

Business, Energy and Industrial Strategy Committee

Oral evidence: Future of Audit, HC 1718

Wednesday 30 January 2019

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Watch the meeting

Members present: Rachel Reeves (Chair); Vernon Coaker; Stephen Kerr; Peter Kyle; Mr Ian Liddell-Grainger; Sir Patrick McLoughlin; Mark Pawsey; Antoinette Sandbach.

Questions 190 - 491

Witnesses

I: David Dunckley, Chief Executive Officer, Grant Thornton; Scott Knight, Head of Audit, BDO; Clive Stevens, Chairman, Association of Practising Accountants; Jac Berry, UK Head of Quality and Risk, Mazars.

II: David Sproul, Senior Partner and Chief Executive Officer, Deloitte UK; Steve Varley, Chairman, EY UK; Bill Michael, UK Chairman and Senior Partner, KPMG; Kevin Ellis, Chairman and Senior Partner, PwC UK.

Written evidence from witnesses:

- [Add names of witnesses and hyperlink to submissions]

Examination of Witnesses

Witnesses: David Dunckley, Scott Knight, Clive Stevens and Jac Berry.

Q190 **Chair:** Thank you very much for coming to give evidence to our Select Committee this morning on the future of audit. We have two panels to take evidence from this morning, the challenger firms first and then the Big Four accountancy firms. We have a lot of questions and I expect in some answers you may agree, so if you do agree you do not need to say that. If you have a strong disagreement, it would be good to hear that. If there are issues that we have not been able to cover, we will follow up in writing to you later on, if that is okay.

I will start with a question to Grant Thornton and to you, David. We will go through the CMA's individual proposed remedies later. As a package, do you think they will reduce the barriers to entry you face at the moment in picking up FTSE 350 work?

David Dunckley: Taken as a package, they could well do that. There is no single measure that would fix it, so you are right to ask the question around there being a package of measures. There is Kingman as well, so we need to see all these things together.

Q191 **Chair:** Do you have the resources? At the moment, if I am correct, you are not bidding for this work.

David Dunckley: No, that is correct. We took the decision not to proactively bid until there is a change in the buy-side environment. Kingman and CMA together go some way to dealing with that. We have capability to do this level of work. We do not have the capacity to do it at the moment.

Q192 **Chair:** How do you know that, Mr Dunckley?

David Dunckley: We do audits for Birmingham City Council, which has tens of thousands of employees and more than £6 billion of assets. We already do FTSE 350 work.

Q193 **Chair:** But, by nature, Birmingham City Council is not a global business. It is local.

David Dunckley: No, but it is complex and we have complex work. We are capable of doing complex work. The issue for us is that we will need investment and time to invest to do it at scale.

Q194 **Chair:** You think that, if these measures were introduced, you would be able to bid and win this sort of work and then carry it out to a high enough standard.

David Dunckley: We do. It is not going to happen overnight. For instance, if mandatory joint audit came in, we would take a period of time to invest in technology and people, to be able to do the level of work that is required.

Q195 **Chair:** Scott Knight, do you think that BDO would be able to do this level

of work? Would it be able to do it across the whole range of FTSE 350 businesses?

Scott Knight: We currently do. We act, up until 31 December, for FTSE 100 and a handful of FTSE 350 clients.

Q196 **Chair:** When you say a handful, how many fingers on the hand would make up your total number of FTSE 350 clients?

Scott Knight: There are a couple that have not announced they have moved their audit to BDO.

Q197 **Chair:** At the moment, right now, can you tell us how many?

Scott Knight: Four.

Q198 **Chair:** David Dunckley, Grant Thornton?

David Dunckley: Six.

Q199 **Chair:** Jac Berry?

Jac Berry: None.

Q200 **Chair:** To you, Clive Stevens, you have expressed concerns about unlimited liability, regulatory fines and issues like that that deter smaller firms from entering these markets. Do you think the CMA and Kingman measures, without those other reforms, would truly open up the market to the firms we have in front of us today?

Clive Stevens: I am more sceptical about that. I welcome the broad measures, but there is an opportunity to provide a pipeline that will take probably 10 or 12 years to get in place. Certainly, my members would probably, as it is, not want to enter the market with joint liability because of that. They could well, if, in addition to all the other measures, we adopted a shared audit approach. It would enable them to get experience, maybe not at a parent company auditor position but lower down, and that takes time.

Q201 **Chair:** Okay. We will come on to some of those issues. I am particularly keen to hear from Jac Berry and others on joint and shared audits. If I ask you, Scott Knight, one of the things the CMA questioned was whether auditors were displaying enough professional scepticism and challenge to managers. In the work you do for the small number of FTSE 350 businesses at the moment, obviously you are keen to win more of that work, but what challenge therefore are you giving to the firms you audit, particularly those bigger ones?

Scott Knight: The challenge breaks down into two parts. It is the ability to identify problems, and that is based upon a deep understanding of the business, and ability to benchmark against competitors. Then, having identified the issue, it is having the resilience and toughness to be able to follow that through to its ultimate conclusion and report that to the audit committee, and if it is in the audit findings as required. It is finding the issue and then following it through to the ultimate conclusion.

Q202 **Chair:** I cannot really ask this question to David Dunckley, because you are not bidding for FTSE 350 work. Jac Berry, are you still bidding for FTSE 350 work at the moment?

Jac Berry: Yes, we are.

Q203 **Chair:** When you are bidding, are you asked during audit tenders to provide evidence of your ability to challenge?

Jac Berry: We are, generally.

Q204 **Chair:** What sorts of questions would they ask you? What sort of evidence would they wish you to provide?

Jac Berry: It is difficult to give evidence on what it looks like, but they ask whether we are willing to stand up, to show them examples of how we stood up, what we expect from an audit committee, not to help us do that challenge, but to support us to do that rigorous job. As I said, we are clearly not in the 350 at the moment. We are tendering for them, but we do a lot of similar international clients. You can take across a lot of what you do on scepticism and challenge there so, yes, they are interested.

Q205 **Chair:** What is the balance like when you are bidding for work, between, say, that professional scepticism and challenge, compared with the cultural fit we hear quite a lot about? I will maybe ask you, Scott Knight. There are those two, in some ways and at some times, conflicting roles of an auditor. How important are those two skills?

