

Business and Trade Committee

Oral evidence: Delivering audit reform: follow-up, HC 663

Tuesday 26 March 2024

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Members present: Liam Byrne (Chair); Ian Lavery; Andy McDonald; and Mark Pawsey.

Questions 46 - 78

Witnesses

II: Sir John Kingman, Chair, Legal and General Group Plc; Lord Sikka, Emeritus Professor of Accounting, University of Sheffield; Frances Coulson, Deputy Chair, Fraud Advisory Panel; and Andrew Ninian, Director, Stewardship, Risk and Tax, The Investment Association.

Examination of witnesses

Witnesses: Sir John Kingman, Lord Sikka, Frances Coulson and Andrew Ninian.

Chair: Welcome to the second panel in today's hearing on the necessity of audit reform. Thank you so much to our witnesses on our second panel for joining us. Mark Pawsey is going to open the questioning for us now.

Q46 Mark Pawsey: My first question is to Sir John. I think you heard the exchange with the previous witnesses. You recommended the creation of a new body. In its report five years ago, the Select Committee agreed with you. That has not happened. We heard a little from the previous witnesses that the FRC had stepped up and was doing more and the big firms particularly had modified the way that they did things. Do we still need ARGA?

Sir John Kingman: Thanks very much. I did hear the exchange. Just to be clear, I agree that the FRC has done a very good job since my report, which is now quite a while ago, to enact both the letter and the spirit of what I recommended, to the extent that it can within the limited remit that it currently has. I want to pay tribute to it and particularly to the previous chief executive, Jon Thompson.

I do think it is an important thing to put this body, which is a strange British creation that has to proceed largely by voluntary arrangements, on a proper basis with proper powers.

Mark Pawsey: You do.

Sir John Kingman: I do, absolutely. There are certain things it simply cannot do at the moment. To give an example, if it wants to go after a director of a company, it can currently only do so if that person happens to be a chartered accountant. That is a completely random fact, but it is a fact.

If you look back at what the FRC was asked to do on competition and separating out audit from non-audit, the FRC did as good a job on that as it could have done within its remit, but it had to do it entirely through voluntary persuasion of these very big and powerful firms. That is simply inappropriate. Any other country would regard it as a very strange thing to have a body that people think of as a regulator but is not actually a regulator because it does not have the powers of a regulator. We need to fix that.

Q47 Mark Pawsey: Is voluntary persuasion not a better way of doing things than mandating and creating new laws that then have to be policed? If they have done it and they have got there anyway, why do we need the legislation? Why do we need to change the structures?

Sir John Kingman: I do not agree with that. In this country, we did away with self-regulation very largely in the 1980s. No one would



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seriously advocate going back to self-regulation in the financial sector, for example. This is a strange hangover and it does need to be fixed.

- Q48 **Mark Pawsey:** Have there been consequences, in your view, of the failure of the Government to take action in the way that you and the Committee expected was going to happen? Have there been additional failures as a consequence? Is it likely that there will be more failures or more fraud? We need to separate that out of the two things. Is it likely that there will be more cases involving either of those two factors, if we do not do the changes you asked for?

Sir John Kingman: That is not the biggest risk in the short term. There is a fairly bright spotlight on this issue, notwithstanding the lack of legislation. The obvious risk over time is that there is a steady falling back from where we have currently got to because that is what happens with organisations that have to do their best through, frankly, old boys' understandings.

- Q49 **Mark Pawsey:** The spotlight has been on them as a consequence of the series of reports five years ago. They have made a bit of a change to keep everybody happy. If the regulation that you asked for does not go through, they will perhaps lapse back into their bad old ways. Is that your view?

Sir John Kingman: I would say they have made a lot of change. I really want to be clear about that. I have no criticism to make of the vigour with which they have pursued the agenda that I laid out, but the final bit of the jigsaw is not in place.

It is worth remembering that when my report came out there was an incredibly strong consensus that this was a sensible agenda. The Government were clear that it was the right thing to do. No good reason has been given for why the Government should not do this. We are told it is due to parliamentary time, but we are also told that Parliament is not all that busy at the moment. I would suggest that we get on and do it.

- Q50 **Mark Pawsey:** Sir John, we have the Minister appearing before us next. What is the real reason for Government not acting in the way you would have wanted them to?

