

Business, Energy and Industrial Strategy Committee

Oral evidence: Future of Audit, HC 1718

Tuesday 15 January 2019

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Watch the meeting

Members present: Rachel Reeves (Chair); Vernon Coaker; Drew Hendry; Peter Kyle; Mr Ian Liddell-Grainger; Sir Patrick McLoughlin; Mark Pawsey; Anna Turley.

Questions 1-91

Witnesses

I: Professor Christopher Humphrey, Professor of Accounting, Alliance Manchester Business School; Vinita Mithani, Lecturer in Accounting, Department of Accounting and Finance, Middlesex University; Ilias Basioudis, Senior Lecturer in Financial Accounting and Auditing, Aston University Business School; Professor Karthik Ramanna, University of Oxford.

II: Leon Kamhi, Head of Responsible Investment, Hermes Investment Management; Liz Murrall, Director, Stewardship and Reporting, The Investment Association; Euan Stirling, Global Head of Stewardship & ESG Investment, Aberdeen Standard Investments; Natasha Landell-Mills, Head of Stewardship, Sarasin & Partners.

Examination of witnesses

Witnesses: Professor Christopher Humphrey, Ilias Basioudis, Professor Karthik Ramanna and Vinita Mithani.

Chair: Thank you very much to the four of you for coming to give evidence. This is the first of our evidence sessions on the future of audit, and we appreciate your time this morning and your technical and academic experience in this area. We have two panels this morning. Investors are coming in straight after this session to give their perspective. You do not need to answer every question. Could we keep questions and answers brief and to the point? You do not need to repeat what other people have said, if that is okay. We will start, first of all, this morning with Ian Liddell-Grainger.

Q1 **Mr Liddell-Grainger:** Thank you very much indeed. Can I ask about the expectation gap and the reviews of auditing? Obviously, this cuts to the chase of what we are here for. Would it be better to have audit quality and to close the gap between what the public expect and what the companies can deliver? This is obviously important. Is there more of a quality gap or is it more of an expectation gap? Which side should we go down? Who would like to start on that?

Vinita Mithani: I will start with that. There are inherent limitations in even the most independent and competently carried out audits, simply because of the information asymmetry. There is no way that auditors will ever have the business information that internals do. However, there have been far too many cases where auditors have been found not to have challenged even the most contentious management assertions. There is no scope for an expectation gap there.

In my opinion, the expectation gap is actually that we expect auditors to carry out their work independently when they could not possibly be fully independent, considering that they give an opinion on assertions by the very people who have the greatest influence in appointing them, remunerating them and dismissing them. The core conflict they have is balancing their commercial interests against any professional regulations as well as legislation.

Professor Humphrey: The issue with the expectation gap is multifaceted in many respects. What you need to highlight first of all is that an issue about an expectation gap focuses your attention on what the role of the audit is. For a Committee like this, it is very important that you get the order right in terms of what you are focusing on. If you do not have the role of the audit clear, how you deal with other issues becomes much more problematic. I know circumstances can drive the way in which you address things, but it is very clear conceptually to make sure you do not see the audit as something that is inherently fixed and incapable of being changed.

With the expectation gap, you should also recognise that it is historically



something that has persisted for a long time. Some people argue that it is an education gap; some people argue that it is a performance gap. Particularly given the range of submissions that you have, it is vital that you very seriously consider the different perspectives that people are writing from, and try to understand what lies behind those perspective, particularly conceptually. One of the things I can see from a number of the responses that you have to a number of inquiries—at least the ones that are publically available—is you have a lot of emphasis on competition and regulation. In terms of the professional perspective, I would look at it and see what the role, influence and significance of professionalism is as a concept. What faith are you placing in various aspects such as competition, regulation and professionalism?

Q2 Mr Liddell-Grainger: Let us follow that through on actual quality. What should good quality audit look like? Who should it benefit? Professor, do you want to try that one?

Professor Ramanna: Sure. Let me say, to answer your first question, it is largely a quality gap. My colleague on the left is correct in saying that you want to start with an understanding of what the purpose of the audit is. The purpose of the audit is deeply tied to the purpose of accounting, which is to reflect management's judgment on what investments in this period will realise in the future. The audit is intended or evolved to provide some sort of assurance of management's reporting judgment.

Audits have moved further and further away from doing that. As a result, they are effectively not supporting what it is a well-functioning market demands. That is where the expectation gap comes from. In effect, if the auditors were doing what the market demanded of it, we would not have the expectation gap. It is as simple as that.

Ilias Basioudis: First of all, thank you very much for inviting us. For myself, my name is Ilias Basioudis and I am senior lecturer in Aston Business School in Birmingham. I also chair the Auditing Special Interest Group of the British Accounting and Finance Association.

To respond to this, in my opinion what we need to understand is that the audit is not a guarantee. It does not provide a 100% guarantee that the financial statements of client companies are free of misstatements and free of fraud. This is something we definitely need to understand, and that leads possibly to an expectation gap, because a lot of stakeholders—regulators, investors—believe that the audit is there to guarantee the non-failure of client companies. This is not going to be the case. No matter what we do and no matter what the regulator does, it is not going to solve that basic fundamental issue, which is that the auditors just check a sample of transactions, books, working papers, emails, minutes and so on. They do not check 100% of all of that stuff. There is a potential there that the auditors can miss material misstatements, fraud and other misrepresentations.

There is definitely an expectation gap, but I would also agree that there is possibly a quality gap there, because in some cases—in the cases that



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create public unrest where there are huge failures, such as with Carillion, BHS and so on recently—the auditors probably did not provide what was expected by those who entrusted them with offering the audit service.

- Q3 **Mr Liddell-Grainger:** There have been a lot of reviews covering auditing. Given how many there are and what they have been discussing, would it have made more sense, in retrospect, to decide what an audit should deliver, which is I think what you were saying, before considering, the other way around, the regulatory and competition rules?

Professor Ramanna: The answer is yes. I was, quite frankly, surprised that it was not part of the terms of reference of the Kingman review. I do not know whether that was a decision the Kingman review made on its own or whether that was the charge it was awarded, but the answer is yes. You could make the argument that the CMA review could not address these issues, because they were looking at other matters associated with competition in the audit industry, but it was certainly within the purview of something like the Kingman review and any further reviews that you would commission.

- Q4 **Sir Patrick McLoughlin:** Can I follow up a bit on that to be clear on what you have just said? The CMA has put forward a package of measures. Are they the right way forward? Would they improve competition in audit quality, bearing in mind that you still have the dominance of the Big Four.

Professor Ramanna: At the end of the day, the market for the supply of auditors is constricted by the ICAEW and the demand is mandated. No amount of increasing the number of players in the market is going to bring us close to what we would consider a competitive market. You can have Coca-Cola and Pepsi, two players in a market, and they can be very competitive as long as you have the basic conditions for competition: free entry and exit. We do not have those basic conditions. You can have 50 auditors and you will still not have competition. That is not where the interesting issue is.

One of the things the CMA was trying to do was address the issue of non-audit services and the impact that might have on the lack of independence of the auditors. They have proposed this “Chinese wall” approach, which is to say that we will create some sort of separation within the audit firms. That is better than nothing, but, quite frankly, we have tried the “Chinese wall” approach before. We tried it with sell-side analyst research and investment banking when sell-side analysts were pushing certain financial products that investment bankers had high margins on. That resulted in a climate of pump and dump. We have seen that movie before. It does not entirely work, but it is better than nothing. That is what I would say.

- Q5 **Sir Patrick McLoughlin:** You used an acronym that I probably should know. What is the ICAEW?

Professor Ramanna: It is the Institute of Chartered Accountants in England and Wales.



Q6 Sir Patrick McLoughlin: Would requiring the audit committee to report directly to the regulator on the tending of audits during an audit improve the performance of audit committees and their ability to interpret what is going on by increasing their independence?

Vinita Mithani: There has been a lot of research evidence showing that, although there are all these rules set up to ensure the independence and competence of audit committees, they remain under management power. A lot of the time the non-execs who sit on the audit committees have been recommended to the board by management, so there are social ties. There is also this view that they are independent although they are directors in the company and have a significant say in the commercial path of the company. They are responsible for financial reporting, internal audit and risk management. Again, there is an expectation gap about audit committees being fully independent. Clearly, that is something the CMA has picked up on, and it has realised that it is something that needs to be managed. I am not sure how effective that kind of regulation is going to be, because there is a potential for more smoke and mirrors between the audit committee, management and the regulators on the other side. It is potentially a step in the right direction.

Ilias Basioudis: On your first question about the CMA reforms, some of them may improve audit quality but there might be unintended consequences.

Sir Patrick McLoughlin: I was just coming on to that. Please take us through those.

Ilias Basioudis: You need to be aware of those, because you do not want to regulate something and then all of a sudden find out that there is something that you did not expect to happen that does happen.

Q7 Sir Patrick McLoughlin: Do you have a particular concern about the unintended consequences of what the CMA is saying?

Ilias Basioudis: For all of these proposals, there might be unintended consequences that we need to be aware of. I can tell you that one unintended consequence came out in 2016 with the increased regulation. Now we have less competition, because Grant Thornton decided not to tender any FTSE 350. That was not the intention of the regulations from 2014-15; it was an unintended consequence.

