

Business, Energy and Industrial Strategy Committee

Oral evidence: Future of Audit, HC 1718

Wednesday 23 January 2019

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Watch the meeting

Members present: Rachel Reeves (Chair); Drew Hendry; Stephen Kerr; Peter Kyle; Sir Patrick McLoughlin; Mark Pawsey; Antoinette Sandbach; Anna Turley.

Questions 92 - 189

Witnesses

I: Steve Barber, Audit Committee Chair, AA plc; Margaret Ewing, Nomination, Audit and Risk Chair, ITV.

II: Sir John Kingman, Chair of the Independent Review of the Financial Reporting Council.



Examination of Witnesses

Witnesses: Steve Barber and Margaret Ewing.

Chair: Thank you very much, Steve Barber and Margaret Ewing, for coming in to give evidence to our Select Committee this morning on the future of audit, particularly looking at the role of audit committees. We really appreciate the time you are giving to us and your knowledge and expertise. We have two sessions this morning, the first with you and the second with Sir John Kingman. Then it is Prime Minister's questions, so we will try to get through our questions to you in a slightly politer way than will happen in the Chamber in a couple of hours, but we will try to do it quite efficiently as well.

Q92 **Sir Patrick McLoughlin:** Steve and Margaret, thank you very much for coming in. I echo exactly what the Chairman has just said. Audit has come a lot more under the public spotlight because of recent events and I want to come on to that shortly. Last week, one of our witnesses questioned whether audit committees are independent of management because they are recommended by the management, basically remain under management control and rely on the management to keep those positions. How would you address that? What would you say to that criticism?

Steve Barber: We are appointed by the board, but everybody relies on our professionalism. Most of us have been professional accountants before. I think you said we were under the control of the board. I do not agree with that at all. We are completely independent.

Margaret Ewing: To clarify, was your question about the auditors being under management control?

Q93 **Sir Patrick McLoughlin:** Yes, the audit committee, the chair of the audit committee. It is appointed by the board. A cosy relationship develops.

Margaret Ewing: As Steve has mentioned, the audit committee is appointed by the board, the non-executive directors and the chairman, all of whom are independent. It is not management, even though management members, the CEO and the CFO, are normally on the board. They may have a say in it, but they do not undertake the appointment. As Steve has indicated, audit committees and the audit committee chair remain as challenging to management as one would hope. Our role is to be challenging but also supportive, and to help improve the performance of the company but also the performance of management. We do that and we challenge where necessary. I would totally refute the comment that we are under the control of management.

Steve Barber: The majority of the board should be independent directors. In my experience, they are independent. They are not under the control of the executive, but they rely on the executive for a lot of information.



Q94 Sir Patrick McLoughlin: If we can move on to the high-profile failures or things that have led to some of the questions, we will look at Carillion and perhaps more importantly Patisserie Valerie. We did have profit warnings about Carillion, but Patisserie Valerie seems to have been a shock, completely out of the blue. Steve, you are chair of the Domino's Pizza Group. In a way, I would say there is a similarity. They are not exactly the same sorts of companies but there is a cross between Patisserie Valerie and Domino's Pizza. How do you think that has come about? How has that happened? How is a company that was worth £500 million three months ago now bust?

Steve Barber: I wish I knew the detail, which I do not. They are in the same business of providing food. It is as simple as that. From what I have read, and it is only in the press, there was a fraud by the finance director, maybe others, and clearly a very extensive fraud, but that is as much as I know.

Q95 Sir Patrick McLoughlin: How are we going to prevent this happening again? I accept that we do not fully know the situation. There could be charges coming and therefore, at the moment, it is a matter of speculation as to what actually happened, but it is very, very disturbing.

Steve Barber: I wish I had the answer to that. The only thing I can say is that sometimes a fraud cannot be discovered. One would expect the audit committee, the auditors and particularly the management to address these things, but if you have collusion and fraud at the top level it is very difficult to find. I do not know the detail of it.

Margaret Ewing: As non-executives, we have a very significant responsibility to not step in to undertake management's job unless things are really very wrong. We have to remain independent. That is how we do the job you ask us to do. As non-executives, you are very dependent on the quality of the information that comes to you and the relationship that you have with management. While you want to be challenging, as I have also mentioned, you need to be supportive. You need to have that open relationship so that management do bring bad news up to the board. If you do not have that and if you have collusion, as Steve has referred to, it is extremely difficult for any board of non-executives to really understand what is going on in the company. Collusion with fraud is very, very difficult for anyone to identify.

Steve Barber: In my experience, the auditors have often been blamed. The first line of defence and the first line of blame is management. It is as simple as that.

Margaret Ewing: You asked how we can prevent it. We need to look at the regime for penalising management when these things happen. At the moment, the professionals, those who belong to the Institute of Chartered Accountants, if they are the CFO or in management with that professional qualification, get penalised but other management get away. That whole regime needs to be extended.



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Q96 Sir Patrick McLoughlin: I take your point about management and the responsibilities. I accept that it is very difficult to talk in detail about this particular case because there is an ongoing investigation and there could well be criminal charges. But what penalty should fall on the auditors who have still allowed this to happen? In a way, you cannot really say, "As auditors, we can only rely on what the management is telling us". Otherwise we might as well not bother having audits. We might as well forget the audits. They are very expensive. There has to be something else behind that.

Margaret Ewing: Absolutely, yes. One of the roles of auditors is to find evidence to support their judgments. For auditors, if there is evidence of negligence, possibly collusion—I do not know—and they have not performed a quality audit, there should be penalties, which should be monetary. Possibly, depending on what the conclusion is regarding what has happened at Patisserie Valerie, there may be even a penal sentence in prison. The firm and the people involved should be penalised.

Steve Barber: The regime of penalties will possibly focus more minds in the Big Four firms or even the top 10 firms than anything else. If we want to increase quality, and to my mind everything we are talking about is quality rather than competition or choice, that is one of the factors that will really stop quality dropping. If people see their reputations ruined and a fine running into many millions of pounds, as they now are, the firms will put immense focus on the quality.

Q97 Chair: Thank you for those remarks and that insight. Some people have suggested a Sarbanes-Oxley-type regime for the UK where the directors of the firms themselves, not the audit firms but the firms you are non-executive directors for, take greater responsibility and sign off the accounts. Is there merit to those sorts of ideas?

Margaret Ewing: A lot more can be done in companies to improve internal controls. There is no doubt about that. Sarbanes-Oxley was a way of doing that in the US. Companies in the UK that are listed in the US have a light form of Sarbanes-Oxley. There were some issues with Sarbanes-Oxley in the way it was implemented. It went to one extreme, but some additional focus on internal controls, whether it be a Sarbox-lite or some other form, would probably be an improvement.

Q98 Chair: Do you share those views, Steve Barber?

Steve Barber: Yes.

Q99 Peter Kyle: Margaret, I would like to ask you to expand on one of the comments you made a little earlier in relation to Patrick's question. We on the Committee are quite interested in the relationship between the chair of the remco and the chair of the main board. Many of us on this Committee have served as non-execs in businesses, so I understand the dynamic of a board. None of us have served as chair of remco before or, I do not believe, as chair of a board. You said a second ago, when it comes to appointing the auditors, that the chair has a say but they do not



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appoint. You said, in relation to the appointment of auditors, that the main board will have a say.

Margaret Ewing: Sorry, I was referring to the audit committee chairman, not the auditors. The audit committee chair and the board have the ultimate say.