Sir John Kingman: I do not know the answer to that. I can only speculate a bit. In the early phase after my report, it was simply a matter of bureaucratic process. The Business Department does not tend to operate at speed, if I can put it that way. More recently there probably has been some political sense somewhere that this is somehow red tape. That is a misguided concern, but, if you ask for the real reason, that would be my guess.

- Q51 **Chair:** I just want to push into this, Sir John. Is your argument that the failure to pursue this reform will basically lead to a withering of good standards in the future?



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Sir John Kingman: That is a risk, absolutely. It may happen; it may not. The bigger point is simply that this is a serious responsibility in a serious country. We have a regulator that is having to operate in a way that no other regulator does and that no other country would regard as a sensible and serious framework.

Q52 **Chair:** What is the peril of that?

Sir John Kingman: The peril of that is they are up against large vested interests and they have to operate through persuasion rather than through power. We would never accept that with the banks. Why accept it with the audit firms?

Q53 **Chair:** Is it a riskier market as a result?

Sir John Kingman: The imbalance of power between the regulator and the bodies it is being asked to oversee is inappropriate.

Q54 **Chair:** What are the marginal gains? If we did pursue reform, what do we gain that we do not have today?

Sir John Kingman: You should put that question to the FRC, but my understanding is that there are a number of things that it is unable to do. For example, it does not have statutory powers to extract information from firms. Again, it has to do on a voluntary basis. As I mentioned, the big negotiations that it had to do on the restructuring of firms had to be done through persuasion. Therefore, we have to assume that there will have been a degree of compromise in that process, which there would not have been if it had simply been able to take a decision.

I mentioned already this point about enforcement, which is a serious one. They can go after some company directors but not others.

Q55 **Chair:** Can you join the dots between pushing ahead with these reforms and other economic goods that we might be seeking as a country? Is it easier to raise the investment rate in our country if we have a robust system of audit, transparency and a better environment for risk management?

Sir John Kingman: I really would not want to overstate that. In terms of the issues driving investment, there are much larger forces at work than this. I would not want to make grandiose claims for that—but no good reason has been advanced for why we would not want to fix this.

Q56 **Chair:** We have heard some noises off that point to red tape and regulatory burdens. Who is supplying the advice to Government that this is all going to be more expensive if we proceed down this path?

Sir John Kingman: I do not sense that there is a huge lobby against this. If there is, I have not come across it particularly. The big four firms are not particularly opposed to this. They accepted it from the outset. They are used to much more robust regulatory arrangements, particularly in the United States.



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I do not sense a huge lobby. I think the fear is more internal to Government, that somehow the symbolism of this does not quite feel deregulatory. That would be my guess.

Q57 Andy McDonald: Frances, could I direct one or two questions to you? Perhaps we can wind back a bit so we can get an understanding. I would like to understand why the UK's statutory audit regime has failed to detect the material risk of fraud. There are many examples we could cite, London Capital and Finance being one. Why did it fail?

Frances Coulson: There is a great gap between what the public thinks an audit does and what an audit actually does. There is a lot of focus on ticking boxes; I do not want to say bean counting. In the 19th century, it was said that an auditor should be a watchdog, not a bloodhound. Sometimes the watchdog might be asleep on the job.

I understand that there is pressure on fees. It is very difficult. If we are subject to an audit in our own businesses, you get a lot of juniors coming along and looking at nominal ledgers and so on and so forth. There may be an absence, in a number of audits, of senior involvement throughout and at an early stage.

The primary responsibility for avoiding fraud lies with management—of course it does. More could be done to make boards responsible for risk-assessing for fraud. The failure to prevent fraud changes, unfortunately, are only going to apply to large companies. I see no reason why they should not apply to all companies. They will be proportionate to the size of company, but we should have proper corporate governance in this country. That should apply to all companies. It makes for fair competition.

If companies are fraudulent, often the money goes out of the country; it does not stay in the country. It is in the country's interest to make sure fraud is prevented wherever it is possible.

Q58 Andy McDonald: You have hit upon that. The public's perception is that they expect audit to pick these things up. When people do criminal things, they expect that to be identified. We have just had a history where people have become fairly blasé: that is how it goes; people get through these audits and things collapse.

A key area for reform is that clarification of companies' risks and controls in relation to fraud. Should audit reform go further in the fight against economic crime?

