blind, whether willful or not.

The fact that the FRC guidance has directors making an assertion that the statement on internal controls applies 'group wide' creates other problems too. Directors of holding companies only have legal duties for the company they are directors of, hence auditors of the holding company, and of subsidiaries have responsibility for the adequacy of accounting records. FRC guidance has the result of taking responsibly for group wide accounts off auditors (including auditors of subsidiaries) and passing it to holding company directors instead.

One practical outcome is that if there is a problem with an audit of a subsidiary, the position of the holding company as the rightful plaintiff to take action against the auditors will be compromised if the holding company's directors have made positive assertions about subsidiary company internal controls and/or their capital positions.

3. Royal Bank of Scotland – the FSA Report (performed by PwC) made no mention of the applicable statutory regime

There is a remarkable difference between the PwC review for the Financial Services Authority (FSA) on the collapse of Royal Bank of Scotland (which was audited by Deloitte) and the review into the collapse of HBOS by the Parliamentary Commission for Banking Standards, chaired by Andrew Tyrie.

The RBS review put emphasis on a lack of liquidity as the cause of its collapse[1]. It is clear from reading the RBS review that the 'expectation gap' is embedded in the PwC analysis. There is no reference at all to the Companies Act regime being applicable, and the capital maintenance regime inherent to it.

The FSA/PwC report states:- '*The immediate driver of RBS's failure was not, however, inadequate capital but a liquidity run (affecting both RBS and many other banks)'*[2].

In contrast, the review of the collapse of HBOS Parliamentary Commission for Banking Standards regarded the HBOS management asserting liquidity as a cause, as an excuse[3].

'The lending approach of the Corporate Division [of HBOS] would have been bad lending in any market. The crisis in financial markets was merely the catalyst to expose it.[4]*'*

That enquiry concluded that a lack of liquidity is the result of a lack of capital (basically no rational creditor would lend to a bank that is bust).

'The problems of liquidity were the occasion for the failure of HBOS, not the cause. If HBOS's difficulties were solely the result of funding and liquidity problems, their lasting effects would have been much more limited, including for the taxpayer'[5]

'The HBOS failure was fundamentally one of solvency. Subsequent results have shown that HBOS would have become insolvent without capital injections from the taxpayer and LBG'.

HBOS management claimed that they had been hit by the crisis, when the truth was that HBOS was one of the banks that caused it.

However, the RBS review for the FSA, played into that defensive view of things. It states:-

'*The **global regulatory capital framework** in place before the crisis was severely deficient'*[6]

That may be correct. But the review failed to address that **the UK's Companies Act framework for capital maintenance** was not deficient, and should have been applied to all companies irrespective of the capital regime from Basel (which was in any case only applicable to systemically important banks).

The RBS Review also stated:-

'With hindsight, RBS's capital before the crisis was grossly inadequate to provide market assurance of solvency amid the general financial crisis of autumn 2008'"[7]

Again, with the emphasis being on 'market assurance', there is an absence of a reference to the assurance that the audit and the accounts of RBS as a company should have given for the protection

[1] Para 6 page 22 The failure of the Royal Bank of Scotland - Financial Services Authority Board Report
[2] Para 9 page 43 The failure of the Royal Bank of Scotland - Financial Services Authority Board Report
[3] 'An accident waiting to happen': The failure of HBOS
[4] Ibid para 32
[5] Ibid para 15
[6] Para 6 page 22 The failure of the Royal Bank of Scotland - Financial Services Authority Board Report
[7] Para 7 Page 22. The failure of the Royal Bank of Scotland - Financial Services Authority Board Report

of its creditors and shareholders. ‘Hindsight’ is a classic defence of an auditor that has missed the issue. Bad lending is not a matter of hindsight, but poor judgment. The failure of City of Glasgow Bank in 1878 was the reason for the introduction of mandatory audits in the 1879 Companies Act. Auditors in the UK owe their living to the policy response to a failed bank.

‘*In one sense, therefore, the big loan loss provisions of 2009 and 2010 were as much* <u>*the result*</u> *as the cause of RBS’s (and other banks’) failure’*[8].

That argument is the precise opposite to that in the HBOS report, and is economically unsound. Loan losses are the result of bad lending. Liquidity (lending to the bank) is on the liability side of a balance sheet, bad lending sits in the asset side. Lending to the bank doesn’t affect the quality of the loans it makes, but the loans that the bank makes does affect its liquidity, the ability to lend to it.

The RBS report also refers to the (post crisis) Basel III restricting the dividends that RBS could have made.

‘*Under Basel III, RBS would not have been permitted to pay dividends at any time during the Review Period*[9]*.’*

But that statement fails to address the Companies Act regime that already controlled dividends and other distributions before, during and after the crisis.

LAPFF notes that one of the specialist reviewers was Mr Bill Knight, also chairman of the Financial Reporting Review Panel of the FRC[10].