Scott Knight: I have seen quite a lot about choosing the right team and the right personality. I am not sure that should be given any significant prominence by audit committees. If there are characteristics you are looking for, they should be robustness, tenacity and the ability to follow it through.

Q206 **Chair:** We probably agree on that, but we are trying to establish what audit committees are looking for, rather than what they should be looking for. What do you think they are looking for when they are assessing your bid compared with somebody else's?

Scott Knight: I think they are looking for an understanding of the business, that you have spent time, through the tender process, getting under the skin of the business, that you understand the industry and the benchmarks in the industry, what is normal and what is not, that you have the tenacity and robustness to follow things through. I think audit committees look at quality measures such as AQR scores and the individual's own personal track record, but I would like to see that given more prominence.

Q207 **Chair:** You think that too much weight at the moment is given to the cultural fit and relationship. You would like to move it more to looking at the AQR scores and the challenge.

Scott Knight: It varies, because all audit committees are different, but we have definitely seen examples of that, where we would push for

quality to be given far more prominence than any kind of cultural fit or personality fit.

Q208 **Chair:** David Dunckley, how do you deal with conflict or management pushback during an audit and how do you document it?

David Dunckley: It is documented as we go through in working papers. What, necessarily, the outside world will not see is the level of challenge that goes on before accounts are published. There is often a challenge and there may be adjustment.

Q209 **Chair:** Who sees that? You say it is documented as you go along.

David Dunckley: The audit committee would clearly be aware of the challenge, as would management. If there is a disagreement, you would need to qualify the accounts. We qualified 60 of our audits in the last 12 months.

Q210 **Chair:** Of how many?

David Dunckley: 7,000.

Q211 **Chair:** Okay. How do you deal with any pushback?

David Dunckley: Ultimately, it is a matter of judgment. If you cannot agree then you qualify, and your ultimate recourse would be to resign, which is a real rarity.

Chair: You said you qualified 60 out of 7,000, so just under 1% you qualify.

Q212 **Stephen Kerr:** My question is about the proposed operational split between audit and non-audit. David Dunckley, you have said that you are against this.

David Dunckley: I have.

Q213 **Stephen Kerr:** It would prevent you from re-entering the FTSE 350 market and you do not think it would increase competition or choice, but would it not focus minds on audit? Would it not lead to better quality audit?

David Dunckley: I am not sure it would directly lead to better quality audit. I can explain the rationale for us opposing it. The paper talks about potential structural and operational split of the Big Four. My belief is that, shortly afterwards, whether it is through regulation or market forces, challenger firms such as ours would have to do similar. For us, that would prevent us providing the investment I talked about in my first answer to re-enter the market. It could be a genuine barrier for Grant Thornton re-entering the market if we were a split operation.

Q214 **Stephen Kerr:** It is not viable for Grant Thornton to operate in an audit-only role.

David Dunckley: Yes, if you are talking about the PIE audit.

Stephen Kerr: Yes.

David Dunckley: Our public interest audit is around about £10 million of turnover. To ring-fence that and have it separately would really inhibit our ability to invest to deliver the quality the market wants.

Q215 **Stephen Kerr:** Can you help me understand why that would be?

David Dunckley: To invest to work at scale, we need more people and more technology. You would have to invest in advance of the turnover and in advance of the fee income to prove you have the credentials. If you ring-fenced us and I had a profit pool just based on public interest audit, there would be insufficient profits to allow me to invest.

Q216 **Stephen Kerr:** Let me turn to Jac Berry. You support the CMA's operational split, its proposal, initially for the Big Four.

Jac Berry: Yes.

Q217 **Stephen Kerr:** Is this because you believe it will deliver better quality audits, and if so, how?

Jac Berry: It is part of the measure. I absolutely understand the costing element of it. Although PIEs are what we are focusing on here, all audits are important. If you look at stakeholders, all the audits that are being signed off affect tax revenues, pensions, people's jobs, et cetera. I have not limited it to the PIE split-off. It was an audit split-off I was thinking about, which I think was in the proposal.

The challenge is, as well as the economics of course, that part of what we need to do to get quality better, in my view, is people. There are lots of tools you need, et cetera, but you need the people to do it right. To get people wanting to be in audit, you have to have the best. There is a tension here, but part of the benefit of having wider experience is that auditors learn to challenge. There is a cultural difference sometimes with non-audit services. I am an auditor. I have been an auditor for 30 years and I learned a lot of my challenging of other auditors and management by due diligence exercises. It is a bit of a roundabout way—

Q218 **Stephen Kerr:** The evidence we have had suggests there is little transfer of talent between these different sides of the business.

Jac Berry: I am not sure that is right. I think it has increasingly become the case, and I do not think it has helped quality. As an auditor, you want to be able to understand things and to be able to challenge people, understand the business, et cetera. There are skills you learn that you get from due diligence in particular.

Q219 **Stephen Kerr:** Having said all that, you are in favour of separating auditing from other operations.

Jac Berry: There is sense in that.

Q220 **Stephen Kerr:** How does it improve the quality of the audits, separating it?

Jac Berry: We have said that there are both elements of it. Independence is a mindset as well as a reality. If you are trying to concentrate on a certain level of profits for the partners, there is a seepage there into being truly independent.

Q221 **Stephen Kerr:** Thank you for that. If I can turn to Scott Knight, you are broadly supportive of operational ring fencing. Is that right? However, you have reservations.

Scott Knight: I have reservations. Legal separation undermines the viability of both our audit practice and non-audit practice because the cost synergies and having to hire deep specialists would be a problem.

Q222 **Stephen Kerr:** That is what David Dunckley was saying, but you are in favour of it.

Scott Knight: There are steps that could be made. There is an issue here that needs addressing. You could address the cultural aspects by moving the audit practice into a separate subsidiary that produces its own financial statements that shows it is suitably profitable and there is no cross-subsidy. It should be governed largely, more than today, by auditors of the audit practice.

One of the issues when we talk about culture is this. In some firms, the audit practice is less than 25% of the total practice. It is becoming too small. You need to have governance by auditors of the audit practice, in terms of the admittance of new partners, and really focusing the mind on what is important for audit. You can achieve that quite quickly without economic separation or legal separation. You just put the audit practice into a separate subsidiary. That becomes a regulated entity. The financial statements are available to the regulator. It deals with the issue of whether there are cross-subsidies, et cetera.