Frances Coulson: As I say, the primary responsibility should be with the board. In circumstances where the board itself might be fraudulent, you need an external check and assessment of the fraud risk. That is very important.



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In my own work, we see companies that have been set up to defraud the tax authorities, for example. You need an external check on that. It is important that third parties are involved.

- Q59 **Andy McDonald:** On that, corporations are soon going to face prosecution for failing to prevent fraud, but they are not required to report against fraud risks or safeguards under the new corporate governance code. That seems to be a contradiction. Does that make sense to you?

Frances Coulson: No, it does not. It does not add a great deal of red tape in general corporate governance to say, "We should be looking at cyber risk, et cetera. We should look at fraud risk". Of course we should. It is very important that that is part of the board's responsibility.

There could also be a specific duty under the Companies Act for directors to take that into account. You have all sorts of other things, such as a duty to promote the success of the company and so forth. Why not have a duty to prevent fraud?

- Q60 **Andy McDonald:** Do you have any idea as to why that is not in the governance code?

Frances Coulson: I would not like to speculate. Again, it is difficult to prevent fraud. In a large company, you cannot look at every single person. For example, the Association of Certified Fraud Examiners found in 2020 that only 4% of fraud is detected by external audit and 15% is detected by internal audit because they know the business.

It is important for boards to report to auditors, for example, about their structure for detecting fraud and perhaps report back year on year on the progress that they have made and the metrics that they have to make sure that is looked after. It is often other people's money that they are supposed to protect.

- Q61 **Andy McDonald:** Just stepping back a bit in terms of the raft of different responses and reforms to corporate governance, insolvency and audit, do you think there is a risk of this becoming somewhat uncoordinated? How would you better address that? I will let you answer the first question first. Do you think there is a risk?

Frances Coulson: Yes, as I say, if you put primary responsibility with the board. There is a pandemic of fraud in this country. It is a huge problem. It is for many countries, and it is probably aided and abetted by technology. You have to start somewhere. If you have different requirements in different areas in terms of anti-fraud provisions, it can only be to the good. If they are a little bit unco-ordinated to start with, it does not mean you should not start.

- Q62 **Chair:** That is quite an arresting phrase. Would you go as far as saying that audit reform is part of the vaccine that is needed to tackle this pandemic of fraud?



Frances Coulson: I would, but I would not overstate it. An awful lot of fraud emanates from smaller companies that might not have to have an audit, for example. That is not going to be cured by this. It is a very difficult balance to say requiring an audit for a smaller company versus the cost, and therefore the competition problems that that might cause, but I certainly think it is one of the remedies that we ought to be applying.

Q63 **Ian Lavery:** Sir John said, about five years ago, that the time had come to build a new house. Mr Ninian, you said that it was absolutely imperative that a strong regulator, ARGA, should be introduced as soon as possible to maintain confidence in the UK's financial markets. Here we are, four years on, and the future of audit, as we have been discussing this morning, is still somewhat uncertain. Mr Ninian, what really does that mean for investors?

Andrew Ninian: For investors who are investing on behalf of ordinary savers and pension savers, having a high-quality audit means that they can trust the report and accounts that they are basing their investment decisions on and how they are holding their stewardship responsibilities. They trust the information that companies are putting out into the market, and they take decisions of how to invest people's savings on the trust and on that information.

As has already been alluded to in both panels, we think the FRC has done a good job and that a lot of improvement has actually been made on a non-statutory basis. Audit quality has increased, but there is still some way to go. Competition is starting to increase the operational separation. As has already been alluded to on this panel, we still think that the establishment of ARGGA would be a good thing. Putting it on a statutory footing with the appropriate powers, with all the tools in its toolkit to hold companies, directors and auditors to account would be helpful, and should ultimately come back to improving audit quality.

Q64 **Ian Lavery:** The UK Government have recently introduced the British ISA to encourage investors back to British businesses. Can investors have the utmost confidence in their investments with these businesses without any audit reform?

Andrew Ninian: As we have said already, progress is being made. There is relatively good confidence in the audit market, but we need to make sure that it is as good as possible. The focus on British business is good, but there are a lot of drivers that are affecting the perception and the competitiveness of listings in the UK. We would continue to promote ensuring that we have a regulator that has all the tools that it needs to hold both directors and auditors to account, but there is a balance with some of the other reforms to ensure that we are attracting the right companies to list and operate in the UK.