Q100 **Peter Kyle:** All right. When the chair of the main board expresses an opinion about things, how is that interpreted by you? In general, what is your relationship with the main board and the influence it may have over you?

Margaret Ewing: All audit committee members are members of the main board, so you would expect the audit committee's recommendations to the board—for the approval of the auditors, approval of the financial statements—given that the audit committee comprises primarily experts in that field, in financial statements and current auditing standards, to be accepted and approved by the board.

Q101 **Peter Kyle:** The key word there is "expect". In your experience, which is considerable, has the board ever not?

Margaret Ewing: I cannot recall but there may be an instance. Purely using this as a hypothetical example, let me take ITV. We have on our board people who are steeped in media and what is going on in this current environment. They may have a slightly different view on the recoverability of a debt or the value of an asset because they know something that has not emerged through audit or at the audit committee. That would be highly unlikely, given the nature of the audit and the interface that all the committee members have with board members, but it is a possibility.

Q102 **Peter Kyle:** How much direct influence does the chief executive have? They would express a view. The executive would express a view. How much impact will it have on you if an executive has a view about the auditor? How do you take that into cognisance?

Margaret Ewing: You mean a view on the auditor themselves.

Peter Kyle: Yes.

Margaret Ewing: Okay. I would listen to that view, but at the end of the day I would make my own judgment and the judgment of the audit committee on that issue. We would not be overly influenced by the views of the executives.

Steve Barber: We are looking at the appointment of auditors. In my experience, the audit committee has made that decision and, in all the instances I have been involved with, the board has gone along with that. I would be extremely surprised if they tried to reject the recommendation of the audit committee.



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Margaret Ewing: Sorry. I thought you were talking about day to day, not the appointment.

Steve Barber: On the day-to-day, the chief exec has an influence but, again, the audit committee will be independent and make its own judgment.

Peter Kyle: As a comment, Chair, the relationship requires a lot of emotional intelligence. Not to make a generalisation, but you both said you spent your lifetimes as accountants. That is not a profession known for emotional intelligence. That is what we are trying to get to the bottom of. It is not a criticism; it is just an observation.

Chair: Unlike MPs.

Q103 **Antoinette Sandbach:** What criteria do companies use when appointing auditors? What weight would you attribute to the various criteria?

Margaret Ewing: The overriding weight and the most important thing, the priority, is the quality: the quality of the team, the quality of the firm. There are many ways that audit committees can judge that. You have the AQR reports and reviews from the FRC. It is possible now to understand what the AQR ratings have been for that particular sector within an audit firm. Take ITV and the media sector. You can even drill down to understand how the partner has performed in previous AQR reviews. You can get a really good sense of the quality of the team.

I also, and many other, if not most, audit committee chairs, will ask the team that is proposing to give examples of where they have challenged management and how they have resolved that challenge. Where there has been a disagreement and it has had to go to the audit committee, how have they dealt with that? I will then personally speak to the audit committee chair concerned to check that that is how it happened. We take references on the teams from current and previous audit clients. We spend a lot of time with the teams that are bidding for the audit. We also want to understand their views on the risks inherent within the business. That gives a very good indication of the quality of the team. We look at the methodology.

Q104 **Antoinette Sandbach:** Mr Barber, what do you understand by the term "cultural fit"?

Steve Barber: If I can add to Margaret's comments, she mentioned taking references, which is a very important point, but looking at the expertise and experience of the team and the firm is vital. In this day and age, the overriding quality we need, other than professionalism and scepticism, is expertise in IT because, without the IT systems, most of these businesses would fall over.

Q105 **Antoinette Sandbach:** Given the evidence that both of you have given, why is it that the CMA, having analysed a sample of auditors from the FTSE 350, found that the criteria for auditors such as cultural fit was



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more important than the factors such as the ability to challenge management?

Steve Barber: I gave evidence to the CMA and it started with that question. My answer was that the No. 1 factor we look for is robustness of the audit. We need challenge and everything else, but people have to work with people; you have to get on with them. Chemistry and culture is one factor. Margaret will add to this, but the overriding factor for the audit committee is to get a good audit, effectively regardless of cost. You want to make sure that audit is properly done and you want it to be robust. The CMA has missed the point there, that the No. 1 factor is getting a good audit.

Q106 **Antoinette Sandbach:** Given the limited number of companies that provide that level of audit, effectively it is the Big Four.

Margaret Ewing: Correct, it is. That is the reality because, as Steve has mentioned, we are looking for a significant number of additional skillsets beyond audit.

Q107 **Antoinette Sandbach:** Can I check whether either of you have had senior partner roles in the Big Four?

Margaret Ewing: Yes, I have.

Q108 **Chair:** Steve, have you, as well?

Steve Barber: I am not sure I would call it that senior. I was not in the management.

Margaret Ewing: I was a managing partner.

Q109 **Antoinette Sandbach:** The failures have happened despite audits from the Big Four.

Margaret Ewing: Yes, and failures will continue to happen. Not all failures have much to do with audit, but I will accept that there have been some failures in audit. At the end of the day, as Steve has indicated, a lot of auditing is around judgment and what you are able to glean from within the company. If the auditors do not have the ability to communicate well with management and draw information out, they are going to struggle.

Q110 **Antoinette Sandbach:** Steve, I want to come back to you. You gave evidence to us just now that quality should be there, almost regardless of cost.

Steve Barber: Yes. That is a battle with management sometimes, but the audit committee wants a proper audit done.

Q111 **Antoinette Sandbach:** Are you saying that accountants or people with audit expertise from different firms, not in the Big Four, do not have that quality and are incapable of providing that service? Is that really the evidence that you are giving to us?



Steve Barber: I would not say they are incapable, but they do not have the depth of resource that the big firms have. In my experience of having pitches and tenders from the smaller firms, they are in a different league.

Q112 **Antoinette Sandbach:** As a final question, how do audit committees ensure there is an appropriate level of engagement from senior auditors during the audit process? I say that in the context, for example, that Sky reported that Steve Denison, a senior partner of PwC, spent two hours working on the BHS audit before it was sold by Sir Philip Green.

Margaret Ewing: You are always going to get the outlier, someone who does not perform their job well. We are dealing with humans and there will always be error, negligence or weakness somewhere. No matter what processes or what regime you put in place, there will always be exceptions. That is very unfortunate. I am very conscious of how much time my lead audit partners put into the role, the time they spend within the company, the time they spend talking to management and the time they spend with me and the audit committee. It is very significant, particularly at certain times of year, such as this point in time, with the year-end being the end of December. I would expect them to be there most of the time. They go out and visit overseas businesses. They need to be out in the business. They are the eyes and ears of the audit committee at the end of the day.

Q113 **Chair:** Antoinette Sandbach gave the example of Steve Denison at PwC. Peter Meehan, who did the audit of Carillion for KPMG, has also just been suspended. It is not just one bad example. There is also the Tesco example. Who knows what happened in the audit at Patisserie Valerie? It does seem it is more than just a couple of people not doing a very good job. The idea that the quality from the Big Four is so good that we should not looking elsewhere does not really stack up with what we are saying. Do you see where I am coming from, Margaret Ewing?

Margaret Ewing: I completely understand where you are coming from. It is just extremely unfortunate that there has been a series of these examples in such a short space of time. My own personal experience is that the quality of audits has improved immensely over the last 10 to 15 years. There is no doubt about that. The use of technology and different audit techniques has helped to improve that.

Q114 **Chair:** Have either of you ever appointed, at either the AA and ITV or other firms where you are on the audit committee or the board, a non-Big Four auditor to audit the business you were involved in?