A lot of these reforms have unintended consequences. That is why you need to be aware of them. For example, there is the joint audit. This is the preferred remedy of the CMA. It might improve audit quality, but it will increase costs without actually providing any assurance that audit quality will be improved. It is a "try and see" approach. In France, it has not helped smaller firms to gain large audits themselves, for example. Joint audits have been there for years. Why should they work here?

There are other things you need to be aware of with joint audits. There is mixed academic evidence that joint audits increase quality, independence and choice. There might be issues there around issues falling through



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gaps between the joint auditors and so on.

There are things that you need to be aware of. You cannot just implement regulations and laws from other countries, with just blanket enforcement of new regulations. I can go on with other reforms that have been suggested if you want me to, but I guess some others might want to chip in here.

Vinita Mithani: I just wanted to say that there has been recent research evidence coming from lenders and investors in Europe who thought that joint audits would hinder independence. They think there will be two audit firms competing to be management's favourite, which increases the risk of opinion shopping.

This kind of brings me back to something I have mentioned in my articles in the ICAEW's magazine, which is that we do not seem to fully understand this relationship between the auditor, management and the people who are meant to be their clients. With increased competition in the current setup, what you are getting is more audit firms vying to get the audit client. It is usually by demonstrating that the audit partner is the right personality fit for management, which is counter-intuitive. That is why, if we are going to have greater competition, we need to somehow change this relationship between management and auditors. Obviously, we tried with audit committees, but that does not seem to have worked very well.

I know Sir John Kingman did respond to a letter to Greg Clark about whether we need to go one step further, in that the new regulatory authority he has suggested could also completely take over the appointment and remuneration of auditors, but I understand that he does not think there is investor appetite for that.

Chair: We might come on to that in the next session.

Q8 **Peter Kyle:** Ilias, in your opinion, how practical or easy would it be to implement a split between audit and non-audit?

Ilias Basioudis: Do you mean completely split? There are already some regulations there that do not allow some non-audit services to be provided by the auditors.

Peter Kyle: Yes, I mean an operational split.

Ilias Basioudis: Yes, an operational split rather than a structural split. Again, it is something that can work. KPMG has already announced that it is not going to provide any non-audit services to their audit clients. They have completely banned themselves voluntarily before any regulation comes in to do that. Deloitte or Ernst & Young has come out and said they will follow KPMG on that one. Again, if we are to look at the academic literature, there is no compelling evidence of audit independence being jeopardised when auditors provide non-audit services to their clients. It will only help in the perception of investors, and mainly the non-professional investors, if there is no provision of non-audit services to clients.



The problem there would be a potential unintended consequence if one of the Big Four dropped the audit market completely because they find the non-audit market is much more lucrative. We have to be careful there, because there might be some unintended problems there. That kind of a decision by one of the Big Four to drop the audit market might concentrate the market even more.

Q9 Peter Kyle: To any of the other panellists, is there any evidence that having an operational split would lead to a greater quality of outcome? One of the possible scenarios is that more of the senior management would be involved in a hands-on way, because they are not continually out there pitching for sales and doing that side of the business. Is there any evidence for that or any credible assertion for that?

Professor Humphrey: In the responses or the submissions to the CMA, you have a lot of detailed explanations as to the problems that split could cause. You also have some people advocating for it. In one sense, it would be worth going through those in careful detail to see the problems. One of the dangers with the approach you have at the moment is that it is asking about individual reforms.

One of the things that I wish to highlight is that, from your own Carillion report, you concluded by saying that the Government “can grasp the initiative with an ambitious and wide-ranging set of reforms that reset our systems of corporate accountability in the long-term public interest”. If you have that as your target, you have to consider audit within the context of the broader corporate governance arena. You cannot just look at audit in isolation. You need to start to look at what you are driving at in corporate governance. If you look at the whole field, there is an enormous amount of activity going on, even just within this Committee, with all of the corporate governance initiatives and the various other things you have commissioned.

As I said earlier, it is vital that you try to pull back to some level of conceptual analysis, because there are contradictions running throughout a lot of these regulatory proposals and competition proposals. For instance, as an illustration, if you are concerned about commercialism within the accounting profession, it is a contradiction to feel then that the solution lies in greater competition. You can run through those. For me, this drives you back. You have to start to seriously contemplate the role of the audit. For instance, one of my arguments has been that, rather than trying to predict where auditing is going, you should try to think about why auditing never changed. I do not know whether you are aware, but there have been innumerable studies on the future of the audit. I have had students study the history of “future of the audit” studies.

Chair: It is a discipline that is unlikely to go away.

Professor Humphrey: Just as an aside, if you are thinking about comparable times—obviously today is a pretty momentous day—in the early 1940s, in the early stages of the Second World War, the Institute of



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Chartered Accountants was debating the future role of audit. That was in 1940, 1941 and 1942. These are things that have been long-running.

What really attracted me to your conclusion on the Carillion report was that the evidence basis you were drawing on was very specific and very particular. In a variety of the responses, you will see statements about how you should be careful about the evidence base you have; be careful to distinguish public-interest entities from non-public-interest entities; and understand the different natures and demands on the accounting profession in those different arenas. You have an opportunity here almost because of a constellation of factors. You have enormous developments going on with technology. You have a whole set of issues that you have raised around the whole process of corporate accountability. If you take care with this, there is a real opportunity to do something that is long-lasting, rather than fudging it and saying, "Which is the one that is politically expedient to do?"

Peter Kyle: Thank you very much, and top marks for quoting one of our own reports back to us. That is great. Professor, one of the options is a structural split. Would a structural split be perhaps easier to implement? Would there be more unintended consequences?

Professor Ramanna: The problem with that is that it is hard to act unilaterally, because this is a global industry. Modern auditing evolved in Britain, and it is great that this Committee is taking a leading role in this. You could be at the vanguard of moving global opinion on this, because what you have identified is not a British problem; it is a global problem. However, this is a global industry, and you have limited leverage in splitting that.

I am not so concerned about the Big Four exiting from the audit market if in fact you effect that split, because that might in fact end up being a good thing. Maybe some new players will come in and bring in fresh blood. Clearly, the system is not working. Something might come out of that. We tend to overcomplicate things by looking at the whole ecosystem and so forth, because we are never going to have the political will or the chance to shift the whole thing. We have identified a problem. We have a number of compelling solutions. We pick one and we go with it.

Q10 **Mark Pawsey:** There are a couple of remedies or ideas that people have suggested, and I want to ask you about those. You have already referred to one of them. Vinita, you spoke about it. That is the idea that there would be joint audits. You said that might hinder things rather than improve them.

Vinita Mithani: Yes, there is a perception that that could happen, because you have a greater chance of opinion-shopping internally between two auditors who are vying to be management's favourite.

Q11 **Mark Pawsey:** One of the things we are bothered about is the cosy



relationship, which you have already also referred to. If a smaller challenger firm were also to be brought into the audit, why would that not provide some checks and balances?

Vinita Mithani: They would both still view the audited company as their client. It does not change the fundamental relationship. We just have two people with the same relationship with management. It actually increases the competitive forces.

- Q12 **Mark Pawsey:** Mr Basioudis, you spoke about what has happened in France. You said that smaller firms had been helped there. I am assuming you are in favour of joint audits. One benefit of them is that smaller companies get some experience and they are able to develop expertise, which means they can at a later stage compete effectively.

Ilias Basioudis: That is the idea.

- Q13 **Mark Pawsey:** Does it work?

Ilias Basioudis: In France it has not worked, because more firms have not taken on larger audits so far. It has not really worked there as you would expect it to work.

- Q14 **Mark Pawsey:** I might ask the two professors, then. You have two colleagues saying they do not work and they are not a good idea. Do you agree?

Professor Humphrey: One of the difficulties is extracting conclusions from different institutional environments. Some of the research will say that you can identify an effect such as increasing costs of audits for joint audits as against sole audits. People highlight that in France the share of the market by the Big Four is lower than in other countries, but you need to try to understand how the audit is functioning within that particular institutional environment. You will find studies that have tried to isolate the impact and the differential effect, and they have said that it is very difficult to do because you have so many countervailing institutional factors that could also drive the difference in results in terms of the quality of earnings.

In the literature, there is actually a limited amount of what you would call qualitative research, i.e. interviews and field-based research, that was spoken and understood the process of doing these audits jointly. Given that absence, you are potentially in a situation where you may want to look at some sort of volunteers who would like to have a go and learn more from that rather than an institutional initiative.

Another thing that stands out for me is when you look through the logic of what you are doing or proposing if you are worried about the scale of performance within the Big Four. There are enough responses in the CMA report to say, "Be careful with statements saying that the system is broken". Yes, companies did collapse. That had dramatic consequences. Maybe you are finding that in certain circumstances the audits were not



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done well or that there were other factors that contributed to that, but there are a lot of companies. Even the FRC itself has evidence to say that a lot of audit committees are satisfied with the work that auditors are doing and stuff like that. In a sense, you just need to retain a degree of confidence.

Go through the logic of joint audits. If you do not trust Big Four audits, why do you trust them to train challenger firms to do an audit? How effective a challenge will the challenger firms be? Are there any other options to challenger firms? Why not open the audit up to other providers—to consulting firms and so on? Where do you stop with the competition? You have to work these things through. My own reading of joint audit is that I do not think, if you work through the logic, the case is dramatically compelling.