The final aspect that people look at is this. Is there subsidisation within a client relationship? Is the audit a loss leader for other services? The idea that people do audits because there are big consulting contracts has gone. The rules are so complicated now that it takes too long to explain them. You have to say, "If you do the audit or the PIE, you do not do anything else". It is pure and simple. The profession should get ahead of regulation and start to restore trust by, rather than having complicated explanations, simply saying, "If you do the audit, you do not do anything else".

Q223 **Stephen Kerr:** You seem to be calling for stronger regulation. You are looking for a stronger regulator. That is what Kingman is recommending, right? You are supportive of a stronger, more US-style regulatory body.

Scott Knight: In terms of the Kingman recommendations, it was an excellent report. It identified the issues. I strongly support most of the recommendations. It is an excellent piece of work.

Q224 **Stephen Kerr:** Let me ask a general question to all three of you before I turn to Clive Stevens. You were describing this culture, Jac Berry, in relation to a commercial mindset, audit versus non-audit services. Help

me understand how a senior partner in audit is incentivised to challenge.

Jac Berry: You have to make this a reality rather than a structure. The reality has to be that you take it very seriously. It has to be demonstrated as well, so people have to get paid based on the quality of their audit. We can talk about how that is calculated, but they have to genuinely get paid based on the quality of their audit.

As an auditor, you should also get remunerated on how you develop people and bring them on. You can build great tools and methodology, et cetera, but it is only when you are in an audit team and people recognise what you are doing as a partner that they learn to take it seriously. It needs to go through to money, unfortunately, but that is part of it.

Q225 **Peter Kyle:** I think I am correct in saying that all of you are broadly supportive of the CMA's drive for greater oversight of audit committees. Is that correct?

David Dunckley: That is correct.

Q226 **Peter Kyle:** Could I turn to you, Scott Knight, first? Do you think the CMA's proposals on greater scrutiny of audit committees are going to drive a culture of greater independence?

Scott Knight: Yes, I think they will. Audit committees range from some that perform excellently, to others that need more of an intervention and more of a nudge. It will work with the latter group to create that independence from management, to focus the mind for appointments on looking for quality rather than anything else, really driving the right behaviours and removing what we sometimes describe as the demand-side bias. That is critical to any package of measures.

Q227 **Peter Kyle:** That is very helpful. Thank you.

David Dunckley: Can I just agree with that? If there is an independent regulator or observer on the audit committee, in our view, they can bring knowledge that the audit committee may have, whether that is positive or negative, about the firm, so I agree with that.

Q228 **Peter Kyle:** Thank you. That is helpful. Jac Berry, you are in agreement there. Is there any other angle you would like to add to it?

Jac Berry: No, I agree.

Q229 **Peter Kyle:** Thank you. That is very helpful. If I could turn to you, David Dunckley, we cannot talk directly about Patisserie Valerie. Could you talk us through, specifically, what measures you take as an auditor when you are undertaking an audit to expose criminal activity going on within companies, and to make sure fraud, should it be happening within a company, is discovered?

David Dunckley: That is the very heart of the future of audit. As you say, I cannot talk about Patisserie Valerie. There is a live investigation, which we will co-operate with. There is a clear expectation gap. An audit fundamentally gives a reasonable opinion on historic information and

does not look for fraud. The market expects that it is doing all those things, so we have that expectation gap that needs to be fixed.

Q230 **Peter Kyle:** Are you confident that your systems are robust at the moment?

David Dunckley: I am confident in our systems. We have invested heavily in our systems and in our quality, such that, yes, I am confident.

Q231 **Peter Kyle:** I am not an accountant. I am not an auditor. I have a question that I need to have answered to myself. This is hypothetical. This is in general. When you have a company that is getting towards year-end, does not have enough money in its system, writes a cheque from a current account that does not have enough money in it, deposits that cheque in another of its own company's accounts, and then takes the money that has been deposited, even though the money does not exist and the cheque will bounce several days later, and then adds it to its balance, is it not extraordinary that the auditor would not pick this up? Would the consumer not—

David Dunckley: Absolutely, the consumer would expect that to be picked up. In a hypothetical situation, you would ordinarily expect the auditor to pick that up.

Q232 **Peter Kyle:** What are the implications for an audit company if it did not pick that up?

David Dunckley: The company would have to look at its own systems and the acts of the individuals at the time.

Q233 **Peter Kyle:** Of course, the audit company is not committing a crime in that case, but its fingerprints would be all over the crime scene.

David Dunckley: We have a set of regulations as auditors. There are two issues. First, there is a set of regulations. The regulator asks, "Have you fulfilled the regulations?" There is a separate question as to whether the regulations are fit for purpose and delivering what the market wants. That is the core of this.

Q234 **Peter Kyle:** If an audit company is not picking up on this type of behaviour, what is the point of audit in the first place.

David Dunckley: The Brydon review is really important in addressing the point of audit and delivering on market expectations.

Q235 **Peter Kyle:** I want you to tell me, because you run one of these companies.

David Dunckley: I do, absolutely.

Peter Kyle: What is the point of an audit company if this kind of behaviour is not exposed?

David Dunckley: As I said, we audit 7,000 companies. There were some individual issues in the past and there is a current one that I cannot

discuss. We have invested hugely in our quality to deliver a service and we have many, many satisfied clients.

Q236 **Peter Kyle:** If I was chair of a company, why would I hire you? It is like being a principal of a school and not being able to trust Ofsted when it comes in and does an inspection. The point of audit, the point of inspection, is to uncover these types of behaviour. Why would I hire you?

David Dunckley: There is a clear expectation gap in the market as to what we do by reference to regulations, and whether the regulations are fit for purpose. That is the core of what we, as a UK plc, need to sort out. There is a clear expectation gap there. The audit, even done well, is not delivering on what the market needs.

Q237 **Peter Kyle:** Bearing in mind what you have just said, are you saying the market is fit for purpose now?

David Dunckley: The market needs to change to address the expectations.

Q238 **Peter Kyle:** You have just dodged the question, so the answer is no.