Steve Barber: Yes, I have, in a small, unlisted company, because we wanted a smaller firm of auditors. We appointed Mazars. I have also appointed BDO at other companies. There is a difference in quality, I am afraid, because they do not have the resource in depth. We were very happy with them for that business, but it was a small business.

Margaret Ewing: I have not for external audit because the companies I have been involved in have been global companies, but we have



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considered it. We are currently looking at doing an audit tender at ITV in the next year or two, and we are considering including them in the tender. I trained and became a partner at a smaller firm and then moved to Touche Ross, as it was. Even then, there was a huge difference in the experience that we were able to gain and the methodology of audit, because the larger firms can invest in the methodology.

Q115 **Chair:** Finally, before we move on, do you find it surprising that the FRC has found that 27% of audits are below standard, given what you have just set out to us, Margaret Ewing?

Margaret Ewing: They are saying that they are improving. I do not think they are saying that they are below standard. It is a different interpretation. The way that the FRC undertakes its reviews of audits is very much focused on what is written in the files rather than the way the audit was undertaken. The US PCAOB takes a very different view. I know from my own experience that, when the PCAOB comes to firms in the UK to do a review of their audits, everyone is very worried about it because it is so thorough. The PCAOB spends at least a day with the audit partner interrogating them on the audit, the company, the process they undertook, et cetera, whereas the AQR goes straight into the audit files and does not really understand those aspects.

Q116 **Chair:** If the process was so robust, you would not expect to see what we have seen at some well-known businesses.

Margaret Ewing: I am saying that I do not think the AQRs undertaken by the FRC were as robust as they could have been.

Chair: We will come on to some of these issues.

Steve Barber: The AQR is very much a tick-box exercise and does not focus on the commercial judgments. Very often, it is the commercial judgments that are at fault. Also, if you look at the AQR, I would focus on how many audits were not satisfactory. If a few boxes had not been ticked, it could put people into the third tier of those rankings. I would not be so worried about that; I would worry about the fact that it was inadequate and in the bottom ranking. There were quite a few of those.

Q117 **Mark Pawsey:** You have told us about the process of selecting a company to do the audit and what happens before the audit. You have touched a little on what happens during the audit process. I want to focus on that, if I may. Members of audit committees are very senior people. They may sit on a number of boards. I want to ask you this: do members of the audit committee engage with those carrying out the audit? The CMA found that some audit committees spent 400 person hours during an audit, yet on others there were only 20 hours spent. From your own experience, what processes do you go through? Would you talk to and engage with those carrying out the audit? Often, my impression is that those carrying out audits are stuck in a little room out of the way, dumped with a whole load of papers and computer files and just told to



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get on with it. What impact do you have as members of an audit committee into that process?

Steve Barber: I was surprised at the CMA numbers. I would expect to speak, as the chairman of the audit committee, to the auditors not just doing the audit but through the year on a weekly or monthly basis, so very regular and frequent communication. During the audit, that would probably increase. Communication is the key.

Q118 **Mark Pawsey:** Would you go and engage with the people actually carrying out the work at the coalface? You would engage with those individuals.

Steve Barber: Absolutely, yes.

Margaret Ewing: I would echo Steve's response.

Q119 **Mark Pawsey:** In doing so, do you think the auditors are providing the right challenge to the management of the business? How would you engage in that process? How would you know whether that was taking place?

Steve Barber: I would encourage that. Often, I will phone the audit partner and say, "Please have a look at this specific area and challenge it". As the audit committee, we obviously have much more detailed knowledge than the auditors of the day-to-day operations, because we have the board meetings and everything. We will know to a very large extent where concerns are, and I would expect to focus the auditors on looking at those and providing us with comfort.

Q120 **Mark Pawsey:** When you say you would focus the auditors, would you focus the employees of the audit firm carrying out the work or would your dialogue be with the senior partners? My question then is to what extent the senior partners in these big firms are aware of the actual activities of those carrying out the work.

Steve Barber: I would usually speak to the partner but often to the No. 2. If they did not know what was going on, I would be very upset.

Q121 **Mark Pawsey:** You would then go and talk to the operative.

Steve Barber: Potentially, yes. I have done that.

Q122 **Mark Pawsey:** Margaret, have you done that?

Margaret Ewing: I have done it in the past, yes. In the way that audits, particularly of the large companies, are structured, there is a very big senior team and then they have their own sub-teams underneath each area of the audit. You would have a conversation with the relevant person who is leading the teams, depending on which area it is. You would always inform the senior partner. You cannot go around that.

Q123 **Mark Pawsey:** Once the audit team comes up with its report, what do you do then as an audit committee? Do you let them bring out the final



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report and then get involved, or would you get involved before the final report? What engagement would you have at that stage of the process?

Margaret Ewing: As Steve has mentioned, you have communication all year round. I certainly, and I think most audit committee chairs, operate on a no-surprises basis; i.e. you want to know when things emerge that are of concern, either to management or to the auditors.

Q124 **Mark Pawsey:** At what stage would you expect to be aware of a surprise if there was one?

Margaret Ewing: Absolutely immediately.

Steve Barber: Yes.

Q125 **Mark Pawsey:** For the person carrying out the audit, the minute they find out something that is a little untoward, you would expect to be notified.

Margaret Ewing: Yes, if it is of a material nature.

Q126 **Mark Pawsey:** Who makes a judgment about what is material?

Margaret Ewing: You would expect whoever within the audit team has found the issue to have then gone to their audit partner and had that discussion. The audit partner would determine whether it is material.

Q127 **Mark Pawsey:** Do you think, in some of the cases we have just heard about, that somebody at a junior level might have identified something? Might it have been covered up?

Margaret Ewing: I cannot comment on that.

Steve Barber: I do not know.

Q128 **Mark Pawsey:** Could that conceivably happen?

Margaret Ewing: It is conceivable. I would not like to comment at all as to whether that is what has happened.

Steve Barber: When we do get the final report from the auditors, every page of it should have been seen by the audit committee chairman before. I do not think the other audit committee members would be involved to that extent.

Q129 **Mark Pawsey:** When you say "seen by", does that include challenge and request for change, or would it just be looking at and initialling that they have seen it?

Steve Barber: It is more than initialling it. It would be challenging it where it is probably wrong and maybe reinforcing it where we think more emphasis is needed.

Q130 **Mark Pawsey:** Where there is an issue, would you expect that to have been discussed with management by the audit committee before



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publishing the final document, or would you wait for the publishing of the final document and then, as the audit committee, challenge management?

Margaret Ewing: No, I look to be told where there are differences of opinion between the management and the auditors; if they have managed to resolve the difference, how they have come to that conclusion; and, if not, for them to bring it to the audit committee and we will resolve it. At the end of the day, the auditors' report is their report but we will influence, where necessary, what is in there if we are not comfortable with it. We like to have the audit committee's views presented in that report.

Q131 **Peter Kyle:** The CMA concluded that investors and shareholders could be doing more to engage with the audit process but, similarly, that audit committees could be providing more information on the tendering and conduct of audits. You are both nodding your heads. Are you both in agreement with that?

Steve Barber: I am in agreement.

Margaret Ewing: Yes.

Q132 **Peter Kyle:** Do you think the balance is correct?

Steve Barber: Shareholder engagement has been almost zero. I carried out a FTSE 100 audit tender, and I wrote to the five biggest shareholders asking for their views and got no response whatsoever. The shareholders are not engaging on that.