Q65 **Ian Lavery:** Is it fair to say that we are not really where we need to be with regards to the reform that is required for full investor confidence?



Andrew Ninian: Our starting point would be to get ARGA on a statutory footing to have sufficient powers and sufficient accountability back to Parliament. That would create confidence. Given the changes that have been made in recent years, the confidence and audit quality numbers have improved, and the operational separation is being implemented. A number of steps have been taken to improve confidence. Moving on with ARGAs would be helpful to continue to improve trust and confidence in the UK markets.

Q66 **Ian Lavery:** Confidence has been boosted, but there are more steps required to get to where we actually need to be.

Sir John Kingman: I agree with Andrew's analysis. I was wondering whether I can take you back to my metaphor of the house. I would say the house has been impressively rebuilt. There is now a decent roof that is not leaking, the walls are in better shape and all the rest of it, but the house is still on inadequate foundations. If you were the owner of the house, you would want it to be on stronger foundations.

Ian Lavery: That is a good analogy.

Q67 **Chair:** Can I just press you on a couple of points, Andrew, if you do not mind? We have heard lots of evidence over the last four months on this Committee about the investment rate in Britain and foreign direct investment not necessarily being in the place that we would like it to be. Can you just talk us through the relationship between pursuing audit reform further than the progress we have made today and the impact on investment conditions in the future?

Andrew Ninian: From an investor perspective, we are looking at this in terms of quality of audit, so that we can rely on the accounts that are being published on behalf of the company. There are two attributes to that. Are auditors providing a high-quality audit that can be relied on, and do we have sufficient competition and choice in the audit market to ensure that companies can choose the right auditor for their business, that they have sufficient choice in terms of auditors, and that those auditors are competing on quality and not just price? Establishing ARGAs would help to establish that.

In terms of the wider competitiveness debate around the listing environment, it goes into a wide range of other issues. I suppose that is where we have seen some of the proposals not being taken forward in terms of the reporting requirements to ensure that the UK is seen as competitive to attract the right companies to list. There is a balance here between setting good standards to attract capital, but also setting the right standards that are not being perceived as burdensome to attract companies that want to list and operate in the UK. We need to get those things in equilibrium to ensure that we have the right governance standards that attract capital, but also attract companies to list and operate in the UK. That has been one of the central debates in the UK over the last year, along with a range of other issues that have been



investigated around how we get more companies listing and operating in the UK.

Q68 **Chair:** Do you think pursuing audit reform would be a deterrent to securing greater investment in the future?

Andrew Ninian: Along the lines of improving competition and choice, and improving audit quality, I do not think so, because that is the audit market per se. The challenge is about the requirements on companies and whether we are asking too much of listed companies, relative to private companies, but also global peer companies.

Chair: That is a very useful distinction. Thank you very much indeed.

Q69 **Andy McDonald:** Could I turn my attention to Lord Sikka and ask a few things? We have heard an awful lot about the building of a new house, and perhaps we might get a conversation going about who owns the house. I think you described the outline of the 2022 audit reform Bill as disappointing—perhaps that was a little bit understated—because it failed to address topics such as auditor independence and stakeholder scrutiny. I think I am right in saying that you had some rather hard-hitting remarks to make about there being no direct representation, within the stakeholder structures, of stakeholders negatively affected by auditor negligence.

We see postmasters sitting on the board who may have had some rum experiences that could inform how business should be done. What was your reaction when the reform agenda was withdrawn from the King's Speech—we have not progressed on it—given all of that background?

Lord Sikka: It is very disappointing that, ever since the BHS collapse in 2016, we have been promised legislation, but nothing has really appeared. Sir John produced an excellent report, but I think there are also problems with that. I will put the regulatory environment into context and then come back to the other issues.

The UK does not have a single central enforcer of company law. It is all spread all over the place. Even when you look at the FRC as it is constituted now, or as it may be when all the reforms are fully implemented, it will continue to be dominated by big corporations and big firms because they, after all, have funded it, will continue to fund it and supply the key personnel. We are often told that that is because you need experienced people, but that is really in-built capture. Nobody suggests that a homeless person should become Minister for Housing, but somehow accounting and auditing experts are the only ones whose world view counts.