Given that the accounting standards, the accounts of RBS, and the audits may have all been been defective, and RBS losses were in excess of £50bn, then it is clear why the preferred emphasis from PwC – as with HBOS management – would be on problems with liquidity, rather than the actual cause; bad accounts and the audit not showing a capital deficiency whilst signing RBS off as a going concern.

[8] Para 16 Page 35. The failure of the Royal Bank of Scotland - Financial Services Authority Board Report
[9] Para 8 Page 40. The failure of the Royal Bank of Scotland - Financial Services Authority Board Report
[10] From 1 March 2004 to 32 March 2012

Summary – framework of audit

Consultation questions.

A) Issues

1. Do you agree with our analysis in section two of the concerns about audit quality?

Yes, the analysis is strong.

2. Do you agree with our analysis of the issues that are driving quality concerns, as set out in section three? In particular:

a. Issues relating to the role of Audit Committees and investors in the process of appointing and monitoring auditors;

b. Limitations on choice leading to weaker competition;

c. Barriers to challenger firms for FTSE 350 audits;

d. Resilience concerns; and

e. Wider incentive issues raised by the multi-disciplinary nature of the large audit firms.

Again yes, the analysis is strong. On resilience, it is important there is focus on the resilience of the market rather than firms, in the sense that a bad firm should be allowed to fail.

B) Remedies

For all remedies:

3. What should the scope of each remedy be? Please explain your reasoning. For example, should each remedy apply to all FTSE 350 companies, or be expanded to include PIEs or large privately-owned companies that could be deemed to be in the public interest?

Given that the public interest in audits is shareholder and creditor protection, there is a case for extending to all PIEs, including privately owned companies.

Remedy 1: Regulatory scrutiny of Audit Committees

4. How could the regulatory scrutiny remedy be best designed to ensure that the requirements placed on Audit Committees by a regulator are concrete, measurable and able to hold Audit Committees to account? Please respond in relation to requirements both during the tender selection process and during the audit engagement.

One solution would be for all tender material to be made public. Some years ago a Big 4 tender for a FTSE 100 insurance company made a clear statement that it was important for the numbers to look good and that auditor could assist with that.

Remedy 2: Mandatory joint audit

5. What should the scope of this remedy be? Please explain your reasoning. a) Should the requirement to have a joint audit apply to all FTSE 350 companies or potentially go wider

by including large private companies? b) What types of companies (if any) should be excluded from a requirement for joint audit?

LAPFF believes that the current model of regulator assisted ‘regulatory arbitrage’ could be lessened with joint audits as it would be more difficult for two auditors to essentially ‘collude’ to avoid the fundamental issues. Also, in respect of PIE audits there may be arguments that the need for joint audit , in the public interest, is even stronger where there is a large, potentially overbearing or controlling shareholder.

6. Should one of the joint auditors be required to be a challenger firm? If so, should this be required for all companies subject to joint audit? Are there any categories of companies to which this requirement should not apply? Please explain your reasoning for each of the answers.

Yes. With only four large firms, there are only six combinations of joint audits:- PwC/EY, PwC/KPMG, PwC/Deloitte, EY/KPMG, EY/Deloitte and KPMG/Deloitte. Joint audits between the Big 4 might actually encourage cartel type behaviour.

7. Should a minimum amount of work (and fee) allocated to each joint auditor be set by a regulator? If so, should the same splits apply across the FTSE 350? (please comment on the illustrative examples in section four). Please explain your reasoning.

There should be safeguards that one of the joint auditors isn’t effectively ‘squeezed out’ by a low allocation of the total fees.

8. Our provisional view is that there would be merit in the joint auditors being appointed at different times. Should this be mandated, or left to the choice of individual companies? How should companies manage (or be mandated to manage) the transition from a single auditor to joint auditors?

The appointment at a different time would avoid the risk that both auditors initially miss the same issue and are then jointly incentivised to not deal with it properly.

9. Should a joint liability framework be introduced to encourage active participation in the market by the Big Four and challenger firms? Please explain your reasoning. In the context of joint audits, what are the advantages or disadvantages of auditor liability being proportionate to the audit fee of the joint auditors, compared to the auditors being jointly and severally liable?

Such a system would appear to already exist. At the moment, directors and auditors are jointly liable where both are negligent, in such cases allocation of liability is a matter between the auditors and the directors. Joint audit wouldn’t change that, merely add another party. There is also the situation where one negligent auditor audits the holding company and another firm audits the subsidiary. This can be seen in the two Barings cases at the High Court, one for Barings plc, one for Barings Futures Singapore. The bulk of the liability was given against PwC (then C&L) for Barings plc rather than Deloitte (the Touche Ross) Singapore.

Remedy 2A: Market share cap

10.How could the risks associated with a market share cap, such as cherrypicking, be addressed?

There should be some form of regulatory oversight, with transparent parameters to safeguard against that.

11.Would it need to apply only to FTSE 350 companies, or also to other large companies, and if so, which?