Q15 **Mark Pawsey:** Professor Ramanna, do you take the same view?

Professor Ramanna: Yes. It is unlikely to be the silver bullet that solves this problem for many of the reasons that have been said. At the end of the day, the reason why a company like Google or Microsoft innovates is because some kid in a garage somewhere can develop a new product that will obviate it. That is not the case with the audit industry, because it is living in a fat and happy regulated world. Bringing in these additional audit firms is not going to solve that part of the problem.

Q16 **Mark Pawsey:** Is it inevitable that a joint audit would be more expensive than a single auditor?

Professor Humphrey: That is what the research says.

Q17 **Mark Pawsey:** Is it inevitable?

Professor Ramanna: It is not inevitable.

Professor Humphrey: Thinking about the way in which audits are done jointly, you do have shared audits, in a sense, which have been voluntary arrangements. Do not forget that within an individual firm there is more than one pair of eyes. There will be independent partner reviews of audits. In some cases, you may well find that those did not function well, but that is a process. It does not necessarily mean that a joint audit has to be done by two separate firms. You can have different pairs of eyes. That comes back to my first point about the extent to which you are prepared to trust professionalism.

Q18 **Mark Pawsey:** The second proposal would be a market cap. Again, we might have heard reference to that. What are your views on limiting the percentage of FTSE 100 or FTSE 350 companies that any one big firm can deal with? I do not know who would like to start with that one.

Professor Humphrey: On the conceptual issue, again, if you are placing so much emphasis on the importance of the market, the continual intrusion in the market seems to mean that you want markets but you do not trust the outcomes you are getting. If you read through the CMA



responses, there are a lot of detailed comments about the complexity of implementing a market cap. Some people prefer it in terms of numbers; some people prefer it in terms of fees. There are a whole host of examples where they raise anomalies in what that capping would achieve as to whether firms will get rid of their riskier clients for other firms to pick up if their market share becomes problematic.

Ilias Basioudis: Creating a market cap means that a share of that market will be offered to the non-Big Four firms, but we know that the non-Big Four firms do not have the experience, the staff, the expertise or the ability to audit such large and complex companies in the FTSE 350.

Q19 **Mark Pawsey:** We spoke to some firms just outside of the Big Four that would disagree with you. They say they have the ability, but they have just been squeezed out of the market. They would point to the costs of preparing the bid as being an obstacle to them doing this, not their competence. You are questioning the competence of firms outside the Big Four to be able to do FTSE 100 companies.

Ilias Basioudis: I think they argue it themselves. As you said, I have spoken to non-Big Four partners and so on. As we know, Grant Thornton does not because it does not feel it can do it. Others say they do not have the staff; they do not have the number of people to be able to support such large and complex businesses based around the world.

I just want to mention that when one partner from a non-Big Four firm was asked how to increase competition, their answer was, "Surely not with more rules, compliances and increased costs to comply with". The non-Big Four feel that complying with all of these regulations is prohibiting them from tendering for FTSE 100 or FTSE 350 firms.

We also need to realise that after every collapse happens there is more regulation. After one more collapse, there is more regulation. We are building up regulation after regulation after regulation. A lot of people say that the regulatory-building and the market might collapse because of the sheer weight of the regulations. We have to be aware of all of these things, because regulation and compliance is costly.

Q20 **Mark Pawsey:** Ms Mithani, what is your view on a market cap?

Vinita Mithani: I just wanted to carry on from where my colleague finished about this increase in regulation that we have had over the years. It is basically designed to tame that core behaviour of the auditor siding with their client and at no point have we tackled that issue head on. We are just trying to prevent it. We think that non-audit service increases their dependence, but audit fees are large enough in themselves. Who is paying for that? We really need to think about how much these regulations are actually going to change behaviour. If we change the way they are incentivised, we might in fact be able to drop a lot of these regulations and make auditing a lot more profitable and a lot more likely to have more market entrants.



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Q21 **Mark Pawsey:** Your argument would be that the solution to the problem is to take away some of the regulation, which would enable more small firms to come in and compete. Is that essentially what you are saying?

Vinita Mithani: What I am saying is that, instead of the audited company being a client of the audit firm, if the regulatory authority takes on that role, it changes the commercial incentive that is built within the contract the audit firm has with the auditor.

Q22 **Chair:** That is somebody else appointing the auditor.

Vinita Mithani: Paying, dismissing, yes. The audit committees have not worked, which is partly why the CMA thinks we need to keep an eye on them as well. We are just adding layers upon layers of regulations to try to prevent that behaviour rather than nailing the incentive leading to that behaviour.

Q23 **Mark Pawsey:** But how do we get more firms at a level where they are able to compete for the audits of our biggest companies?

Vinita Mithani: If you change the way auditors are appointed, dismissed and paid, you change that core incentive not to challenge management. Therefore, you can loosen a lot of the regulation currently in place that tries to tame that behaviour. That can help reduce the cost of an audit as well, which is part of the reason why a lot of perhaps the mid-tier firms have not found it worthwhile to develop that expertise.

Q24 **Vernon Coaker:** Can we just pick up on this? What we are really talking about is what the CMA called "professional scepticism" and the relationship between the auditors and the people they are auditing being too cosy. Challenging the management and challenging the accounts does not happen as often as it should. The CMA made a number of recommendations. The Chair mentioned one, which was the independent appointment of auditors. There is the whole idea of rotating auditors much more frequently and so on. How is this going to be done? We have the Big Four. They are all working well, as far as they are concerned, apart from a few bits that have gone wrong. This goes to the heart of it, does it not? This relationship is regarded as too close and cosy. To each of you, very quickly, how are we going to incentivise that?

Ilias Basioudis: If I may start, I do not believe that the auditors do not provide the necessary or adequate scepticism required. What you have to bear in mind is that a recklessly run business will always be a threat to an audit and the auditors, no matter how much regulation you have and no matter how many reforms you are going to introduce. That is what Project Flora needs to look at. It also needs to look at the other side, the client side and the business side. It needs to look at the reporting and the culture there, because there will always be people on the demand side, on the business side, who are willing to run a business recklessly and the audit can do nothing about it because they do not provide it or because they do not check everything. The scepticism is there. I do not think the auditors lack scepticism.



Vinita Mithani: There has been a lot of evidence that, when cases have gone to court, it has been found that auditors did not challenge the key assertions where it was contentious. Instead, they decided to tick and bash through processes and procedures to prove they did a good quality audit. As I said, to change that incentive would require breaking that client-auditor link.

However, on your point about management incentives, that is an important area to consider. There are clearly incentives for management to potentially misbehave.

Q25 **Vernon Coaker:** The CMA is concerned about it. Are they right to be concerned?

Vinita Mithani: Yes, absolutely.

Vernon Coaker: The concern is fine. It is what you do about it.

Vinita Mithani: Yes, absolutely.

Vernon Coaker: That is what we are wrestling with. We are all concerned about it, but so what?

Vinita Mithani: Absolutely, yes. The idea was that remuneration committees would be independent and would approve the right kind of incentives for management, but that has not worked.

Professor Ramanna: I agree with what my colleague to my immediate right said, which is that you cannot address this issue without effectively bringing the competition issue into play, but, that said, the auditors are not doing enough of a job with the scepticism they need to.

Vernon Coaker: There is a problem.

Professor Ramanna: There clearly is a problem, yes.

Professor Humphrey: If you read the FRC's review for 2018, they do highlight that their feedback from audit committees was more positive than the results they are obtaining from their inspections, so the situation is not clear-cut.

Q26 **Drew Hendry:** The Kingman review was referred to earlier on. Do his proposals for a new regulator with statutory powers address concerns on both audit quality and the need for more rigorous regulatory oversight?

Professor Ramanna: I wrote a book about this a couple of years ago. In the 1970s we had a similar issue in the United States. We decided to create a new regulatory body for accounting rules called the Financial Accounting Standards Board, which is still in place. At the time, we looked at state-of-the-art evidence in social and political science, et cetera, on how to design an independent institution, so it was given the capacity of an independent board that would be in charge of its finances. The staff were very well paid. They were paid the current equivalent of



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about \$600,000 a year, which is more than the President of the United States makes. They were given a lot of research resources.

Drew Hendry: So it was well resourced.

Professor Ramanna: Yes. The point is that it did not work. It is a small and cosy world, where everybody knows everybody. They all start thinking and breathing in the same way. Today, we end up with a system in which effectively the regulations serve the regulated. Is the Kingman review right in recognising that the FRC has seriously gone off the rails? Yes, absolutely. Is the solution to propose a new body? Yes, probably. Is that new body in itself going to work? No, probably not.

Q27 **Drew Hendry:** You all seem to agree that the powers and sanctions are not really appropriate within that body. Would that be correct?

Vinita Mithani: Yes, unless, as I said, that authority took over its contract with the auditors and broke that link. There is a suggestion to keep an eye on audit committees, which might not be necessary if we are going directly with a regulatory authority, but perhaps we also need to consider how the remuneration committee is operating in terms of the management incentives that are approved, so shareholders feel, "Yes, there is an independent board there approving the right things". Time and again, we have found that they did not quite consider the long-term performance of the business.