David Dunckley: As I said, there is an expectation gap that auditors are doing something. We are not doing what the market thinks. We are not looking for fraud. We are not looking at the future. We are not giving a statement that the accounts are correct. We are saying they are reasonable. We are looking in the past and we are not set up to look for fraud. That is the fundamental expectation gap in the market.

Q239 **Chair:** Can I just ask you a couple of other questions? When you are auditing a company, are you confident that you see all the bank accounts in that company's name?

David Dunckley: That I would have to get back to you on. Intuitively, yes. I am not an auditor by nature, but part of our normal systems would be to look at the bank accounts.

Q240 **Chair:** Jac Berry, you are an auditor.

Jac Berry: I am an auditor.

Q241 **Chair:** You have 30 years of experience. When you are auditing a company, would you be confident that you have looked at all the bank accounts in that company's name.

Jac Berry: It is critical.

Q242 **Chair:** It is definitely critical, but would you be confident that you have?

Jac Berry: Yes, I am.

Q243 **Chair:** Scott Knight, are you an auditor?

Scott Knight: Yes, I am.

Q244 **Chair:** When you are auditing a company, would you be confident that you are looking at all its bank accounts?

Scott Knight: Yes, but there is always the risk that there are hidden bank accounts with banks that you do not circularise and get confirmations from. You search for unusual transactions where money is coming in and out of bank accounts.

Q245 **Chair:** There is this issue about the expectation gap. I will maybe ask you, David Dunckley. Do you think the public are right to expect more from an audit than they are getting at the moment?

David Dunckley: Like in any expectation gap, both sides probably need to move. The audit profession needs to move and deliver more on the public's expectations.

Q246 **Chair:** You think the public should also move in what they expect from an audit.

David Dunckley: There has to be an acceptance that, if there is a sophisticated fraud happening in the business, the audit, as is now, and maybe as is in the future, may never see it.

Q247 **Peter Kyle:** What about an unsophisticated fraud? Should they have a right to expect you to expose that?

David Dunckley: The audit is not, in its core systems, set up to look for fraud.

Q248 **Chair:** Do you offer your clients anything above and beyond this very unsatisfactory audit model? If there are things that you think the public and shareholders would rightly expect, do you ever say to a company, "We know that the audit is not fit for purpose. We all agree on that. Here are some things we think should be in an audit that are not currently. We can offer those to you"?

David Dunckley: You would, within the boundaries of what the ethical guidelines allow you to do. In a PIE audit, no, you would not, but we are supporting a clear delineation between audit and non-audit.

Q249 **Chair:** You are delivering to firms something you recognise is not satisfactory and that is just what the audit is.

David Dunckley: We are delivering something that, as we have been speaking out about for some time, needs to be amended. We are hugely supportive of the Brydon review, because that is really important for the future of our industry.

Q250 **Chair:** I know, but it is sort of like asking somebody else to fix it.

David Dunckley: It is asking someone else, but we have already written to him. We are very keen to help and support in that review. It is not just standing on the side lines.

Q251 **Vernon Coaker:** Can I pick up what you said, Mr Knight? You are saying it would be normal to see the bank accounts, but of course there is always the possibility of hidden bank accounts. People deliberately hide accounts from you. Can you say a little more? I think people would be

astonished. You are the auditor. You go in and raise the issue of hidden bank accounts.

Scott Knight: You would look at all the known bank accounts. You would circularise the company's bankers, et cetera, and get confirmations of the balances at the period end. If a company or an individual, unbeknownst to anybody on the board, had opened a bank account with a completely separate bank, you do not circularise every single bank in the country, asking whether there is a bank account with that particular company. In order to identify if there are any bank accounts that are not on the balance sheet, not in the company's records, you would look for movements between different bank accounts to identify any transactions.

Q252 **Vernon Coaker:** If you were auditing someone, would you not expect that, if they are hidden, the implication is that they are hiding them for a reason? Why, if you are auditing a company, would somebody not say, "These are all our accounts. These are all our financial transactions and dealings. We need to be open"?

Scott Knight: It is highly unusual.

Q253 **Vernon Coaker:** How many times have you come across this?

Scott Knight: I have never come across it in 25 years. It is highly, highly unusual.

Q254 **Vernon Coaker:** Why do you raise it if you have never come across it?

Scott Knight: It was raised in a hypothetical scenario.

Q255 **Sir Patrick McLoughlin:** Can I ask both Scott and Jac whether they agree with what David Dunckley said about not looking for fraud in an audit?

Scott Knight: You look for material frauds. In a lot of companies, there will be small frauds. They should not be of particular interest to shareholders. If they are sizeable and material, you have to look for them. An audit follows through not just on representations. You look for evidence from third parties, so you look to follow that through.

Q256 **Sir Patrick McLoughlin:** You have to check it is a true account of what the company is doing financially.

Scott Knight: Yes, you should, but in a large organisation there will be petty frauds that are ongoing. That is not something an audit is designed to wheedle out. If they are material to the financial statements and of relevance to the shareholders, you should be expected to find them.

Jac Berry: Very simplistically, my job is to support a true and fair view, as an auditor. As part of that, we can talk about expectation gap, and it is important, but what the public expect is to be able to rely on a set of accounts. Clearly, there are lots of things about materiality, et cetera, but anything of significance that will affect what the users of the accounts see in those accounts is of interest to me as an auditor.

Q257 **Chair:** There is a bit of a difference, then, on the panel about whether detecting fraud is part of the job of an audit. Scott, you think it is part of an audit to detect material fraud.

Scott Knight: Yes.

David Dunckley: When you sign off the audit, you are not signing off to say there has not been a fraud. If there is a fraud that affects the materiality of the accounts, you will want to find it. My point was that the nature of an audit itself is not designed to target fraud necessarily, and there is an expectation from the public that it is.

Q258 **Chair:** As Jac Berry has said, you would expect to detect a material fraud that affects the true and fair accounts, because that will have a material impact on whether those accounts are true and fair.

David Dunckley: If people are colluding and there is a sophisticated fraud, that may not be caught by normal audit procedures.

Q259 **Chair:** But it should be, and that would be part of what an audit was looking for.