Q133 **Chair:** Who were your biggest shareholders?

Steve Barber: I cannot remember who they were but the usual suspects, I would say.

Q134 **Peter Kyle:** Is it a similar experience for you?

Margaret Ewing: I agree, yes.

Q135 **Peter Kyle:** What more could you be doing proactively, if they are not responding? Is the onus all on them? You are here and they are not. We do hear from investors and we all quiz them, but what more could you be doing?

Steve Barber: I have been on some roadshows with the CFO and the only investor who has engaged with us has been Standard Life, or what was Standard Life, and Guy Jubb. Other than that, unless there is something wrong, they are not really interested.

Margaret Ewing: Those that do engage tend to be the ESG departments, not the fund managers. They are looking from a different perspective. You really want the fund managers, who are making the investment decisions, to engage more.



Q136 Anna Turley: Thank you both very much indeed. In Sir John Kingman's report and the letter accompanying it, he was concerned that audit committees were not providing a sufficient break between auditors and management, nor ensuring enough robust scepticism and independent challenge from auditors. Do you think that is a fair assumption and would you support his recommendation that regulators should appoint auditors instead of audit committees? If not, what else would you do?

Margaret Ewing: Most audit committees do exert scepticism and challenge. There will always be, as I said before, a weak committee or a weak chair. We ensure that there is adequate and appropriate robustness and challenge from the auditors. With regard to the recommendation, I do not think it would be appropriate for the regulator to appoint the auditors. I do not see how a regulator can have a better understanding of what is required by the business than the audit committee. I would also be concerned, if the auditor proved not to be right and did not produce a quality report, about who would be held responsible. But the regulator could be more involved through the audit tender process. There could be a dialogue with the audit committee chair on a regular basis and information flow in both directions, but I would not support the auditor being appointed by a regulator.

Steve Barber: If the regulator were to be doing that appointment, it would have to have incredible knowledge of the company and what was required. It takes a couple of years at least on the board to realise what is required. The last thing the audit committee is looking for is "yes" men or women to be the auditors. They want a robust challenge, but different firms have different expertise. In financial services, there are certain bits of expertise that we want. In IT, as I mentioned before, some firms have better IT or sector experience and would be able to deal with that. Having the regulator appoint the auditor would be a very, very dangerous thing to do and could have severe unintended consequences. I am quite against that.

Q137 Anna Turley: That is very helpful, but those issues do remain. Another option that has been talked about, in particular by the CMA, is increasing the powers of the regulator in terms of its engagement with audit committees.

Steve Barber: Sorry, I could not hear that.

Anna Turley: Sorry. Other proposals that have been put forward involve having greater oversight and intervention for the regulator, as we have just referred to. The CMA has proposed, for example, that the committee should report to the regulator before, during and after tendering, and potentially having regulatory observers on audit committees. Do you think those are more sensible options, Margaret?

Margaret Ewing: They could be workable. We need to be proportionate in the remedies. Certainly, banks have a regulator. The FCA will occasionally attend and observe audit committees. Also, the regulator has access to audit committee and board minutes. For those companies that



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are of concern to a regulator, I do not see why that could not be a solution, but I would not have a regulator sitting on an audit committee. I have been an external member of audit committees and not on the board, for John Lewis Partnership, for example. It is a very dangerous role and not one I would recommend to anyone. If you do not understand board discussions that are going on regarding an issue or the context of an issue, you can give the wrong opinion.

Steve Barber: The regulator should have the right to attend the meetings, but to expect the regulator to attend all meetings is unworkable. Often, these meetings will take place at very short notice or to extreme deadlines. A right to attend, and that would be in the companies where there could be issues, I would support.

Q138 **Drew Hendry:** What specifically should Sir Donald Brydon be looking at in his review of audit standards and the purpose of audit?

Margaret Ewing: That review is absolutely paramount. It is so important. In many respects, maybe we should have started with that review, because there is no doubt that an expectation gap exists between what an audit is as defined by auditing standards and what the wider public and different stakeholders expect.

Q139 **Drew Hendry:** On that, should the audits meet those expectations of the wider stakeholders and the public?

Margaret Ewing: That is what needs to be determined by the Brydon review. Can audit be all things to all men? Audits were defined, as they are today, a number of years ago. Things have moved on greatly since then, both in the way that audits are undertaken and in the expectations. There is much more focus now on societal impact and other stakeholders. That needs to be defined. Within the wider spectrum of corporate governance and corporate reporting, what is required in that respect and how does audit fit into that? I do not think you can just look at audit by itself, but having that review undertaken and understanding what an audit can be, because there must be limits on that, is the critical priority.

Q140 **Drew Hendry:** Following on from what you have just said—and I would like Steve Barber's view on this as well—should in your view the audits include, as you have said, wider issues of corporate governance like payment practices, especially those involving smaller companies?

Margaret Ewing: At the moment, there is lots of information provided in an annual report of a company that would meet the needs of many stakeholders. How often those stakeholders actually review an annual report, including the investors, I would question, but there is a lot of information there. At the moment, much of that information at what is called the front end of an annual report is not audited. There could possibly be an extension of an audit to cover those things that would give greater assurance to the other stakeholders.



Steve Barber: I am a member of the steering group of the audit quality forum at the Institute of Chartered Accountants. About a year and a half ago, we had an open meeting where it was absolutely clear that, with Transparency International, they expected the audit to be something very different from what it is, particularly with regard to materiality where, for some people, £1 million is a lot of money, but in the terms of BP, Shell or HSBC it is utterly immaterial. We decided then to start something called Project Flora, which has now turned into Brydon. We really do welcome that.

The big question is this: who is the audit for? At the moment, it is taking responsibility to the shareholders. You quite rightly ask whether it should be for other people. There are a host of issues in there. As Margaret said, there is lots of data at the front end of the accounts, which is not particularly audited, but I am not even sure it needs auditing. If it were to require auditing, it would require quite a bit more expense. If one is going to take a duty of care to banks, creditors and other people, the audit would have to be even more extensive and more expensive.

Q141 **Drew Hendry:** Sticking particularly with the cost angle, the CMA has proposed mandatory joint audits and operational splits. Would the increased costs of the joint audits be justified by more competition in the audit market? Would audit quality suffer in the short term?

Steve Barber: Yes, to all those. Yes and no, depending on which bit of it. Would joint audits be good? In my view, they are a detrimental step. They would definitely increase cost and there is no evidence whatsoever that they improve audit quality. Quality is the focus here. Joint audits were really introduced in France to help fight the Anglo-Saxon domination of the audit profession, and Mazars is the particular proponent of that. I have seen no evidence to say that joint audits would be better. They are more expensive and less efficient.

Margaret Ewing: I would agree on that. I have been involved in joint audits, many, many years ago. The smaller firm struggles to cope. There is possibly a solution where, instead of joint audit, you give the challenger firm part of the business to audit. It could also maybe sit at the audit committee meetings and be part of the overall audit planning. That would give it the experience and exposure that would help it to grow, over future years, to be able to take on bigger audits. But it is a very difficult process. As Steve says, there is no evidence that it would improve quality at all.

Steve Barber: It would also reduce competition.

Q142 **Drew Hendry:** On the subject of competition, would audit companies be comfortable with appointing challenger audit companies alongside the Big Four?

Margaret Ewing: Is this in respect of joint audits?

Drew Hendry: In respect of joint audits, yes.