Q28 **Drew Hendry:** Do you all agree that the regulator should be more proactive about intervening and monitoring?

Vinita Mithani: Yes, I personally agree.

Drew Hendry: Is that shared across the panel?

Professor Humphrey: You need to be careful about what the impact of that is. Again, one of the conceptual issues to contemplate is what we mean by the notion of audit quality. One of the concerns over regulatory regimes is that they drive things down a procedural type of approach. If the judgment is not properly documented, it is potentially going to be an inspection finding that the judgment was not properly documented. It could have still been the right judgment. One of the issues on the regulatory side is about the extent to which it changes the way in which audit work is undertaken and the priorities that auditors follow in their work. This is where you hear the concerns about checklist-orientated audit approaches and stuff like this.

On the other side, I know the FRC has come in for a lot of criticism, particularly over issues in various high-profile cases, but if you look at the previous review around 2011-12, there were comments that the FRC was working quite well. It would be worth paying some careful attention to what has happened in the FRC over the years in terms of the transformation. My reading of a number of the submissions is that people feel that bolstering the power of the regulator and giving it a greater



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remit, particularly over boards of directors where they are not professionally qualified in accounting, so extending their reach to those, is going to be a powerful development with respect to corporate governance. This is coming back to some of the points you were making. We need to address corporate governance reform, not just audit reform. It is a little bit of a mix. I will maybe say something at the end about where audit quality can take you.

Chair: I am mindful of time. We have another session to get through on this and we obviously have important business in the Chamber later today, so can we try to move on a bit more rapidly?

Q29 **Drew Hendry:** Sir John Kingman recommended that the proposed audit reporting government authority should take over the registration of audit firms conducting public interest entity audits from recognised supervisory bodies such as the Institute of Chartered Accountants in England and Wales. Would this measure deliver any improvements? From what you have said, you sound very sceptical about it.

Professor Ramanna: If they simply took it over without changing anything, it is not going to change anything, is it? If they took it over and said, "Let us open this business up to consulting firms; let us open this business up to IT firms"—because they probably have even more effective technology to conduct audits than the audit firms do—then, yes, it might change something. It really depends on what the regulator is going to do rather than who the regulator is.

Q30 **Drew Hendry:** Are there any negative changes that could occur from this?

Professor Ramanna: Do you mean from shifting from one regulator to another?

Drew Hendry: Yes.

Professor Ramanna: Probably not, no. The current regulator is captured.

Ilias Basioudis: It would be the cost.

Vinita Mithani: Yes, it would be cost.

Ilias Basioudis: Cost would be the main requirement of this new regulator. Who is going to take on that cost? Is it investors?

Professor Ramanna: It is the cost of that versus the cost of already having a captured regulator. We are not living in an ideal world.

Q31 **Anna Turley:** Moving on but sticking with the Kingman review, it also recommended that serious consideration should be given to whether the US Sarbanes-Oxley regime could be adapted for the UK? Do you think that is right? What would be the advantages and disadvantages of that?



Vinita Mithani: There has been recent evidence looking at the effectiveness of those regulations in the US. They found that they did not have the impact they thought they would have. These regulations have worked in a strange way, because the regulations, and SOX 404 in particular, require that management disclose any weaknesses in their systems. What they found is that where management had disclosed those weaknesses and a mistake was later found in the financial statements, there was a higher risk of them being sued by investors because there was a higher chance of winning on the basis that management could not deny not knowing about this. It has backfired, and management now would rather not disclose those than disclose those. It is a very strange example of how regulations end up impacting firms.

Ilias Basioudis: Can I make a brief comment there? We have to bear in mind that the UK approach to governance is largely code rather than legislatively based. That might create issues if we go down the route of the Sarbanes-Oxley Act.

Professor Humphrey: My understanding was that a number of the large accounting firms have written papers that are supportive of considering the possibility of adopting a Sarbanes-Oxley UK or European-adjusted reform on the grounds that they feel it puts more pressure and responsibility back on corporate directors, particularly with respect to things around internal controls and the functioning of the control system within corporations.

I would add two cautionary comments. One is that you are moving in very different institutional environments. What UK or European-adapted means goes back to issues about principles versus rules-type regulatory regimes. The other thing, though, particularly in the early days of Sarbanes-Oxley and the assessments of internal controls surrounding accounting issues, was that people found it was very difficult to specify what a good internal control system was. One of the things that comes through from some of the research is that to get a good judgment on internal control, you need people who are diverse in their skill sets, which then has knock-on effects if you are coming back to say, "We want people doing audit-only firms". If you broaden the scope of audit, you may need to broaden the qualities, attributes and skills of the auditors doing those sorts of things.

Q32 **Anna Turley:** Moving on, you all talked a lot and very articulately about the purpose and values of audits and some of the things that need to change. We had the announcement in December that there will be an independent review into the future of audit chaired by Donald Brydon. Here is your chance to get on the record what specific issues that report should look at, if you do not think current audit is not fit for purpose.

Professor Humphrey: I would say something very briefly about this whole issue of the audit as something that looks backwards and, secondly, is a secondary function—i.e. the value of the audit depends on the value of the information that is being audited. That is a relatively



restrictive view or conception of what an audit could be. An audit means to listen, but an audit can also mean to learn, enable or teach. I have a colleague from Japan, Naoko Komori, who has looked very closely at the different cultural make-ups in societies and what an audit function could do. That could be very much more of a dependent and closely related function, rather than something that is an independent check.

The other side is that very often when we have these debates on audit people keep coming back to notions like, "An audit is an audit". We all know what an audit is. If you start to propose something, people say, "That is not an audit". I would like to see a switch here. This goes back to your stuff on Carillion. Instead of saying, "This is the audit and this is something we could do within the remits of an audit", why not start to address the issue in terms of what some people, like Richard Sennett at LSE, have called a dynamic repair rather than a static repair, where you say, "What does society need? What can we do to contribute in that way?" If you look at that, audit potentially becomes a much more dynamic function than it is at the moment.

Vinita Mithani: I just wanted to make one point. It would be really useful to get to the core of the issues—to get to the incentives leading auditors into the direction that they go. Evidence has found that, despite a lot of regulation, auditors as well as management are quite optimistic. They put less weight on the risk of any repercussions that they consider to be distant and probabilistic as compared to their immediate commercial interests. For the auditors, they want to retain the client and keep a good relationship; for management, they want to present good financials. It is important to get to the core of those incentives leading people into those directions, which is why I made my suggestion about having the independent authority managing the relationship.

Q33 **Chair:** Vinita, you have been quite clear about the thing you would like to see. I would be keen to get from the other three panellists what you think would make the biggest difference. Vinita's point is that it should be an independent appointment system to appoint the auditors so it is not the audit committees that do it to change the relationship between the auditor and the company being audited. I get that. Could we hear from the three other witnesses?

Ilias Basioudis: I will mention something that I do not have any evidence for. This is probably my personal view of what might work in the future. It would be good to do some research on it in the future. As I said at the start, the audit is not a guarantee. It does not check everything; it just checks a sample of transactions and so on in a business. A lot of the junior auditors do not enjoy doing their job anymore, because it is just a tick-box exercise because of the regulations. A lot of departments are saying the same thing. Given all of that, what about doing something very radical, which is to consider whether it is time to abolish completely the statutory audit? Let the market decide itself what it wants. It will ease off the pressure in the market, it will be a consensus agreement



between those who request the audit and those who provide it, and it might work. I do not know. That is a personal view.

Professor Ramanna: Go after the conflict of interest within non-audit services. They make more money than auditing. That is really what is driving the corruption here, if there is any.

Professor Humphrey: For me, there is a problem of dialogue. There are so many things going on at the moment that you need to get people together in an environment where they are prepared to tell you what the underlying situation is. There is a lot of politics in this at the moment. People are saying, "If we back this, will we get away with it? Is that going to be enough? We do not want to mention that". You have raised many different issues in a variety of your inquiries. I know you have been to the ICAEW to give a speech and stuff like that. Given the seriousness with which people are treating these things and the time limits they are working with, which are pretty short, it would give due respect to the complexity of the issues if you created some sort of dialogue where key stakeholders got together and started to look and say, "Where do we take the audit in the future?" because it is more complex in terms of the role of audit going forward than it is to do these quick market or regulatory fixes.

Chair: Thank you very much to the four of you for coming to give evidence to us this morning.

Examination of Witnesses

Witnesses: Leon Kamhi, Liz Murrall, Euan Stirling and Natasha Landell-Mills.

Chair: Thank you very much to the four of you for coming along. You were all here for the first session, and I hope you found that as useful as we did. We have a number of questions, and the same rules apply to the questions and the answers. Could we try to keep it brief? We have a lot to get through in this session, even more than in the first one. If we could all try to live by those rules, that would be fantastic. We will start with Peter Kyle.

Q34 **Peter Kyle:** Could I ask you to say, very briefly, after all of the high-profile failures we have seen in the sector recently, whether you still have faith in auditing?

Euan Stirling: I would say limited faith.

Leon Kamhi: Likewise.

Natasha Landell-Mills: Likewise.

Liz Murrall: It has started to undermine trust in audit.



Q35 **Peter Kyle:** Is it a quality problem or an expectation problem that we have? Who would like to go?