There is also a problem with the current FRC structure. If it is reconstituted, it would not owe a duty of care to any individual stakeholder. That itself is a huge problem. The FRC has also given up the capacity to set accounting and auditing standards. It primarily modifies,



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adopts and adapts international accounting and auditing standards. Whether or not they are relevant to the UK is another issue.

One of my disappointments with the proposed legislation is the FRC has never ever set an auditing standard that touches upon auditor accountability. That is a complete vacuum. I will just take us back a little while to the BHS audit. I will declare an interest. I was an adviser to the Work and Pensions Committee for that investigation. At BHS, the audit partner from PwC was allocated only two hours to do the audit and 31 hours for consultancy. The audit team, for day-to-day purposes, was led by somebody with only one year's post-qualification experience.

When I looked at the account a day or so later, my gut feeling was, "These accounts have not been audited for years". That was subsequently confirmed by the FRC. There is so much hold on the audit firms by the people who appoint them. The PwC audit partner also backdated the audit report to enable Philip Green to sell the company.

Why is there absence of any discussion about transparency of the audit itself? We have heard in the earlier panel, and even now, about how the directors are accountable. Let us look at the auditors. There is no transparency. If we want auditors to be accountable, why not open up their audit files to everybody? What is so secret in their audit files? Is there something about troop movements or satellite positions that nobody else must know? This secrecy encourages corruption and enables them to do deals.

It was the same at Carillion—again, I was an adviser to the Work and Pensions Committee, and it is the same thing. The FRC knew from its internal investigations. For three consecutive years, they flagged up that KPMG's audit of Carillion was deficient in respect of goodwill, yet absolutely no action was taken.

Let me just put it in a wider context. The FRC's reports have been telling us that anywhere between 20% and 50% of the audits that they have sampled over the years have been deficient. Can you imagine if somebody was making aeroplanes or cars for 100 years and still produced a product of which 20% to 50% were deficient? They would be shut down. Their directors would be prosecuted for fraud. No firm is ever shut down—no big firm, at least, is shut down. The fines are puny. They have become the cost of doing business.

We need independent regulation. Simply tweaking the FRC will not do. We need stakeholder representation on it. I would ideally favour a two-tier board structure for any regulator. One is the executives, who do the day-to-day running. The second is made up of stakeholders who exercise oversight. Are they doing the right thing? Are they holding the culprits to account? We just do not actually do that.

The current state of audit and the corporate governance problems we have are a direct result of the regulatory structure that we have. Put



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another way, the audit market is not a natural market. The earlier panel referred to a market. It is created by the state. The state has guaranteed a market for accountants belonging to a few trade associations. There is no state guaranteed market for engineers, mathematicians and scientists, but there is for accountants. It is not accompanied by adequate pressure points. Regulation is weak.

It is impossible to sue negligent auditors because they enjoy too many protections. Under the limited liability partnership law, for years they had wanted to form a limited liability company. That was given to them in 1989, and then they did not want the disclosures, so they wanted LLPs instead. The auditors, at best, only owe a duty of care to the company and not to any individual shareholder or sub-postmasters. Ernst & Young clearly knew what the Post Office was up to. I have said to that effect in the House of Lords; I have put that on record.

What is the nature of this competition? You have one firm that replaces another. It is essentially accountants retaining the monopoly. You do not have a situation that says that the only shareholders for a chemist must be chemists. You can have outside ownership if you want to create competition, but accountants have resisted that.

Q70 **Chair:** That is quite a manifesto. If you were just to pull out the two or three key points that should be at the heart of reform, what would you underline for the Committee?

Lord Sikka: First, I would want independent regulation, as I have already said. Secondly, you cannot let the companies appoint their own auditors. That is what happens at the moment. Imagine going through an airport and your passport is audited—

Q71 **Chair:** That is the second point. What would be the third priority?

Lord Sikka: The third point is I would not want auditors to sell any consultancy service of any kind to anybody. I would want audit-only firms, not firms that can sell consultancy to somebody else. I would want audit-only firms. I would want accountability and transparency along the lines I have indicated. They would be the starting points.

Q72 **Andy McDonald:** According to a report by Deloitte, fewer than half of UK employees trust their employers. That trust deficit has been reflected in recent evidence to this Committee on the Post Office and Asda, for example. Is British business in danger of having that tag of being untrustworthy and, ultimately, unsustainable? Do you think that is a risk?