David Dunckley: In an ideal world, you would absolutely want it to be and you would want to be able to rely on it. In the real world, for a sophisticated collusion, it might be difficult. It might not be spotted by ordinary audit work, which is in accordance with our standard regulations.

Q260 **Chair:** Yes, but in a shop that sells teas and cake you would think that sort of thing might be spotted. It is not a multinational complex organisation.

David Dunckley: As I said, it is not for me to comment in this forum on that particular matter.

Clive Stevens: But you are right. In the planning stage, auditors really should plan their tests with a reasonable expectation of picking up major fraud. It is not an absolute guarantee because things can be sophisticated. Obviously, it is an offence, as we know, for people to lie to auditors if they do that. That is one of the things the Companies Act legislates against. In the rare circumstance that there is a major fraud, and I hope it is rare, there is legislation there, but the tests should be designed with a reasonable expectation of picking up something. It is not 100% guaranteed.

Q261 **Chair:** The FRC ISA 200 rules from June 2016 say an audit must pick up material misstatements, whether due to fraud or error. Do you agree with that ISA 200 rule, David Dunckley?

David Dunckley: I am not aware of that specific rule. Audit is not my fee-earning activity.

Q262 **Chair:** But you are the managing partner of an audit firm, Mr Dunckley.

David Dunckley: I am managing partner and clearly I have a head of audit. We have chosen not to bring the head of audit here because this

involves our entire firm, not just our audit practice. The point I am making is that, if there is collusion, your ordinary audit standards may not actually spot it. That is at the heart of the expectation gap.

Chair: Yes, they may not spot it, but the FRC ISA 200 rules of what you expect an audit to do say an audit must pick up material misstatements, whether due to fraud or error. You can ask a friend and ask the audience, but that is what an audit is expected to do.

Q263 **Antoinette Sandbach:** Mr Knight, one investment fund manager told us that auditors are failing to ensure that companies adhere to a fair and true view of their financial accounts, or to the capital maintenance regime requirements. Obviously, the capital maintenance regime requirements are a legal requirement under the Companies Act. Is this a fair criticism?

Scott Knight: I think it is more aimed at the financial reporting standards, rather than the audit regime. The financial reporting standards that include fair values create profits that are not realised.

Q264 **Antoinette Sandbach:** We saw that in Carillion, did we not, to dramatic effect? The requirements of sections 830 and 831 of the Companies Act are that the company can only pay dividends out of past realised profits available for distribution. That is not really around accounting standards, is it?

Scott Knight: Also, that rule relates to the company rather than the group, so it is a—

Q265 **Antoinette Sandbach:** I am sorry; it is a legal obligation relating to the financial accounts. Are you saying that is not something that you should audit?

Scott Knight: No, it is something that is audited, but it is in relation to the company, rather than the consolidated financial statements. It is whether the company at the top of the group that is paying the dividend has sufficient reserves to pay that. That is different to whether the group reporting has, on the consolidated basis, sufficient reserves.

Q266 **Antoinette Sandbach:** Are you saying that requirement in the Companies Act does not apply to all the subsidiaries as well?

Scott Knight: No, because they are not paying the dividend. The dividend is coming from the top company at the top of the group.

Q267 **Antoinette Sandbach:** Are you not required to check the veracity in order to know whether that is a fair and true picture?

Scott Knight: Yes, you are.

Q268 **Antoinette Sandbach:** Can any of you define what counts as realised profits in company law? What is the difference between that and reported profits?

Jac Berry: Sorry, I just wanted to clarify something. I absolutely agree that it is very complex and there is a difference between group and the

rest, but the ability for a company to pay a dividend or not pay a dividend is a legal requirement. It is a law. As an auditor, part of the role is to make sure they adhere to laws and regulations. I just wanted to say, to clarify, it is complex but, yes, it is part of making sure the company was acting lawfully.

Q269 **Antoinette Sandbach:** Is the reality not that the expectation gap is actually what is not being looked at. Audit companies are reporting to financial standards and not to the legal standards that apply to the companies.

Jac Berry: But they should not do, sorry. It is very complex, but the reality is that there is an accounting framework. They have to adhere to that. There is also a Companies Act and a legal framework, and they have to do both.

Q270 **Antoinette Sandbach:** Looking at the high-profile failures we have had over the last two years, do you think you can say that audit companies are doing both?

Jac Berry: There are a lot of assumptions in financial statements now. Because of the accounting standards, there are a lot of very important things to do with companies that are not in their financial statements anywhere. Even if we assume the financial statements were perfect, management can do an awful lot to destroy a company's operations that is current not reflected in there.

Q271 **Antoinette Sandbach:** Would you support full disclosure in the accounts of distributable reserves, how they are calculated, and the same for realised and unrealised profits?

Jac Berry: Absolutely. It is complex, but it is something I would expect management to do, to have a record so they know they are legally making distributions properly. I do not understand why it is not a legal requirement. Some people do it voluntarily.

Q272 **Antoinette Sandbach:** Do you agree with that, Clive Stevens?

Clive Stevens: Capital maintenance and paying dividends out of realised reserves covers the whole market, private and public. I know that when the audit partners in my firm look at that it is a prime consideration for them. Certainly, in the private market we work to make sure the accounts are presented in such a way that they meet the standards and dividends are paid out of realised profits. I believe that is part of the job.

Q273 **Antoinette Sandbach:** So you think there should be disclosure in the accounts of distributable reserves, how they are calculated, and the same for realised and unrealised.

Clive Stevens: I do, yes. Then it comes back to the challenge. If something is wrong in the balance sheet or in the accounts, that produces some other result.

Q274 **Antoinette Sandbach:** If there is a new regulator, do you think it should ensure that audit companies are complying with the Companies Act

requirements, or auditing the Companies Act requirements on firms as part of the standard practice of their audit?

Clive Stevens: Yes.

Scott Knight: It should even go further, in that the current responsibility is to ensure there is the legal ability to pay the dividend. As I think we have seen in some failures, it is not just whether there is the legal ability but whether it is sustainable. You look at whether it creates pressure on working capital within the next year, but are the dividend levels reaching a point that it is impacting on the business model? As we look at the future of audit, there is an expectation that auditors are considering the business model, including the level of dividend.