Leon Kamhi: I would say it is both. The issue is not only about audit; it is also about accounting standards. We need to move back to a true and fair view and a prudent view, where the auditor looks at the underlying performance of the business and its future prospects rather than just ticks a bunch of boxes and is over-focused on compliance.

There are three things one might want to think about there. First, we have to focus on the business and what is material in the business, rather than compliance. Secondly, we have to think about accounting treatments. There is a range of accounting treatments that can be used that really reflect the underlying performance of the business. Goodwill provision is just one of those. Any CEO can kitchen-sink as soon as they come in. Thirdly, there is this thing about realised and unrealised profits and the quality of profits. If we got those things right and focused the auditor on auditing that, it would be a big step forward.

Peter Kyle: Great, thank you. How was that, Chair?

Chair: Very good, Peter—best in class.

Q36 **Mark Pawsey:** How can shareholder and investment engagement with the auditing process be improved? Is it adequate currently?

Liz Murrall: Investors have a number of powers. We vote on the re-appointment of the auditor; we vote on the auditor's remuneration. We also vote on the appointments to the audit committee. We have a dialogue with certain audit committees, and we also meet annually with the audit firms. We meet with their executives and independent non-executives, and we ask them about issues around quality. We could do more, and we would like to, but we need more transparency on audit quality and the judgments that are made in the accounts.

Q37 **Mark Pawsey:** So what more could you do? You said you could do more.

Liz Murrall: We could do more to hold auditors and audit committees to account for the judgments made.

Q38 **Mark Pawsey:** Is that view commonly shared? Does everybody agree that you do not have a big enough role in this?

Euan Stirling: It is important to reassert the authority of the shareholder in this relationship. That was perhaps missed in the last session. Shareholders are the effective appointers of auditors. They are also the recipients of the audit report. In many cases, that has been missed.

Q39 **Mark Pawsey:** Effectively, you are the customer. You are paying for the damn thing.

Euan Stirling: Exactly that. This is an opportunity to reassert the power and influence of shareholders.



Q40 **Mark Pawsey:** Why has your power and authority diminished recently?

Euan Stirling: There are a number of different reasons. At the heart of it is a drive on the part of some institutions to enhance the stewardship we provide over the assets that we invest in. It does not happen universally. When we speak to audit committee chairs, who we appoint on an annual basis, in many cases we find that they do not have a strong dialogue with the investors in the companies they are managing.

Q41 **Mark Pawsey:** Are there other views?

Natasha Landell-Mills: I would absolutely echo that. It comes down to this core incentive problem that was raised in the previous panel. Incentive is not just about managing conflicts of interest; it is ensuring accountability to the right end customer. That is the shareholder. I would probably go a little bit further and say that, generally speaking, apart from some very proactive investors, the whole appointment of the auditor and approval of audit committee members with regard to the audit is very much a rubber-stamp affair.

Q42 **Mark Pawsey:** Is that because the firms are much of a muchness? There is not a lot to choose between them. There are four big firms. You have to pick one of those four. What difference does it make?

Natasha Landell-Mills: That would go to what Liz just mentioned, which is transparency. There is a perception that we just cannot make that decision. We do not have the information available. Kingman makes some very strong recommendations about further disclosure around the FRC's audit quality reviews and things like that.

Q43 **Mark Pawsey:** Do you not have the information because investors are not asking the right questions? Are they not being assertive enough, or is it just that this is the way things are?

Natasha Landell-Mills: It is absolutely true to say that, where investors have been made aware of problems, they just continue to vote in favour. There is a real lack of willingness or perhaps resource devoted to this kind of scrutiny. I should also mention that the proxy agencies have also not really done the right kind of due diligence to support investors in terms of providing the necessary research that would help inform the decision on reappointment.

Q44 **Mark Pawsey:** Mr Kamhi, you are presumably not going to just accept any old auditor's report. Your firm are going to be asking challenging questions and making sure they have the right people in post.

Leon Kamhi: I would say the four of us are quite engaged, not only on this topic but on a number of different topics. Overall—I would include ourselves—we all need to step up here as shareholders and engage much more. When do we really engage? We engage when there is a Carillion or a Tesco. Then we see it as an issue and we say, "We had better engage with that". But to what extent can we get ahead of it? Stewardship resources are limited, and we invest in lots and lots of different



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companies. However, when we are engaging with a company, we should be seeing the audit committee chair on a regular basis systematically and really challenging them in terms of the accounting.

Q45 **Mark Pawsey:** Are you telling us—you guys are investors; you manage our pensions and all sorts of important investments—that you guys have not been doing your jobs properly?

Leon Kamhi: As I said, as an industry we need to step up in terms of engagement and put the right resources behind that as well.

Q46 **Mark Pawsey:** Is there a sense across the panel that you have not been doing your job properly?

Natasha Landell-Mills: One of the key conclusions from the banking crisis, which John Kay reviewed, was that there is a problem of ownerless corporations. It is a market failure. We have a problem of diffuse ownership amongst million and millions of shareholders. Asset managers need to take on their stewardship responsibilities, as Leon referred to. Therefore, we have the Stewardship Code. There are some very strong proposals within the Kingman review suggesting that that is abolished, or, as is our view, that what needs to happen is that it needs to be given more teeth.

Q47 **Mark Pawsey:** Liz, do you acknowledge that you guys have not been doing your job properly?

Liz Murrall: When there have been issues, we have engaged with companies but that has probably been after the event. What we need so we can do more—and we want to do more—is more transparency from audit committees. The EU Audit Regulation gave audit committees quite a strong role.

Q48 **Mark Pawsey:** What specifically would you like to hear from audit committees? What are you not getting now that you should be getting?

Liz Murrall: They are required to report on the effectiveness of the audit and the independence of the auditor, but few actually say how they have satisfied themselves that they have received a quality audit.

Q49 **Mark Pawsey:** Can I challenge you there? Do they not say because you are not asking?

Liz Murrall: We have put out guidance for audit committees on a variety of issues, and we are going to be developing further guidance just to be clearer on this issue. We are also going to be convening regular meetings with audit committees.

Q50 **Mark Pawsey:** That sounds like a yes.

Liz Murrall: Yes, we are going to be doing this.

Euan Stirling: We are doing that just now. To Leon's point, there is a minority of significant investment institutions involved actively in this part



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of our responsibilities. We are meeting with audit committees regularly; we are encouraging them to do more in terms of adding transparency to that, doing better reporting and doing more reporting. Through that we expect higher-quality audits and higher-quality appointments of auditors.

Q51 Mark Pawsey: Are those more regular meetings leading to a cosy relationship or to a more challenging relationship? Challenge is clearly what we are looking for.

Euan Stirling: Absolutely. It is us challenging the audit committee to challenge the finance function and the auditor. There should be challenge all the way through that process of authority.

Q52 Chair: Can I just follow up with a couple of questions? You will have heard in the first session this morning that there is a view about how auditors are appointed and whether they should be appointed by the new regulator that Sir John Kingman has recommended. Sir John Kingman says that could be a more radical option. It is not his actual recommendation, but he said that was something that could be done to change the cosy relationship between the auditor and the audited. The Investment Association was not keen in the written evidence you gave to us, but I would keen to explore this with you, Mr Stirling, and the others. Euan Stirling, you came and gave very helpful evidence to us in the Carillion inquiry on your worries about the audit and how you were not able to rely on it in the way you needed to in order to make investment decisions. Perhaps we could start with you, if you think auditors should be appointed in a different way.

Euan Stirling: Greater oversight from a new regulator that has more explicit powers in this area would be helpful, but I would worry if that appointment was taken away from shareholders. That would break that relationship of stewardship. It might have further adverse unintended consequences.

Q53 Chair: It is the audit committee chair who essentially appoints, but that is on behalf of shareholders.

Euan Stirling: Yes, it is on behalf of the shareholder.

Q54 Chair: Okay, so you agree with Sir John Kingman's recommendations that perhaps you should have someone from the regulator in the room. If there has been very poor quality, the regulator could step in.

Euan Stirling: Indeed, but it is useful if a new and more powerful regulator holds the chair of the audit committee to account for that appointment, rather than interfering in the appointment process itself.

Leon Kamhi: The key thing is not to take the accountability away from the chair of the audit committee. Otherwise, it becomes your appointment and they say, "Well, it was your appointment". They are the ones who need to be responsible day to day, so we have to be careful not to micromanage from this side.



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Q55 **Chair:** So are you happy with Sir John's recommendations?

Leon Kamhi: If you mean his recommendations in the side letter, no.

Chair: Not the side letter but the overall report.

Leon Kamhi: Yes.

Natasha Landell-Mills: I would also be supportive of that recommendation. The fear, ultimately, is that you replace market failure with regulatory failure. We have to ensure we get the balance right. At the same time, going back to the earlier point, as part of all of this, we need much more disclosure to shareholders, so that shareholders have the information to hold the audit committee chair to account. We also then need scrutiny of the shareholders in what they are doing in enforcing that.

Q56 **Chair:** Liz, we have three investors here today who invest in a lot of the companies we talk about in this Select Committee. Do we have a representative sample of investors here today? Do we have the engaged ones here today who do take their stewardship responsibilities seriously? Are they at one end of the spectrum of investors?

Liz Murrall: You have a range of investors here. You have particularly well engaged investors on the accounting and auditing issues that we are discussing today.