Margaret Ewing: It depends on the company. Steve alluded to BP. You could not possibly contemplate having a challenger firm as joint and several, and truly joint, on a BP. If you looked at a much smaller company in the FTSE 350, if you were going to go down the route of joint audits, which Steve and I both think is not the right solution, you could see how you could have a challenger firm involved in that audit. Quite honestly, to get the challenger firms to a situation where they are in any way competing for the big audits is going to take many years and a lot of investment.

Steve Barber: I doubt whether the challenger firms would want to get involved in some of these companies anyway, for instance regulated businesses or financial services businesses, as the level of risk and complexity is so high that the investment in IT and staff would be beyond their dreams.

Drew Hendry: You both do not believe it would lead to a better focus on quality. Thank you, Steve Barber. Thank you, Margaret Ewing. It has a good ring to it, that name.

Q143 **Chair:** Can I come back to an earlier question from Peter Kyle about the regulatory appointment? You both said you would be quite relaxed and you could see how it would work if the regulator was to sit in on those decision meetings. Do you see any unintended negative consequences from that?

Steve Barber: I certainly do, but I am not sure what they are because they are unintended consequences. There are issues that could arise. A lot of that would be in education for the regulator. If the regulator's person were to sit on that audit committee for one meeting, it could take a long time to bring them up to speed.

Margaret Ewing: Audit tenders take up a lot of time if done properly. They involve the audit committee, particularly the audit committee chair, in many, many meetings. They can for the biggest companies extend over three to six months and involve a lot of resource. For a regulator or a representative of the regulator to come to the final decision meeting and be able to take a sensible view would be very, very difficult indeed.

Q144 **Chair:** You both said before that you could see that.

Margaret Ewing: I could see involvement by the regulator in terms of the audit committee chair briefing it through the processes as to how they are progressing, the potential conclusions and if we are getting to a stage where one firm is being cut out of it because we do not think it is suitable. There could be that involvement in briefing the regulator.

Q145 **Chair:** Would you see any advantages to that process of briefing and involving the regulator more in your decisions?



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Margaret Ewing: If it is a two-way communication, if the regulator has information that has not become apparent to the audit committee, there could be real value.

Steve Barber: I agree.

Q146 **Sir Patrick McLoughlin:** You both seem very hostile to the idea of any joint audits. You think that would be a move in the wrong direction. Are you both satisfied that the current situation we have with the dominance of the four main companies is the way forward?

Margaret Ewing: It is very unfortunate that we only have four, but we are where we are. There is such a gap between those four and then the next firms in their scale, the resource levels they have within them and the investments they have made in audit technology and other practices. As I say, we are where we are. It is a very unfortunate position. Even when, for audit tenders, there are only two firms tendering, the level of competition is extremely intense between those two firms. There is no complacency. A huge amount of effort goes in by all firms concerned to win those audits.

Q147 **Sir Patrick McLoughlin:** Margaret, let me push you a little more on this. You say there is no complacency and I find that rather hard to accept, in that they know there is nowhere else for them to go other than probably those two companies we are talking about. If you have to change your auditor, that rules one out. You are down to not a choice of four but, as you rightly say, a choice of two. I wonder if it is a conservative approach to the way it is built up and the cosy cartel that is now there.

Margaret Ewing: There is not a cosy cartel, I can assure you, but I know perception is almost reality. The amount of money and time that the Big Four firms invest in audit tenders is a very clear indication that there is no complacency. Some audit tenders cost the firms literally tens of millions of pounds. They are not cheap by any means. When you see the quality of their proposal documents and the time that is invested, these firms really want to win. There is no complacency, because they know there is another firm that could be appointed.

Steve Barber: I would echo Margaret's comments. One thing that has not been mentioned, which is partly about perceptions, is the role of the non-audit services that auditors provide. I personally feel very strongly, and try to impose this on the companies I am on, that the auditors should not be allowed to provide any services other than broadly defined audit services.

Q148 **Chair:** Would you support the CMA recommendations to have a structural split between the audit and non-audit part of the business?

Steve Barber: That will not stop the perceptions. Even if they had that split, I would strongly recommend that the firm was not allowed to produce or provide any non-audit services.



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Q149 **Chair:** Would that be in addition to or instead of what the CMA suggested?

Steve Barber: That is in addition.

Margaret Ewing: The structural change that has been suggested is very difficult to implement. If you take into account that over 70% of the revenues and profits of the FTSE 100 are earned overseas, you can make an assumption that 50% of the audit work is undertaken overseas. All of the Big Four have different global partnership structures. How are you going to prevent the elements of the audit team that are overseas from being part of their wider local partnership? If I take Deloitte, for example, it does not have a UK partnership; it has a north-west European partnership. Many of the audit partners elsewhere in north-west Europe will be involved in UK corporate and UK plc audits. How are you going to apply the structure that is being proposed in that example?

Q150 **Chair:** Would you support Steve Barber's other recommendation that, if a firm is doing your audit, you should not be able to buy any other—

Margaret Ewing: Absolutely, and most audit committee chairs apply that today anyway.

Q151 **Chair:** You would like that to be implemented but not the CMA recommendations.

Margaret Ewing: That is for the firms to deal with, but I do not see how it would operate.

Steve Barber: Also, it would not increase choice.

Margaret Ewing: And it would not improve quality.

Steve Barber: It is unlikely to.

Q152 **Chair:** Sorry, what would not?

Steve Barber: Splitting the audit business into a separate part.

Q153 **Chair:** I thought you just said you were in favour of that.

Steve Barber: I am in favour of banning non-audit services. Splitting the firms would be very difficult and would have unintended consequences, particularly for staff recruitment and a host of other measures. I am not sure it could be managed, per se. My suggestion is to stop the non-audit services. Having a split within the firm is potentially cosmetic. It would be quite difficult to manage that.

Q154 **Chair:** It would increase competition, though, would it not? If you had a split, you would not have a situation where another firm could not bid for the audit because they were providing non-audit work, where there was a proper split between the two of them.

Steve Barber: I do not think I agree on that. If a firm is providing non-audit services, regardless, you still have four firms. If they are not audit



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clients, they will be providing those. Stopping the non-audit services is a matter for the audit committee to plan years ahead. If they are going to have a tender, they should be looking two years out and saying, "Which firms are doing non-audit services? They should plan to stop those then".

Q155 **Stephen Kerr:** Thinking about the CMA report and the FTSE 350, what about the market cap?

Margaret Ewing: That is also very difficult to implement. I would not like to be the audit committee chair on a company that found itself with no choice because the Big Four or whichever firm I thought was the most suitable was not able to undertake my audit. That would be extremely difficult. To use an example, you would not like, in any other service or situation, to be told you have to take second best. That is what a market cap would result in.

Q156 **Stephen Kerr:** I conclude from everything you have said this morning that you do not feel there is a way that the challenger companies can ever rise to the level of competing with the Big Four.

Margaret Ewing: It is going to take a lot of time. They will need the assistance of the Big Four to help them do that. It is going to require a significant amount of investment. Those challenger firms need to determine for themselves whether that is what they want to do anyway. We know that Grant Thornton has now declined to bid for audits in the FTSE 350. BDO's merger with Moore Stephens is a good start but it is going to take time. I am not saying you cannot get there, but there needs to be a concerted effort from many people, not just the firms.

Steve Barber: On the market cap, I really do think that is a very bad idea. It would not improve audit quality. In fact, the big firms would shed their riskiest and least profitable clients. I am not sure small firms would actually want that. There is an element there of danger of reducing audit quality.