Lord Sikka: These risks are always present. You have to look at the systems of corporate governance, and auditing is part of that. Bear in mind that we only become aware of audit failures when a company goes belly-up. Nobody has ever volunteered to say, "By the way, we have not done a good audit, and you ought to know". That inevitably erodes confidence.



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The audit scope is also much narrower. As I indicated, other stakeholders are completely omitted, and they have little or no say in auditing matters at all. I would like to see the audit contract and audit tender published, as well as the composition of the audit team. I would like to see the time budget and, after the audit is stated, a list of questions asked by the auditors and management replies. If we had a broader system of corporate governance and if the stakeholders were present on company boards, whether they are employees or customers, I would want them to have a right to have their own separate audit because a conventional audit, under the terms provided by the management, has not really served them well at all.

Q73 Andy McDonald: We are concerned that there will be a drag on firms that are doing things correctly and in the right manner. They are being unfairly tarnished by the practice of others. What is your overall view of this White Paper? Are the reforms that are there sufficient to rebuild any loss of trust in business, more broadly?

Lord Sikka: They obviously would help. One would not reject them all, but I do not think they go deep enough in some ways. As I said, for the last 100 years, the emphasis in the UK has always been on focusing on directors, and auditing has always lagged. We heard earlier that it is a director's duty, but what about the auditor's duties? Interestingly, the auditor's duties are usually expressed in a negative way: it is not their job to do this. The question is, "If a big four firm is charging £1,500 an hour"—which they do—"what can we expect in return?" That is usually put in a negative way, and we may need to define the auditor's duties by law.

Q74 Mark Pawsey: Sir John, what do you think of what you just heard from Lord Sikka? He seems to be wanting to go rather further than you suggested five years ago. Are his asks reasonable, or is there a middle way between what Lord Sikka would like to see and perhaps where we are right now?

Sir John Kingman: First of all, we agree that we need to put this regulator on to a proper basis. That is worth noting. It is true that, at the point at which I did my report looking at the FRC, there is evidence to show that that body was excessively close to the firms that it was regulating. That needed to stop. I do not think that is now true, to be clear, but I do think we need to put all this on a proper, permanent basis. I would not go quite as far on every issue as Lord Sikka, but he is raising very real issues that we need to be attentive to.

Q75 Chair: Just in the time that we have left, Sir John, can I just try to pull out which, on reflection, you think are the most important components of the unfinished business? We have a slightly vague set of objections, which we are going to cross-examine the Minister on in a moment. Words like "burdensome" and "red tape" will no doubt come up, but if we were to zero in, in priority order, on the key pieces of the puzzle that you think still need putting into place, what would be the things that you would



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highlight for the Committee?

Sir John Kingman: First of all, this needs to become a legal body in its own right with its own proper governance. This is a body responsible for governance in the UK, and its own governance is not in good shape. That needs to be fixed, and then it needs to have the critical powers.

It would be valuable for the Committee to ask the FRC itself which things would be prioritised if we were forced to choose, but, frankly, I do not really see why we should be forced to choose. I do not sense a great body of evidence that anything in the legislation is vastly burdensome on anyone. Given the extraordinary degree of consensus that existed at the time that my report was published, the burden of proof should be on those who do not want it to make their case, not the other way around.

Q76 **Chair:** If you were asked to prosecute a case that these changes were burdensome and did add to red tape, how easy would it be for you to make that side of the argument?

Sir John Kingman: It would not be very easy because I did not think I was in the business of making recommendations that were burdensome. I would not have wanted to do so. I was assisted by an advisory board who would have been quite vociferous if they thought that that was the direction of travel.

Q77 **Chair:** Frances, from your point of view, you think a further pursuit of reform would be a good thing when it comes to reducing the level of fraud and economic crime.

Frances Coulson: Yes, I do.

Q78 **Chair:** Andrew, from your point of view, you think that pursuing reform would improve audit quality, and that would be positive for investment in the UK.

Andrew Ninian: Yes.

Chair: Thank you very much indeed. That has been an excellent summary. You have underlined a number of the conclusions that we heard in our first panel: that this would be positive for the economy and bad for economic crime. That is a pretty good conclusion to draw from this panel. Thank you very much indeed for your evidence. The Committee is very grateful indeed to you. That concludes this session.