Q57 **Chair:** Leon and Euan have alluded to this. Is there a frustration on the part of investors like yourselves that other investors are not stepping up to the plate? Is it a certain type of investor? Is it passive funds that do not engage and active funds that do? Is there a reason why you take a different view and play a different role than perhaps other investors do?

Leon Kamhi: It is fair to say that, in a sense, stewardship is our social licence to operate. Otherwise, how do we add value by trading shares? Some fund managers win and some fund managers lose, but in aggregate we do not add value. Stewardship is really what we need to provide. Historically, stewardship has not been that important. The vast majority of the activity of a fund manager is the trading and the back office that goes with it. As an industry—we are stepping up, but we have a lot more to do—we need to increase the level of stewardship that we do.

Euan Stirling: One way to do that would be to encourage asset owners to take that more seriously and to hold us to account as asset managers. We do find that these considerations are making it into fund-manager selection processes, but increasing the weighting attached to that would be helpful in encouraging asset managers to do more.

Q58 **Chair:** You mean the ultimate shareholders.

Euan Stirling: Yes, the pension funds and the insurance companies, the big blocks of assets.



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Q59 **Chair:** When they choose you, they should be asking you questions about how you approach your role as stewards.

Euan Stirling: Exactly.

Q60 **Chair:** Natasha Landell-Mills, did you want to add anything?

Natasha Landell-Mills: Not really. I think I would agree with that.

Chair: That is a very refreshing answer.

Q61 **Drew Hendry:** Do you believe that audits really do ensure that accounts make the Company Law Act 2006 in terms of giving a true and fair view of the assets, liabilities and financial position and profit or loss of the company, but is there a danger that the audits have simply become a box-ticking exercise; following standards, but not expressing a professional, informed judgment on the financial state of the company?

Liz Murrall: Yes. We very much welcomed the enhanced audit report that was introduced for year-ends from 2013 onwards. The FRC was a pioneer in that, internationally. This required the auditor to give a much more discursive opinion. They reported on the risk of material misstatement and the scope and materiality used. It was very interesting that one audit firm, KPMG, went one step further, and in relation to the risk of material misstatement they reported graduated findings, i.e. whether management's judgments were pessimistic or optimistic when they were preparing the accounts. Investors really welcomed that.

KPMG then wrote to all its audit clients and said "Investors want this. Can we do this for all our audits?" It was disappointing that they did not take it further, and only nine clients agreed. That did not send a very good message to the investor community, who are the real clients of the audit process and wanted these graduated findings. We very much welcome Sir John Kingman's recommendation 53, which suggests that the regulator considers introducing that for all audits. That would give investors much more information on what the auditor had actually found.

Q62 **Drew Hendry:** Unpacking that—and I will come to you, Natasha Landell-Mills—is it a fair and true view?

Natasha Landell-Mills: No. Our biggest concern with accounting standards today is that they are not aligned with the true value requirement in company law, in that they are not aligned with fulfilling the capital maintenance requirements, which is particularly set out in part 23. Effectively what you are talking about when you are talking about capital maintenance is a regime that ensures that the paid-in capital that the shareholders are providing is protected, so that directors are not making any distributions out of that. What they are making distributions out of is a value that has been created by the business. That is an absolutely fundamental pillar of the entire Companies Act in that it underpins trust in companies, such that we are therefore willing to hand over equity into these businesses and know that that capital is protected.



The difficulty that we see is that the core means through which that capital maintenance regime is implemented is through the accounts, but the problem is that International Financial Reporting Standards—IFRS—are a set of standards that are designed not to fulfil capital maintenance. It is a set of standards designed to ensure comparability of performance internationally, and so there is a disconnect there, and that is where we think the core problem lies with much of this discussion.

Q63 Drew Hendry: I will get the view of the other two, but can I add a further question to that? Should auditors report separately on the distributable reserves of capital of companies?

Euan Stirling: The auditor can only report on what is put before them, so I guess at the root of your question is whether companies should be disclosing those additional pieces of information, and we would find that useful. Just to support the point that Natasha was making, with the introduction of International Accounting Standards we have lost—or certainly it has been suppressed—the overriding concept of prudence being applied, the professional judgment that was referred to earlier. That appears to have lost its importance, and reasserting that would be useful as well.

Liz Murrall: Could I just say how investors use accounts, just to put this into context? I am here from the Investment Association. We have 250 members; they have £8 trillion in assets globally. 67% of those holdings are held outside the UK, and what investors want is accounts that show international comparability. IFRS is not necessarily perfect but it is the best tool to do that and it is very important. We want accounts that allow us to make investment decisions and capital allocation decisions, and also hold management to account. It is vital that these accounts are subject to a quality audit. Part 23 of the Companies Act, which Natasha is referring to, does not relate to the group accounts that we are addressing here in the FTSE 350 companies; it is actually the parent-only accounts. That is a completely different concept to the international group accounts that investors are interested in.

Leon Kamhi: Liz is right. There needs to be comparability internationally; however we must not lose facts. We want to see what the performance of the business is, and this whole mark-to-market thing can lead to unintended consequences. I will give you an example. Someone has £100 million of debt with a company. It is in distress. That is marked down to £50 million, so what goes into the account is £50 million but the company still owes £100 million. Regarding realised gains and unrealised gains, coming into the crisis the banks paid huge bonuses on unrealised profit, and those profits were not realised. Not only were they not realised, but there were huge losses that occurred because they actually went through that. It is so important for us to understand what is realised and what is unrealised, and also—and this is not easy and I do not have the answer on how to do it—what the quality of the profits is, because a profit could either mean that you are going to achieve that profit in the



years to come or it might mean that it is just a one-off. In terms of unrealised, it could be in an instrument that is so volatile, or it could be in something that is much firmer. We need to understand better what the quality of profits are.

- Q64 **Chair:** As you know, we came to this issue of the future of audit because of the collapse of Carillion and what we saw when we took evidence on that. Our ultimate goal is to improve the quality of audit, because there is a huge amount of evidence that there are problems—not just at Carillion, but you have mentioned Tesco and BHS, and the FRC saying that 27% of audits are not of a high enough quality. We are then also drawn to the fact that there is a lack of competition in the sector; there are essentially just four firms competing for the audits of the listed companies and public interest entities. In your view would increased competition lead to an improvement in quality, or is there a conflict between the two? If we try to bring more into the market, do we potentially risk diluting the quality of the audits? Do you have views on that, any of you?

Natasha Landell-Mills: The previous panel also touched on this quite well. If you have competition around the wrong product, you will potentially make matters worse. That is what we are touching on here. We have to figure out what exactly the audit is there to do, and the audited accounts are there to deliver for shareholders. Once that is very clear then competition around that will be a good thing. We need to make sure we are not putting the cart before the horse by trying to increase the number of firms from four to eight. Having eight firms trying to deliver the wrong thing is certainly not a better situation than having four.

Euan Stirling: The two issues in my mind are definitely linked. We talked earlier about the appointment process; that is a process that is struggling at the moment because there is a lack of real choice available to audit committees when they are seeking to go through the tender process. That can boil down to technical skills. It is particularly acute when there is the provision of non-audit services because it makes the audit firm non-independent, so that choice of four can quickly become three or two. That consolidation at the top of the profession has led to a drop in professional standards. It has led to complacency, because it has happened over so many years.

I would describe the issue that we have associated with choice and competition as a chronic one rather than an acute one. I would support the mechanisms that have been suggested by the CMA and by the Kingman review as things that we should try, over the course of a period of time and perhaps in a phased introduction, particularly joint audits, as a way of addressing that.

- Q65 **Chair:** Let me come to that. Peter is going to pick up on the issue of an operational or a structural split within the Big Four. I wanted to ask about the joint audits. How easy would it be to implement joint audits for listed companies in our country?



Liz Murrall: One of the issues with joint audits is that you have joint liability. If the aim is to increase the remit of the challenger firms, I really question if you have a BP—or whoever; I do not know who audits BP now—and you have a PwC and you have a Moore Stephens, they are jointly liable. What does that do to their professional indemnity? That makes that very difficult.

Q66 **Chair:** There is a difference between shared audits and joint audits. On a joint audit you would be joined and separately liable. With a shared audit you could share out.

Liz Murrall: You could divide up the work, but then you would always have the issue that you would still always have a junior player, so it would not necessarily open up the market.

Q67 **Chair:** What do others think?

Euan Stirling: What would be useful—and it would need to be carefully monitored by a new and more powerful regulator, because joint audit could cover a multitude of different approaches—is in some cases an extra pair of eyes, specifically in instances where there is a lot of judgment being applied to the production of the accounts and the annual profit figure. An extra pair of independent eyes could add additional assurance to the whole audit process, and that is why we would support the gently phased introduction of that.

Q68 **Chair:** When you say “gently phased”, what do you mean by that? Do you mean starting with a few firms?

Euan Stirling: Exactly; try it and see how it goes. Isolate the areas where you think it might add most value, and have very clear oversight by the regulatory body to make sure that whatever objectives you are setting in the mandating of a joint audit are more likely to be met. You could use that as a template then to roll it out.

Q69 **Chair:** In a joint audit would you split the work 50/50, or do you think that would be unnecessary or even not possible at an early stage?