Q275 **Antoinette Sandbach:** I am going to move on now to, potentially, the independent appointment of auditors. Mr Dunckley, I know Grant Thornton has argued strongly in favour of independent appointment of auditors.

David Dunckley: We have in the past, yes.

Q276 **Antoinette Sandbach:** Do you think this is more likely to incentivise auditors to provide more challenging audits than the CMA's preferred remedies?

David Dunckley: We made some quite public statements, based on our experience in the public sector, that an independent body could change the buy-side environment. Reflecting back on the suggestions from the CMA, there are some really good suggestions there. It may get to the same result, which will deliver that independence that the independent body might otherwise have done.

Q277 **Antoinette Sandbach:** Do you agree with that, Ms Berry?

Jac Berry: If what we want is a quality job and openness in the market, the other remedies are better. If there is a mentality of forcing people to have particular auditors, et cetera, I am not sure that helps to build a greater quality. That is my view.

Q278 **Antoinette Sandbach:** What is your view on that, Mr Knight?

Scott Knight: I believe that, in the most part, audit committees do a good job. They understand the company, the sector, the environment. They are in a good position to select the most appropriate auditor. We believe the best intervention is regulatory oversight, rather than taking that decision away from them. We are against a public appointment authority. I think, over time, it would morph towards a procurement agency, whereas the best skills for appointment sit with audit committees.

Q279 **Antoinette Sandbach:** In terms of the length of term that auditors are currently able to hold, it is 20 years before they have to rotate. Do you think this time period should be reduced?

Jac Berry: Yes.

Q280 **Antoinette Sandbach:** Where would you suggest it should be set at?

Jac Berry: It is really difficult, because we are trying to get to a safe set of accounts, which has a safe audit opinion underpinning it. There is a tension there between too short and too long. Obviously, we will come on to joint audit shortly, but a staggered approach helps a bit. I would say seven years or something like that.

Q281 **Antoinette Sandbach:** Does anyone want to bid any higher or lower than seven years?

David Dunckley: We said five to seven years in our written submissions.

Scott Knight: The UK is ahead of the rest of the world in terms of rotation. Although 20 years seems like a long period, there are companies that have just had their first audit tender that have been in existence for more than 100 years. The amount of change that has gone on in the last few years is really significant. I would like to give time for that to bed in, but I think 10 years is the right period for rotation; 20 years still feels too long.

Q282 **Antoinette Sandbach:** What about you, Mr Stevens?

Clive Stevens: Clearly, 20 years does seem too long to me. There is a familiarity threat there. It is one of a number of packages. If you want to broaden out and open up the market, on its own there is no evidence, from the changes we have had, that that would actually increase the entrants into the market. There are other things that have to be around it.

Q283 **Antoinette Sandbach:** It needs to be part of a package.

Clive Stevens: Yes.

Q284 **Mr Liddell-Grainger:** Can I ask BDO and Grant Thornton about joint audit? I think you have differing views on this. If it was introduced, how ready are you to deal with joint audit?

David Dunckley: We said we would be supportive of joint audit. It would depend on the nature of the business. Right now, are we in a position to do a joint audit of some of the largest FTSE 100 companies? No, we are not. That would take a considerable amount of time and investment of specialist skills to do. There is a whole range of companies where we could be in position in relatively short order. If there is going to be a shift of up to 20%, which has been talked about, and 80% market cap, we are talking about a period of investment that could be three or four years to be in a position to do that.

Scott Knight: When I describe a joint audit, it is definitely close to a joint audit, not an 80/20 split. Things like that concern me. That is not a joint audit. It needs to be closer to a proper joint audit. I agree with my colleague that, for firms such as BDO, the top 30 of the FTSE 100 would be a challenge for us in any significant role, and there I am talking about a proper joint audit. From that level down through the FTSE 100, we have

the capability. The capacity depends on how quickly the changes are brought in.

Once you get into the FTSE 250, we have the capability to audit any FTSE 250 business, and in a joint audit we have the capability and the capacity. We have an audit practice in the UK of £200 million, with 2,000 auditors. We have the capacity and the capability to move quickly there. However, I have concerns about joint audit as a remedy.

Q285 **Mr Liddell-Grainger:** Surely, joint audit is splitting away services from audit, so why do you have a concern about that?

Scott Knight: I look at it through two lenses, both quality and competition. In terms of quality, I have yet to be convinced that it is a superior product. It creates issues, potentially, of things falling through gaps. Secondly, I like the correlation between the auditor's reputation and when things go right or wrong. In a joint audit, that becomes muddled and if things go wrong there is finger pointing. I prefer a direct correlation.

In terms of competition, it locks in the current market structure. In 10 years' time, if we looked at the FTSE 350 auditors, for the majority auditor, it would look pretty similar to today, dominated by the Big Four with the likes of BDO and Grant Thornton in a smattering. Then you look at the minority or the junior auditor and it would be a series of challenger firms. It would be difficult for firms to break out of that minority role into the majority role. I do not think it solves the competition angle and I am not sure it is a superior product in terms of quality.

Q286 **Mr Liddell-Grainger:** Given Peter's questions, that is a strange answer. Can I come back to David? You are not auditing anything in the FTSE 250 at the moment, are you?

David Dunckley: I think we do one.

Q287 **Mr Liddell-Grainger:** You do one.

David Dunckley: We do one. We do six in the 350.

Q288 **Mr Liddell-Grainger:** If there was a joint audit, David, would you then get back into the 250?

David Dunckley: We would. The reason we withdrew is that we pitched, we thought we had good capability, it cost us a significant amount of time and money to pitch, and there was just a bias: "Why would someone move away from the Big Four firms?" If there is a mandated change in the buying behaviour, that would give me a business case in which to provide the investment to do that. We have capability to do it in a limited way, in terms of volume of resource. The issue we need to address is increasing the volume of resource to do more of that work.

Q289 **Mr Liddell-Grainger:** You are sort of arguing against yourself where joint audit is concerned. Getting in with a joint audit would not make a difference on that.

David Dunckley: Can I just say I think it would? If we were doing 20% or 30% of a significant audit, we could work with them to build up our capacity to do more of that work.

Q290 **Mr Liddell-Grainger:** All right, yes. Mazars, you do joint audits, do you not?