Again a PIE test may be relevant. Some subsidiaries of overseas banks may require public interest audits for example.

Remedy 3: Additional measures to reduce barriers for challenger firms

12.We welcome evidence from stakeholders on the existence of barriers to senior staff (including partners) switching quickly and smoothly between firms. We also welcome views on how justified such barriers are, bearing in mind commercial considerations that audit firms have.

It may be that international accounting standards lobbied for by Big 4 firms act as a barrier to entry.

13.We welcome estimates on the costs of setting up and running a tendering fund or equivalent subsidy scheme, and views as to how this should be designed.

LAPFF is not in a positon to make such an assessment.

14.We welcome comments as to whether the Big Four should be compelled to license their technology platforms at a reasonable cost to the challenger firms, and/or contribute resources (financial, technical, algorithms and data to enable machine learning) towards developing an open-source platform. In the first scenario, we also welcome comments on how such a 'reasonable cost' might be determined in such a way that it is affordable for challenger firms but does not disincentivise Big Four firms from innovating and developing new platforms.

It is difficult for outside parties such as LAPFF to draw a conclusion on the content of these 'platforms'. That said, with the audit quality problems that exist, can it be assumed that these 'platforms' are of any worth to other entrants in any case? [ ]

Remedy 4: Market resilience

15.How could a resilience system be designed to prevent the Big Four becoming the Big Three, not just in the case of a sudden event, but also in the case of a gradual decline? Please also comment on our initial views to disincentivise and/or prohibit the movement of audit clients (and staff) to another Big Four firm.

Market cap based solutions may be the only way to prevent four becoming three.

16.How could such a system prevent moral hazard? Please comment on our initial view.

There is an argument that the moral hazard is already in the system due to the regulatory arbitrage that is occurring regarding the audit as a product.

17.What powers would a regulator and a special administrator require, and how would their roles be divided? At what point should a regulator or a special administrator be able to exercise executive control over a distressed firm? Please comment on our initial view.

LAPFF does not have a position on this point.

18.What could be done regarding the challenges relating to the fact that an audit firm's value lies in its people and clients – which would be complicated to restrict? Please comment on our initial view.

As suppliers of a product defined by legislation, then the value of the firm should flow from that. The Kingman Review is clear on the risk of the values of the firms at the moment transmitting to the regulator. That would not be a problem if the firms had the right moral values in the first place.

Remedy 5: Full structural or operational split

19.Do you agree with the view that the challenges to implement a full structural split are surmountable (especially relating to the international networks)? If not, please explain why it would be unachievable, i.e. that the barriers to implement this remedy could never be overcome, including through a legislative process.

Given that statutory audits follow jurisdictional boundaries, then none of these issues should be difficult. It appears in any case that the firms 'firewall' themselves already for purposes of litigation risk, indeed in the early part of this decade KPMG transferred most of its UK audit business from one KPMG firm to another. Some parties assumed this was defensive in the context of several bank failures where KPMG had been auditor.

20.How could an operational split be designed so that it would be as effective as the full structural split in achieving its aims, without imposing the costs of a full structural split? In your responses, please also compare and contrast the full structural split to the operational split.

LAPFF does not have the information, but the fact that KPMG transferred its audit business voluntarily (Q19) would suggest that the cost was not a relevant factor.

21.With regards to the operational split, please provide comments on: a) implementation risks and whether they are surmountable: e.g. how any defined benefit pension schemes could be separated between audit and non-audit services; b) risks of circumvention and how they could be addressed e.g. how audit firms could circumvent the remedy through non-arm's-length transfer pricing and cost allocations; c) implementation timescales to separate the audit firms and how soon the remedy could be brought into effect; d) ongoing monitoring costs for the audit firms and a regulator; e) role and competencies of a regulator in overseeing ongoing adherence to the operational split.

The ring fencing of banks should provide a good model.

22.Under an operational split, how far, it at all, should it be possible to relax the current restrictions on non-audit services to audit clients? For example through changes to the blacklist or to the current 70% limit.

LAPFF sees no argument for relaxing existing limits.

23.Should challenger firms be included within the scope of the structural and operational split remedies?

Yes. The same measures should apply to audit firms if the risks are the same.

24.Which non-audit services (services other than statutory audits) should the audit practices be permitted to provide under a full structural split and operational split? Please explain your reasoning.

This should be solely the services that legislation and regulation requires the statutory auditor to perform.

Remedy 6: Peer review

25.What should be the scope (i.e. which companies) and frequency of peer reviews, if used as a regulatory tool?

LAPFF does not have a view as this seems to deflect from the main thrust of other proposed reforms.

26.How could peer reviews be designed to best incentivise auditors to retain a high level of scepticism, and thus improve audit quality?

See Q25 above.

C) Next steps

27.What are your views, if any, on our proposal not to make a market investigation reference?

LAPFF is supportive of this position, provided that the option to do so if necessary is kept open.