Euan Stirling: It would absolutely be determined by the circumstances. If you had the introduction of a very small firm taking on part of the audit you would not want it to be 50/50. Pragmatism would have to prevail.

Q70 **Chair:** Euan Stirling, you mentioned that the advantage of a joint audit would be that two sets of eyes were cast over the accounts, and different views. There is also the argument that over time it would enable challenger companies to gain the necessary experience, expertise and reputational benefits to be able to take on more work and then have more genuine competition. Would that be a good thing in itself, having more choice in the sector?

Euan Stirling: I think so. If we are talking about a profession that is too concentrated then that would help to break down the barriers to entry for some of the challenger firms.



Q71 **Chair:** Another option put by some are shared audits or peer review as another way to allow challenger firms to get more experience without—this is the point that Liz raised—the liability, but also perhaps without the visibility. Liz, would you be more sympathetic to that sort of approach rather than the joint audits?

Liz Murrall: There is no silver bullet to any of these. As Euan says, they would need to be gradually explored. We do have concerns about joint audit; there is no evidence that in France where it is mandated that it has necessarily improved audit quality, and that is really key to institutional investors. There may be a case for exploring peer reviews. Firms could gain expertise and knowledge from the larger firms by doing that. I do question some of the issues around joint audits—the liability issue, issues falling between the gaps, and also you are limiting choice because you have got two incumbents if you are tendering your audit.

Q72 **Chair:** But the whole point of it would be that it would not be a joint audit between PwC and KPMG; it would be a joint audit between a big one and a challenger one, so over time it would mean that there was more choice because more would have that expertise.

Liz Murrall: There would be more choice on the market, but immediately there would be a limit on choice because you have two people that are ruled out. We have seen in France that, if you look at the CAC 40, they are all audited by two of the main firms.

Q73 **Chair:** Yes, and so, if you were going to do this, one of the practicalities is that you would have to put in some sort of clause that you could not choose two of the Big Four to do your joint audit. Would that be your view? You would not want a situation where you now have two of the Big Four providing audit; it would be a Big Four and a challenger firm, certainly in the first instance.

Leon Kamhi: I would agree with that. We should be careful not to mix the quality and the competition. The peer review is really good for quality but might not address the choice and less concentration in the market. We should see less concentration in the market as the objective, and there is no straightforward way of getting there. All the remedies have their issues, but we should not lose sight that we want more competition and that we want less concentration, as much for the resilience reason as for anything else. KPMG South Africa did not go under because who wanted to go to the Big Three in South Africa?

We have been battling this around since 18 December internally, and we are really struggling to decide whether joint audit is better or market share cap is better. They all have their pros and cons. We would say what should drive the decision should be that there is choice, and the auditor does not choose. You need to avoid the cherry-picking. The second thing is you want to get the market to get back in as quickly as possible, so once you impose the market share split, the market is then able to operate. We have struggled to have a very clear view.



Q74 **Chair:** You have come to an important point there. Every different presentation or combination of changes recommended by the CMA, Sir John Kingman and potentially our Committee, has advantages and disadvantages. The easy thing is to stick with the status quo where we are at the moment, but that does not work and it has failed, so we have to take a risk on something else. We need to make sure we have thought through the consequences of anything we do, but when we make a change we have to be honest that it is not perfect but we are replacing a highly imperfect system, and so it right to try something new.

Leon Kamhi: I would agree with that.

Q75 **Peter Kyle:** Natasha, how practical is an operational split between audit and non-audit?

Natasha Landell-Mills: That is certainly a concern: how would you actually implement it in practice? This idea that you would have some items that would be shared—back office, training, technology, et cetera, would be shared—between audit and non-audit makes us feel a little bit uncomfortable. In fact, we started out saying that we felt that the core requirement should be that the auditor cannot do non-audit work and there should be a cooling-off period of three years, but having looked at the CMA's evidence that they have gathered, et cetera, and what Sir John Kingman has put forward, this idea of working out how an operational split would actually function in reality and whether that would genuinely deal with the conflicts of interest is problematic. For that reason, we would favour structural.

Q76 **Peter Kyle:** Does anybody have a view on structural split?

Leon Kamhi: To be honest, there is not that much difference between the two. What the CMA are suggesting is that you have a profit pool for audit and a profit pool for non-audit, and you have audit partners, who basically own the firm, only looking at the audit profit pool, and then the other partners looking at the other. What they then get into is a supplier agreement between them, in terms of using other people's resources.

I am going to be cautious on this one. We feel that there are a lot of other things that we should be getting at first. Do we have evidence that this is the real reason for poor audit quality? I am not so sure that this is the major driver. I recognise we would much prefer it to be cleaner. It would just be much cleaner; different people have different incentives.

Q77 **Peter Kyle:** Do you think it would have any impact on quality or competition?

Leon Kamhi: It could in the interim. Eventually the quality will go up, but in the interim it could have an adverse impact on quality. I would much prefer, if these guys are going to be doing the audit in the future, to focus on getting closer to a true and fair view, being stronger in terms of quality of profit and the like.



The other thing I would be looking for, which I do not think is in the CMA review—I looked for it but I could not see it—is there being strong governance around either the audit firm, if you do split it, or the audit and consulting firms. We would be looking for an independent chair, we would be looking for a majority independent board and we would be looking for disclosures that looked like a listed company's, so there should be an annual general meeting and an annual report.

In terms of the incentives, at an audit firm there is real pressure to get that profit per partner up. There is real pressure, as otherwise you might lose the partner. Do the partners also get reviewed on audit quality? The incentives are really important to get right.

Thirdly, are the resources right in the audit firm? Is there enough diversity, less in terms of gender but more in terms of the skills you are bringing to bear?

Fourthly, are there enough quality reviews going on internally? We would expect all this to be disclosed and presented back, because ultimately audit is a public services service, and so it is important that they disclose much more. They have started with two non-execs or three non-execs. Some have good ones and some have less good ones. They have really got to get their governance right.

Peter Kyle: Thank you. That is the first time I have heard audit described in a context of public service. That is quite a helpful way of looking at it.

Q78 **Anna Turley:** Leon, just now you talked about how you had been batting around internally some of the proposals. One of the ones that I wanted to focus on is the issue of market share cap. Do you think that is a good option? If so, why, and at what level should it be set?

Leon Kamhi: I would not want the market share cap to be chosen by the auditors because of the cherry-picking issue that the CMA raised. It could be, as some of the Big Four are saying, imposed from outside. If you have it imposed from outside what that does is take away the choice and accountability from the audit committees, so it is not great from that point of view, but at least once it is in place the market is allowed to move on with it. Those are what we saw as the cons and pros of that one.

Liz Murrall: We broadly had more support for a market share cap than some of the other remedies. In particular, if a firm was nearing its cap it may incentivise good staff to move to one of the challenger firms. That would actually enable them to increase their resources. As Leon has said, there are issues around cherry-picking. It would need to be kept very carefully under review and monitored to ensure it did not have any adverse consequences, and also, if you imposed it, do the challenger firms have the capacity to pick up that 20% of the market? Do they have the global reach to do that? That could adversely impact quality if they did not.



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Euan Stirling: One of the attractive aspects of the way that the CMA has put its recommendations together is that there is not one single recommendation that they think will fix the issues that we are trying to address, and so this will be part of a menu of options.

- Q79 **Vernon Coaker:** We talked in the last session about the CMA's concern about professional scepticism and perhaps the too cosy relationship between the auditors and the people they were auditing. What is your view about their suggestions about increasing that level of professional scepticism? Do you accept that they are right? Does anyone want to start with that?

Euan Stirling: I agree with the principle that is being discussed. Accountants view themselves as professionals. They consider that auditing and accounting is a profession, and it requires that degree of separation from your customer, from your client. I would just go back to the point that I made earlier: that a degree of complacency has crept into the profession, where commercial considerations are clearly being allowed to rise in the balance of decision-making within some of the accounting firms at the expense of the public interest or ethical considerations.

- Q80 **Vernon Coaker:** What can we do about that? What should be done about it? The CMA has made a number of recommendations.

Euan Stirling: The broad range of measures being proposed here goes some way to addressing that. Hopefully, in the future we will end up with better governance, with more concerned audit committees and, standing behind them, a group of more concerned investors. That should reassert the right balance of professional scepticism, in my view. Seeking to break up the whole construct of corporate responsibility is probably taking on a job that none of us around the table would want to consider at this point. If we accept that we have a construct that can and should work, and has worked in the majority of cases, then tightening up some of the rules and regulations around it will serve us well.

Liz Murrall: We need a lot more transparency from audit committees, in terms of how they have satisfied themselves that they have had a quality audit and that the auditors have challenged management and they have questioned the key assumptions and judgments. This is not currently transparent in the audit committee reports.

- Q81 **Vernon Coaker:** The CMA did not totally agree with what you have just said. It challenged whether there was enough professional scepticism. They were saying that the relationship was too cosy. Do you not accept that, or do you think they have gone over the top?

Liz Murrall: It is not really transparent to investors. That is where we want audit committees to report on how they have ensured the auditors have been challenging, and that would in turn encourage the auditors to be challenging.