Q157 **Stephen Kerr:** Let me ask you a quick question about Sir John Kingman's proposals for a new regulator. He called the FRC a rather shambolic house and other such terms. Do you feel that Sir John's proposals address concerns about audit quality in any way? Could there be more rigorous oversight?

Margaret Ewing: That would be very good. I am supportive of most if not all of Sir John Kingman's recommendations. We would benefit from having a much stronger regulator.

Q158 **Stephen Kerr:** Should it be more interventionist?

Margaret Ewing: There is a way to work together to ensure that it does not feel too interventionist, but I like many of his ideas.

Steve Barber: I would agree with those comments. Appointing the auditor by the regulator and having a regulator sit on the audit committee is too interventionist, but 95% of the recommendations I



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would definitely stand with. Particularly, audit committees will benefit from having a regulator they can talk to and hopefully pre-clear things with. At the moment, dare I say it, being the audit committee chairman can be a lonely job because you do not have a support mechanism. I would see the regulator being quite a support mechanism, as opposed to the opposition.

Q159 **Stephen Kerr:** A more proactive regulator would be welcomed by both of you.

Margaret Ewing: With quality resource and proper investment.

Stephen Kerr: With proper talent deployed.

Margaret Ewing: Absolutely, yes.

Steve Barber: Absolutely.

Q160 **Chair:** Thank you very much to both of you for coming to give evidence this morning. You do a very important job in helping to ensure that we have good audits in our firms. I hope some of the reforms that are being suggested will make our audits better in the future, and perhaps give you the support of the regulators and better audit firms so we can improve the quality of reporting. Do you want to make a final remark, Steve Barber?

Steve Barber: One has to beware of the unintended consequences of everything.

Chair: We have heard about those.

Steve Barber: As the UK profession, we may have sounded very defensive of it and we obviously come from that profession, but it is a world leader. The good bits need to be retained. There are several reviews going on, particularly the Brydon review to come. I would strongly urge that any final decision waits until all those reviews are completed.

Margaret Ewing: I would echo that. It is very important that you have the findings from the Brydon review before you take any precipitous steps, other than maybe some low hanging fruit.

Chair: We are very aware, though, that there have been big failures at firms and in audit. The public trust in audit has all but evaporated and there is a need for reform to restore that trust. You mentioned earlier, Steve Barber, being able to attract people into these jobs. People will not be attracted to work for firms they think are failing and not providing what they need to. It is important, both for the industry and for wider stakeholders, that we get this right, but that we make the right reforms, as you both say, to improve the quality of audit and corporate governance in our firms.



I am going to end it there, if that is okay. If there are things you would like to have said but have not had the chance, you are very free to write to us. We are going to take evidence now from Sir John Kingman. Thank you very much.

Examination of Witness

Witness: Sir John Kingman.

Chair: Thank you very much, Sir John, for coming to give evidence to our Committee this morning. I think you heard the first part of our evidence session. I hope you found it as useful and informative as we did. We have a number of questions to get through, and you will see that the Committee is very well informed and interested in this, given other work we have done in these areas of corporate governance.

Q161 **Stephen Kerr:** Good morning. What is the end goal of your proposals?

Sir John Kingman: Good morning. The end goal, really, starts from the remit I was set by the Government. The Government were quite clear to me that they wanted to see a strong, credible framework of regulation in this space. The Government consistently urged me to set a high bar, and that is what I have tried to do in this report.

My personal background, having been involved in the journey that financial regulation has travelled since the crisis, gives me grounds for optimism. By this I mean, at the time of the financial crisis, quite understandably, the reputation of Britain's financial regulators was on its knees, candidly. Since then we have come on a journey. There has been a lot of change, a lot of legislation, lots of changes of people, and I think we now have a vastly more credible and respected framework of financial regulation in this country.

It is interesting that the FRC did not go through the same process of soul searching at that time, even though to some degree the financial crisis was as much as anything a crisis of financial reporting and failures of audit. In that sense, I think my review is belated.

Q162 **Stephen Kerr:** Is part of what you want to achieve that Britain's companies will be run more prudently?

Sir John Kingman: I would start from a slightly different place. We want a regulator who sticks up for and cares about the interests of consumers of financial information and financial reporting, and the important part that credible and sceptical audit plays in giving assurance on that. We want a regulator that is working to achieve those aims. That would be good for investment in British companies. That would therefore be good for British companies and the credibility of British companies. I also happen to think it would be good for the audit firms.



It is interesting: as part of the review I spent time in Washington, talking to the US regulators, the PCAOB and the SEC, which are widely regarded around the world as setting a very high standard and being very tough. It was interesting talking to the Big Four audit firms in the US, which said, "It has been a painful journey living with these tough regulators", but they felt it had been, net-net, positive for their firms and the quality of their business that they had tough regulators.

Q163 Stephen Kerr: In essence, do you feel we can save some of our companies from themselves? When you think about the spectacular failures that we have had recently, can we save these businesses from themselves through this sort of activist regulation?

Sir John Kingman: Up to a point, but we need to be clear sighted and realistic about this. Companies, even major companies, will sometimes fail. Bad things will happen, and I do not pretend for one moment that anything in this report will mean that we never have a major corporate failure in the UK.

It is possible to imagine a new regulator that is tasked with and capable of being a good deal more proactive in acting on warning signs where there are warning signs. I attempt to map out, in this review, a process by which the regulator would have a completely new power to go in and have a look. That is something that the financial regulators do very often. It is quite a powerful tool for the financial regulators.

I do not think you would be mapping across precisely the same arrangements into the general corporate sector. It is possible to imagine a lower probability of unnecessary corporate failure, but I really would not want this Committee to come away with the impression that somehow I can save Britain from corporate failures.

Chair: That might be beyond even your capabilities.

Q164 Antoinette Sandbach: Sir John, what should Brydon's review look at?

Sir John Kingman: First of all, I should say I am really pleased that it is happening and that he has been asked to lead it. He has been given a considerably tougher exam to pass than I was given. The questions I was asked to address were more self-contained and less inherently complex. I do not envy him his task.

The point I made in this review, in saying that I thought it was a good idea to have this wider exercise, is first of all that there clearly is an expectations gap, so for somebody to come in and attempt to put some clear delineation around this is a very good idea. The main point I made is that it is important that that exercise comes from the perspective of the users of accounts and of financial information, and the original idea for this exercise came from the accounting profession. It was absolutely right to propose it, but I felt it was important that somebody who was clearly independent minded and would take a user perspective should lead it. Brydon is a good choice.



Q165 **Antoinette Sandbach:** You have already spoken about the importance of the end user of the information. What do you think the role of audit should be?

Sir John Kingman: That is precisely the question that he has been asked to address, and I do not have an answer up my sleeve to that. I would simply observe that there clearly is a very large gap between what the audit profession thinks it is doing and what many stakeholders think they are getting from an audit. It is clearly in the public interest to narrow that gap, and I do not think the profession should assume that it can only be narrowed by the public lowering their expectations. I would expect Brydon to be challenging to the audit profession about what it is there for.

Q166 **Antoinette Sandbach:** You may remember a famous campaign encouraging people to "tell Sid". The small shareholder relies on published information and does not have the expertise of the big, institutional shareholders that are likely to be investing their pension. How are they supposed to make decisions or judgments on audited accounts at the moment, or have faith in audited accounts, given what has happened?

Sir John Kingman: That is a fair question, and I fear the answer cannot be that, simply because the company has been audited, it cannot fail. We should be realistic about that. I make the point in my review that there has been a natural tendency over a long period, not restricted to the UK, whenever anyone wants to improve information flows to investors, endlessly to add requirements. The volume of annual reports has got longer and longer. It is not obvious to me that that necessarily takes us into a better world. It may make these documents, if anything, more off-putting.