Jac Berry: Yes. I personally have done joint audits as a partner for 20 years.

Q291 **Mr Liddell-Grainger:** You obviously favour them.

Jac Berry: We favour them.

Q292 **Mr Liddell-Grainger:** What are the counterarguments? You have heard from David and Scott. Come the other way.

Jac Berry: I will come back to specifics if you need. From a reality perspective, in the French stock exchange index, CAC 40, joint audits have been in place for longer than I have. We do a third of the joint audits there. Each of the Big Four does joint audits there and I have worked with all of them on joint audits. It is a practice that seems to work. From a quality perspective, it works. I can explain why. From a significant audit failures perspective, it seems to work, in that there has not been that perception. I would disagree with the junior role and I would disagree with the proper or improper joint audit role, if you need details. It seems to work from a reality perspective, and I have seen it work from my perspective, in terms of bringing the challenge and everyone just trying to get to the right answer.

Q293 **Mr Liddell-Grainger:** Does it increase costs?

Jac Berry: Is that to me?

Q294 **Mr Liddell-Grainger:** Whoever. I am interested to know. Does it increase costs if you do a joint audit?

Jac Berry: It is very hard to decide. There is a lot of data out there. In our view, it does not significantly increase them, but it increases quality. I guess my closing remark would be that Sarbox increased costs enormously, 30% to 40%, depending on what number or statistic you look at, but the quality in the US market has gone up.

Mr Liddell-Grainger: They are not great taxpayers in the UK.

David Dunckley: The answer has to be yes. It must increase costs; that would be our view.

Q295 **Mark Pawsey:** We had Sir John Kingman give evidence to us last week and I want to ask you about some of his proposals for improving the situation. Scott, you referred to it. Does everybody support the Kingman proposals?

Scott Knight: They are very good.

Q296 **Mark Pawsey:** How would a new regulator, a more powerful regulator,

help the perception of your profession, just quickly? How would that help?

Jac Berry: There would be greater understanding of what the regulator should do and what they bring, and how they actually do it. At the moment, it is a hard job, I am sure.

Q297 **Mark Pawsey:** What, being the regulator?

Jac Berry: Being a regulator, I am sure, is a hard job. Let us be clear; it is a hard job.

Q298 **Mark Pawsey:** They have been a bit cosy with your profession up until now, have they not?

Jac Berry: There is an argument for that. That is certainly not what we have found. There is a difference between challenger firms and other firms, perhaps. I do not know. We were reviewed last year. The grades were good. They need to be very clear on what they are doing from a practical perspective, in terms of challenging audit firms.

Q299 **Mark Pawsey:** Mr Stevens, one of Sir John's proposals was greater transparency when a regulator carried out an audit. That is getting more information about failures out into the public domain. Is that a good thing?

Clive Stevens: It is. There are two roles for a regulator. One is to make sure that if work is deficient it is called out, because I do not think anybody in the profession wants poor work to continue.

Q300 **Mark Pawsey:** Is the profession happy for its failures to be publicised?

Clive Stevens: It is happening at the moment.

Q301 **Mark Pawsey:** So it will not make any difference.

Clive Stevens: In an airline-type situation, where we are learning from that, that is a good thing. The other element where the regulator could work with the profession is to support new entrants and get people up the learning curve, so as to improve the range of the market.

Q302 **Mark Pawsey:** Is there a way in which it might help new entrants? The regulator has power to apply fines where it recognises wrongdoing or there has been poor performance, but the fine is not related to the size of the company. Would it make more sense for the fine to be proportionate to the size of the audit firm? It is particularly relevant to you three, as challenger firms, because a big fine will be a bigger proportion of your income than for a much larger organisation.

David Duncley: I absolutely endorse what you have said: a firm regulator that has an objective around broader learning. Where they enforce, it has to be proportionate, or else it is going to be a disincentive for firms like ours to be in this market.

Q303 **Mark Pawsey:** Jac, presumably you would go along with that.

Jac Berry: The penalties have to be fair and they need to take into account the facts of the case. Wantonness is obviously more important. They need to be fair.

Q304 **Mark Pawsey:** May I also ask you about his thought that auditors should use graduated findings? I was very interested, David, when you said that 60 of your 7,000 clients had been qualified. We have been told that qualification of accounts is pretty much a nuclear option. You are implying, if that is 1% you have qualified, that 99% have essentially been passed, but one assumes there was quite a spread of quality within that 99%. Do you think it would be better to be able to have a graduated indicator of how a company is being managed?

David Dunckley: We still grade it through that. I would say, on the qualification point, that you do not see the many, many conversations where we have suggested an adjustment and the adjustment is made, and therefore there is no need for a qualification. A lot of the auditors' work does not get seen.

Q305 **Mark Pawsey:** How often does that happen?

David Dunckley: I would genuinely have to come back to you in writing, given there are 7,000.

Jac Berry: It happens in a significant number.

Q306 **Mark Pawsey:** Is it two-thirds? In two-thirds of accounts the accountants would identify something that they would suggest to the company as an improvement.

Jac Berry: I would not say two-thirds. Sorry, I cannot give you a real answer.

Q307 **Mark Pawsey:** Come on; you guys are doing this all the time. Mr Knight, give us a figure.

Scott Knight: It is really difficult. I am not being evasive. It is really difficult to put a finger on, because it varies from company to company. I would say the product today that involves a binary decision of a qualification or a clean audit report is lost in the past. There need to be more tools in the toolbox. It goes to the expectation gap. If it is in relation to funding, the auditor's role is not to stop companies going bust. Sometimes they need to go bust, but the signs should be there. The signposts should be there. There should be disclosures of risks, prudence in the balance sheet.

Q308 **Mark Pawsey:** It is an indication of concern.

Scott Knight: Yes, signs should be there.

Jac Berry: I think this is relevant to your question. I will be quick. Part of it is transparency and allowing people to have the knowledge. To the point about where they were wrong but you made management change something, at a completion stage, every firm does something called an audit committee report. That enables people to see clearly what the

judgment areas were, what the difficulties were, what was adjusted and unadjusted. They are made public in the public sector and I think that would help people.