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Q82 Anna Turley: Obviously we have talked a lot about the recommendations in the Kingman report, and it suggested that the proposed Audit, Reporting and Governance Authority should take over the registration of audit firms conducting public interest entity audits from recognised supervisory bodies like the Institute of Chartered Accountants. Do you think this would deliver improvements or not?

Natasha Landell-Mills: Could you just repeat that?

Anna Turley: There is a recommendation that the Audit, Reporting and Governance Authority should take over the registration of audit firms that are conducting public interest entity audits; would that work?

Natasha Landell-Mills: Again, it is one of a package. It is absolutely one of the biggest concerns that we have had. It has been the power that the institutes—the professional associations like the ICAEW, have retained within the regulatory framework, and yet they are not themselves a public body and do not have the public interests at heart. It seems slightly odd that they have retained so much responsibility and authority to make those sorts of decisions. I absolutely think that a reconstituted, independent regulator, which has a firm statutory basis, taking on the responsibility for the approval of the auditors, amongst other things, makes a lot of sense.

Q83 Anna Turley: How could you see that implemented, Euan?

Euan Stirling: As Natasha suggested, you transfer that responsibility to the new regulator. They obviously have the power of sanction if they are carrying out the reviews of auditors; they are owning and controlling the codes of corporate governance and of stewardship. It puts them in a very good position to be able to pass judgment on the auditing firms and decide whether or not they are appropriate. It would also allow them the ability to introduce non-accountants to the world of auditing, which an accounting institute is unlikely to do.

Q84 Anna Turley: Are there any downsides that anyone can see? I will move on to the question that you might have heard me ask in the first session as well, about whether we should give serious consideration here in the UK to the US Sarbanes–Oxley regime, whether that could be adapted and what the advantages and disadvantages are.

Leon Kamhi: If I am honest I do not know Sarbanes–Oxley very well, but six or nine months ago we were acquired by a US firm.

Chair: You do now.

Leon Kamhi: And now I have to attest every quarter. It does focus the mind. With the attestation, there is no harm, and hopefully I will not get complacent about it over time, but I think the attestation helps.

It makes sense, from a common sense point of view, that the auditors should look at the controls that there are the company. It is a no-brainer that they should do that. If that is part of bringing Sarbanes–Oxley here,



that is a good thing. There is one thing I would caution, though. I should disclose that I used to be a consultant with Deloitte over 20 years ago. Sometimes if you look too much and you just rely on the systems and controls, you miss the big picture. It should not be a replacement for going in and really speaking to the people, and really understanding the business. Yes, those should come in, but let us not lose that other side.

Liz Murrall: I would be supportive as well of consideration being given to it. Under the corporate governance code, directors are required to report on how they have ensured a sound internal control system. We are not quite clear what exactly that involves in practice. Regarding the auditors opining on that, I used to be an auditor. We used to do compliance testing at the interim, where we tested the controls, and then we did substantive testing at the year-end, where we did testing of the balances. Now we have got very much big data; the auditors can penetrate the whole population and analyse it. That is moving the whole audit approach to more substantive testing. We are investors; we want to invest in well-governed and controlled companies, and it is very important that somebody is looking at those internal controls and making sure they are effective.

Euan Stirling: There is statutory provision in the UK in the Companies Act 2006. It is section 172. It obliges company directors to act in the best future interests of the company, so it sits at a much higher level than Sarbanes-Oxley. There has been debate amongst the investment community, as well as the corporate community more broadly, as to whether more detailed provisions are required, because it is not clear that section 172 is enforceable in any way. A review of this would be very welcome.

Q85 **Drew Hendry:** As we have heard, Sir Donald Brydon is currently leading a review of audit standards and what the purpose of audit should be. It seems that audits are not really fit for purpose at the moment. First of all, do you agree with that assertion? If so, what specific issues should Sir Donald be looking at? Perhaps I could come to Leon Kamhi first.

Leon Kamhi: I would just go back to what we were talking about before, which is the true and fair view and prudence, and how to sit that alongside the IFRS, which we have, and how to make that really work on some of the capital maintenance regime issues that Natasha eloquently talked about before.

I would also say there is definitely something about the audit committee—as Liz has spoken very well on—and how it could reflect back on what it is doing, and how there could be more shareholder engagement.

I would also like to put forward, just as an idea, something that could be trialled. Maybe there could be a shareholder committee that is elected by shareholders, and that shareholder committee could not only review what is going on in terms of the audit committee but could also review what is



going on in the remuneration committee and the nominations committee. That way we could get more engaged. There is obviously a resourcing issue in trying to get it done, but that way just implies that we will have more engagement from the shareholders, and then those shareholders on that committee would be accountable to the other shareholders in that particular company.

Natasha Landell-Mills: Leon put it perfectly. Above all we have to remind ourselves what exactly the audited accounts are there to do. He needs to dig into that and flush out all these different arguments.

Euan Stirling: We have talked at some length about the expectations gap and the quality gap. Both do exist, and we have been trying to encourage audit committee chairs to expand the scope of their audit, so not just to look at the numbers in the profit and loss account and the balance sheet, but to think more expansively about what that means for the company's future. We have had limited to zero success in doing that so far, but I would encourage Sir Donald Brydon to look into that. You could also shine a brighter light on some of the existing mechanisms already in place, and add transparency to outside users of accounts, shareholders and others, to exhibit how that professional scepticism is being applied at every stage of the process.

Liz Murrall: Corporate reporting has evolved. It has changed over time, but no one has really looked at the scope and the purpose of audit. It has been very much set as to a true and fair view on the accounts, and it is probably time that we started to look to see whether or not audit assurance over the wider matrix that companies report on their performance should be covered by audit.

Q86 **Drew Hendry:** I have one final question just following on from that. Should audits meet the needs of wider stakeholders, including the public, and should they include information on corporate governance issues such as executive pay, company payment processes, especially those involving small companies, and things like that?

Leon Kamhi: Currently the audit does cover the numbers in the executive pay report. Overall, something that we have not talked about is what company reports are there to do. We believe it should go beyond the financials.

Drew Hendry: To the wider public.

Leon Kamhi: Yes, and also to think about what the returns are to other stakeholders. If you get the returns to other stakeholders right, the company is likely to be more sustainable in the future, as long as you take a sufficiently long-term horizon. We would suggest that the audit and assurance could be much broader than just simply the financial accounts. We would also say that these company reports have got very, very big. I am not the greatest brain at Hermes; I do not understand a lot of what is in it, and that is certainly true of banks and insurance. How



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do we make some of the accounts a little bit more intelligible—that is why they are there—for anyone in the street?

Q87 **Drew Hendry:** Would the other members of the panel like to add anything to that?

Natasha Landell-Mills: One of the reasons it is required by law to have an audit is because it is in the public interest, and that is absolutely the starting point. We need to have a system that makes sure that the corporate sector is as sustainable as it can be, and audit is a part of that.

Euan Stirling: Every business activity these days needs to consider its position in the society in which it operates, in terms of its social purpose. Addressing public concerns is important.

Q88 **Chair:** Can I just come back to one point around stewardship? I will address my question to Euan Stirling. You said, Euan, that better stewardship is part of the answer to low audit quality, but Sir John Kingman in his report thought the Stewardship Code was so weak it might as well be abolished. He was very critical of investors and the stewardship role that you play. Do you disagree with Sir John on that? Would you stand by these points that stewardship is part of improving audit quality?

Euan Stirling: I would argue against some of his analysis, but certainly against the conclusion. There are two ways of addressing this. You can seek to enhance the standard of stewardship by introducing a stronger code, by more effectively measuring the activities of us as investment managers and stewards of our clients' capital. That would be a much more positive response.

Q89 **Chair:** You would say strengthen the stewardship code through legislation, and also as Leon Kamhi suggested, you would like the investors to play a greater role, not just on audit but also on remuneration and other issues that this Select Committee and others have spoken about.

Euan Stirling: Yes.

Q90 **Chair:** Can I come to my final question? I asked it to the last panel at the end. Of all the different suggestions that we have heard from the CMA, from Sir John Kingman and from others about how to improve audit quality, are there particular recommendations or suggestions that you might have that you think are particularly important and could really deliver change?

Liz Murrall: More scrutiny and better reporting by audit committees would enable shareholders to exercise their stewardship responsibilities and hold audit committees and auditors to account.

Natasha Landell-Mills: For fear of sounding like a broken record, the key thing for improving audit quality is making sure that we know what a high quality audit looks like. With regards to the actual proposals, the



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points about transparency are absolutely vital, because sunlight, as ever, is the best disinfectant.

Leon Kamhi: A focus on business quality, not a box-ticking exercise.

Euan Stirling: There is no silver bullet. You need to look at all of the measures that have been suggested in aggregate and introduce them thoughtfully.

Q91 **Chair:** So introduce the Kingman and CMA proposals and hope that, together with some of the suggestions that others have made, that improves the quality. Would you all be comfortable with that?

Leon Kamhi: Yes.

Euan Stirling: I am not sure.

Natasha Landell-Mills: I am not equally supportive of all of the CMA's proposals. Some of them require more analysis, particularly the joint audit, but things like peer reviews and looking at the operational structural split are absolutely vital.

Liz Murrall: I agree. There are unintended consequences with each of the CMA proposals and they need to be considered carefully before they are taken forward.

Chair: Thank you very much for your time today. It has been a really interesting session.