Now, there is a difficult trade-off, because a lot of this information is needed and is used. Leaving aside Brydon, what I say in this review is that it would be a healthy thing if the new regulator had a requirement to do a report once a Parliament on the overall state of financial reporting and financial information, stepping back and asking, "Is this really working, from a user's point of view?"

Q167 **Antoinette Sandbach:** Your proposals are for ARGA, in effect. It is a slightly speculative question, which is a bit unfair, but if it had been around in the 2000s, would we be in a different place now? What specifically do you think it would address in relation to audits that is the gap?

Sir John Kingman: First of all, I really am not going to make grandiose claims that, had these recommendations been in place then, X would not have happened. It is impossible to say that with certainty.

If I had to boil it down, the most important thing we need to see is more challenge and more scepticism in audit. The regulator is in a position to promote that. It is clear that market forces left to themselves are not



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delivering as much scepticism and challenge in audit as we would all like to see. To be fair, the FRC has said that as much as anyone. But you need a regulator with the tools, and indeed the culture and mission, to do something about that. Right now, the FRC does not have the tools to do the job. It has no regulatory levers over the audit firms at all, because we still have self-regulation for major audit firms.

If I had to pinpoint one really fundamental recommendation in this report, it is that we move away from self-regulation of the major audit firms. The UK is an international lagger, not an international leader, in this respect.

Q168 Drew Hendry: How do we ensure that ARGA is not simply captured by the industry?

Sir John Kingman: In the end, a regulator will earn respect and credibility by its actions and will be judged by its actions. If I go back to the point I made earlier about the financial regulators, Britain's financial regulators may well not be perfect, but I do not think anyone really feels they are captured by the industry, whereas some people did feel that about the old FSA. Those regulators have come on a journey, and I would like to see the new regulator come on the same journey.

We need this regulator to have a chief executive and a board who are capable of establishing that credibility. It will take time. I am sure of that, because building credibility does take time, but we have seen other regulators in this country come on that journey, so I see no reason why this one cannot.

Q169 Drew Hendry: ARGA is going to cost a lot more than what it is replacing, so how should the Government think about what would be the right level of resource to apply to it?

Sir John Kingman: This regulator will cost more. It will cost more because I am proposing that it should have more functions. I am also proposing that it should have really good people and somewhat more senior people, particularly working on the audit quality work, as the US regulator does. I am clear that this regulator should be funded by those it regulates, not by the taxpayer, which is the same as the financial regulators. The budget should be set by Ministers, having consulted the regulated firms.

It is interesting to me if I go back to my experience in the Treasury. The Treasury sets the budget for the PRA and the FCA. There is remarkably little pressure from regulated firms to cut the budgets of either of those regulators because, fundamentally, regulated firms want to be regulated by capable people doing a good job. It is perfectly possible to replicate those arrangements for the new regulator. There will be an additional cost. I have not put a number on it.

Q170 Drew Hendry: What if you had to take a guess at a number?



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Sir John Kingman: I am not going to make a guess at a number, but the Government, assuming, as I believe they will, they support the broad thrust of this review, should go out there and say, "This is roughly what we think it is going to cost". They should consult with regulated firms before taking a final decision. On the basis of the conversations I have had with stakeholders, I would be extremely surprised if regulated firms were pushing for a cut-price regulator.

Q171 **Peter Kyle:** Sir John, you are suggesting new duties for auditors and directors, and more powers for the regulator. Is it your working assumption that the current regime is just too weak at the moment?

Sir John Kingman: My focus is really on the duties and powers of the regulator, and they are very clearly deficient. I tried to bring out in the review that this organisation has a history. It has come out of a world of self-regulation. It is interesting that it is called a "council", and I think that tells you something about it having come from a more consensual tradition than currently commands credibility. We need to get to a better place.

Q172 **Peter Kyle:** Is it fair to say you want a culture change?

Sir John Kingman: Yes.

Q173 **Peter Kyle:** Do you believe the culture change will come about by having a more assertive regulator, auditors and committees that have more powers, and the expectation that they use them?

Sir John Kingman: Yes, the culture change I am focused on is in relation to the question I was asked: "What do we want to see from the regulator?" There definitely needs to be a culture change in the regulator.

To be fair to the FRC, the FRC has asked for and not been given powers in the past. The FRC even now operates under a requirement from the Government that it uses self-regulation to the maximum extent possible. To be fair to the FRC, things need to change around it for the culture of the FRC to change.

Q174 **Peter Kyle:** In terms of directors, you heard from two chairs of audit previously, and it was fair to say that they accepted the need for change, but with all the proposals for change were not quite so comfortable. People, in my experience, always want change, but change that does not feel different. What is it you believe they will be doing differently in their jobs as a result of your report that they are not doing today?

Sir John Kingman: It is for all those reasons that you need a stronger regulator, so my report is all about strengthening the regulator.

Q175 **Peter Kyle:** What will they do differently in their job?

Sir John Kingman: What, the regulator?

Peter Kyle: No, the people who are directors in companies.



Sir John Kingman: Look, I do not attempt to make recommendations about the directors of British companies. I am talking about, given the market forces that prevail and operate, what kind of regulatory regime we need to make sure users of financial information are getting what they need and we have more sceptical and objective audits in this country. I am quite clear that it will require stronger regulation to get there. If I were to point to a cultural change that I hope will flow in the wider world as a result of this regulation, the most immediate one is that I would like to see stronger pressures on the audit firms to be doing what they should do, which is delivering sceptical and useful audits.

Q176 **Peter Kyle:** A lot of people are going to turn up to work doing their job differently as a result of your report. That is what you are saying.

Sir John Kingman: My report is focused on the regulator and fixing the regulator. I am not fixing the regulator in a vacuum, because I think there is a huge public policy purpose in having an effective regulatory regime. That regulator will then achieve things in relation to all the firms it regulates.

Q177 **Peter Kyle:** Do you agree that the capital maintenance regime is not being enforced?

Sir John Kingman: I have not looked at that issue. I am aware there is quite a lot of debate about it. It was well outside the terms of reference of my report. It is highly likely that Sir Donald Brydon will be having a close look at that.

Q178 **Anna Turley:** Sir John, you will have heard my questions in the first session. I wonder if you could tell us a bit more about your personal view on the independent appointment of auditors by your potential regulator.

Sir John Kingman: To be absolutely clear, I was specifically asked by the Secretary of State to address the question of whether there should be any change in relation to who appoints an auditor. It is a very legitimate question, for the reasons I set out in a letter to him, but quite a complicated one.

I did not recommend that there should be a change in who appoints the auditor. The main reason is that I do not think we should make such a radical change in absence of any support for that change from investors, given that the whole point of this reform, if you did it, would be to benefit investors. I did, however, suggest to the Secretary of State—and I hope he will pursue this—that the regulator should have the power to take responsibility for appointing the auditor in certain very specific situations. I suggested three situations in my letter. One is if there are persistent problems with audit quality. A second is where companies and auditors part company outside the normal appointment cycle. The third is if there is a significant shareholder vote against the appointment of the auditor.



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I am proposing that one of the additional tools we should give our new regulator is the power, effectively, to go in and take control of the auditor in those very specific situations.

Q179 Anna Turley: That is very helpful. Thank you for that clarification. What is your view on the shareholder response to that, and where do you think the investor community is on that recommendation?

Sir John Kingman: I make the wider point in my review that we have a problem, in that we have a regulator here that is supposed to be acting on behalf of investors, to have high-quality audit, financial information and so on. But the engagement between the FRC and the investor community is not as deep or as strong as it should be. It is only relatively recently that the FRC has set up a group of investors that it talks to. Those investors tend to be ESG people rather than fund managers, a point made by one of your witnesses earlier. I just think that dialogue is not as strong as it should be.

I make the point that I do not think all the blame for that should attach to the FRC. It is also true that investors have not been as interested in particularly the technical questions of accounting and audit as they ought to be and should be. It is also true to say that, while shareholders have the power of approval of the appointment of an auditor, and it is right that they should have that power, they hardly ever exercise the power to do anything. It is extremely rare for that to be used.

It takes two to tango, and I would like to see a regulator that has much deeper relationships with investors, but that is going to require investors to come to the party.

Q180 Anna Turley: Finally, on a specific point, there has been some discussion and debate as to whether your recommendations are consistent with the current EU legislative framework. Is there anything you want to tell us on record about that?

Sir John Kingman: I am not a lawyer, I am sorry to tell you, but I am quite clear that the role I am recommending for the regulator could be delivered within EU law, and I have seen serious legal advice on the question.

Q181 Chair: In the previous evidence session, Sir John, Steve Barber said that they had very little engagement from their investors. He could not name their largest investors. Is that experience common?

Sir John Kingman: A lot of audit chairs would say the same thing. I have heard that too. I chair a very major investor, and the investor I chair, I hope, is seen as being very much at the more engaged end. Yes, I think this is a problem. Investors have slowly and steadily become more engaged in their stewardship responsibilities, but we have a lot further to go, and these audit and accounting issues are a very good example.

Q182 Chair: How often in the last year has L&G voted against the appointment



of an auditor?

Sir John Kingman: I would be happy to write to you with chapter and verse. There are a number of cases where we have involved ourselves in these. We do have dialogue with audit chairs. When I make the strong statements in the report that I do about it being desirable for investors to do more, I include L&G in that. We take our responsibilities very seriously, and we have a large and well-respected team that does this. Many people would say L&G is the best of the major UK institutions in those terms, but that does not mean we cannot do better.

Q183 **Chair:** The previous panel suggested that investors did not engage. Maybe L&G is the exception to that. We took evidence a couple of weeks ago from Hermes, Aberdeen and Sarasin, which was very helpful, and they said all the things that they do to engage. Yet we are hearing this from the audit committee chairs and, indeed, in your report you were quite critical of investors.

Sir John Kingman: I am absolutely not sitting here saying to you that I believe any UK investor, including the one I chair, is perfect. I am saying we take our responsibilities seriously. We are respected for that, but can we do more? Absolutely, we can.

Q184 **Chair:** Is it realistic to ask investors to do more to hold boards to account?

Sir John Kingman: Investors should focus, in a rational way, on companies where they see the greatest risks. It would not be realistic or sensible to look to investors to take responsibility for appointing auditors. I looked at that as one possibility, but I could not see any workable way of doing it.

Where you want investors focused is, first of all, where there are warning signs, which we do see in companies. Some of those can relate to audit issues and accounting issues. You also want investors to have the capability to engage with companies, with the audit profession and with the regulator to make sure that accounts and audit are telling them what they need to know.

Q185 **Antoinette Sandbach:** You said there are sometimes warning signs. I sat on the Carillion inquiry, and the treatment of write-downs, effectively, for good will was quite extraordinary. It seemed to me that the complacency at the FRC around good will and the international standards that applied was extraordinary. Also, there were a lot of signs in the market. They were being short sold by BlackRock and various other institutions, and yet none of that seemed to have highlighted the auditing issues, or the underlying issues in the end. How bad does it have to be before that gets picked up by auditors?

Sir John Kingman: I have not attempted an in-depth post-mortem on Carillion specifically, but I agree with you that there were multiple warning signs in that case, and evidence that stakeholders were acting on



them: shareholders selling down, and so on. I think I am very clear in this review that the regulator of financial reporting and audit is in a very interesting position to both actively harvest those warning signs, and think and do something about them. To be fair to the FRC, that is not the role that has traditionally been expected of it, and my review makes a significant ask of the new regulator in terms of setting up a unit that is thinking about warning signs.

Those warning signs might tell you something specifically about the accounts or about the audit, in which case it should definitely do something under its powers in relation to those. They might, as you rightly say, tell you something significant about the running of the company. For the first time my report would be recommending equipping the regulator with a power to go in and have a look. If it discovers things that are concerning about the running of the company, first of all, it should recommend changes to the company, but it should have the power to issue a public report to say, "This is what we have found", and in the worst case to make a recommendation to shareholders that they do something.

Q186 Mark Pawsey: Can I follow that up by asking you about the ability of the auditor to find out things that are going wrong, and the audit fee that goes with it? The concern currently is that there is a fixed fee, and that means, if something untoward is identified, there is often not the time available to go into it in further depth. What is your view about some degree of variability in the audit fee?

Sir John Kingman: I have not specifically thought about the question of variability. This goes beyond the scope of my review to some degree, but it is very important that audit is properly priced and resourced, because that is the only way of getting quality. Some people believe that audit is still being used as a loss leader by the audit firms, for a variety of reasons. An important attraction of what the CMA is proposing is that there would be a clean ring-fencing within the firms, such that cross-subsidy could not occur. The new regulator I am recommending needs to understand the economics of audit, and needs to be on top of whether audit fees are sufficient and consistent to deliver quality. That might well include looking at the structure of fees, I had not thought about that.

Q187 Mark Pawsey: You propose that the regulator should have powers on fees, and a variable fee works in the legal profession. Why should it not work in the accountancy profession?

Sir John Kingman: I have not thought closely about the question of variability, but in the end economics shapes behaviour, and that applies to audit as to everything else. If we have a regulator that is concerned with audit quality, it needs to understand the economics of the audit business, and needs to ensure that audit is properly resourced.

Q188 Mark Pawsey: Finally, can I ask you what you have heard from the Department or from Ministers about implementing the proposals you



have brought forward?

Sir John Kingman: I have had very positive engagement with the Secretary of State in particular. He took a very close interest in the review as it progressed. There are 83 recommendations in here and some of them are quite intricate. On some of them, I recommend consultation. You will need to ask him yourself, but the sense I have from him is that he wants to make really serious progress in this area; he wants to see a new and more effective regulator. I have been very encouraged by the discussion.

Q189 **Mark Pawsey:** In terms of timescale, what is your view on how long it would take to implement?

Sir John Kingman: I must say, here I part company with your previous witnesses. I would like to see the Government get on with all of this. Chapter 7 of the report sets out a whole bunch of things that can be done without legislation, and I would like to see the Government and, indeed, the FRC acting on all of those things as swiftly as possible. The most concrete of those would be the appointment of a new chief executive and a new board. None of that requires legislation; I absolutely would not want that to wait for legislation.

The biggest risk I see for the review is getting legislation, because in the end fixing the powers cannot be done without legislation. With all of the uncertainties of Brexit, I have no idea when it would be possible to legislate. I would like to see the Government legislate as soon as possible.

Chair: That is very helpful. Thank you very much, Sir John. We will be taking evidence next week from the FRC as well as from the challenger firms and the Big Four audit firms. Some of the answers you have given today will feed into those questions. Thank you very much for the review, and for your time today.

Sir John Kingman: Thank you.