Q309 **Mark Pawsey:** May I also ask you about what Kingman had to say about fees? Fees are negotiated, with a figure that you tender, and you get paid that fee regardless of how difficult and complicated the audit is. It is a set amount, and he spoke about a graduated fee and perhaps some hourly billing. I have a question for Mr Dunckley. In a situation such as Patisserie Valerie, where something may be there, does the situation not militate against delving deep? You are being paid a set fee for the audit, rather than being able to spend extra time on it at the client's cost if you find something untoward.

David Dunckley: It is a very fair question. In our experience, no, it does not. Quality is so important to us, and there are individual assessments of individuals and partners working on an individual case doing that extra work, even if there is not capacity.

Q310 **Mark Pawsey:** So there is a danger of running an audit at a loss.

David Dunckley: You would flag issues as you go to the audit committee, that you have had to do more work.

Q311 **Mark Pawsey:** In the real world, if you know you are being asked to do a whole load of extra work at an extra cost, no organisation wants to make a loss on something, so is there a danger that that deep dive will not happen?

David Dunckley: In our experience, generally not, because we assess quality so strongly and it impacts the individual so strongly.

Q312 **Mark Pawsey:** Mr Stevens, does that apply across your profession as a whole?

Clive Stevens: That is also a role for the audit committee. My experience is that audit quotes may well quote a fixed price, but it will be subject to a number of provisos. If there is more work or there is something extraordinary, it is the auditor's responsibility to go along to the chair.

Q313 **Mark Pawsey:** How often does that happen?

Clive Stevens: That happens commonly and a lot, in my experience. Whether the auditor then gets the figure they want—

Q314 **Mark Pawsey:** The auditor goes back to the company and says, "We have discovered one or two things. We want to increase our fee".

Clive Stevens: It is not necessarily a confrontational thing. In my experience, the best clients welcome some challenge and want ideas. That is the other thing about it. They want that from their auditors. Provided the relationship is great, that is a discussion and a commercial discussion. There can be extra fees. As a chair of a charity, it is a

conversation I know my finance people have with our auditors every year.

Q315 **Vernon Coaker:** We have heard this morning of a number of issues with respect to the future of audit, and we have the Brydon review. We have heard about trust, culture, competition, the inability to break into the Big Four market, whether we investigate fraud. Then we have these various reviews. For the people watching this or reading it, Kingman has made recommendations; the CMA has made recommendations. Should we wait for Brydon, or should we just get on with it? How is this going to happen? We all say there has to be change and we are all wringing our hands. What is going to happen?

Scott Knight: The biggest risk is no change.

Q316 **Vernon Coaker:** What are we going to do about that?

Scott Knight: You could wait for all these reports and then further consultation, and it gets kicked further down the road. I think the public want to have confidence and need to see change in the next couple of years. A lot of these changes can be implemented quickly. They should not be delayed.

Q317 **Vernon Coaker:** We need to get on with it.

Scott Knight: Yes, definitely.

David Dunckley: I agree with that. The sooner Brydon can report, the better.

Q318 **Vernon Coaker:** We should not wait for Brydon to report.

David Dunckley: No, we should not. Kingman chapter 7 already lists some matters that can be proceeded straight away. If the buy side conditions change, firms like us will see a business case to invest.

Q319 **Vernon Coaker:** Will the Big Four agree with you when we ask them later? Will they all agree to get on with it?

David Dunckley: I will let them answer that question.

Q320 **Vernon Coaker:** Okay, but that is your message to them: "get on with it".

David Dunckley: Yes.

Jac Berry: I agree; we need to make change now.

Q321 **Vernon Coaker:** Now, get on with it and you are going to work to drive that. The public can be reassured from everyone. You are saying this in front of the Committee, but change is going to happen.

Jac Berry: Absolutely.

Clive Stevens: I have some sympathy for your view and statement as well. Brydon can deal with the expectation gap. It is not good enough to say there is an expectation gap. If, as a result of that, something else is

required of audit or the profession develops to deliver something else, so be it. The rest of the package probably should go forward. The flaw at the moment is that they do not go far enough in opening up the market if you want competition. If you take a joint audit approach, as the CMA has suggested, you may well have three or four entrants to that and you may feel that is enough. But you have the opportunity to do something more and develop a longer pipeline through adding a shared audit approach and giving audit committees the choice of being able to do that.

Vernon Coaker: That message from all four of you is very clear: let us get on with it.

Chair: Thank you very much for coming to give evidence to our Committee this morning.

Examination of Witnesses

Witnesses: David Sproul, Steve Varley, Bill Michael and Kevin Ellis.

Q322 **Chair:** Thank you very much to all four of you for coming to give evidence to our Select Committee this morning. Can I start by asking whether you think that, taken as a package, the Competition and Markets Authority's interim suggestions on reform will improve or reduce the quality of audit? Let us start with you, Bill Michael.

Bill Michael: Good morning. My view is that they will, as a package. Again, how we implement these things I am sure we will talk about, but in terms of the key findings of the CMA—

Q323 **Chair:** We will come on to those, but overall you are saying—

Bill Michael: Overall, I am supportive. It is the right direction of travel.

David Sproul: We agree with the policy objectives the CMA has, in terms of choice, quality and dealing with conflicts. We think some of its proposals will be very positive in that regard and some of them will have unintended consequences.

Q324 **Chair:** Taken as a package, you are not so sure it will improve the audit quality.

David Sproul: We are sure of many of them, but not all of them.

Kevin Ellis: I and my firm are absolutely up for change. We support the idea of a new, robust, statutory appointed regulator responsible to Parliament. We absolutely support more choice in the marketplace, as proposed by the CMA, and we support a fundamental review of audit as it is now and in the future.

Q325 **Chair:** What about as a package, Mr Ellis?

Kevin Ellis: As a package, we support the changes as put forward in those areas.

Q326 **Chair:** You think the CMA measures will improve audit quality, taken as a package.

Kevin Ellis: Most of the points in the package will improve audit quality.

Steve Varley: At EY, in reviewing the CMA's package, we believe that five out of the seven remedies would improve choice and, if implemented correctly, would sustain or improve audit quality. Two of the remedies we do not believe would improve choice and would definitely put audit quality at risk.

Q327 **Chair:** One of the key recommendations is joint audits. You have all said, overall, you think that five out of seven of them will improve quality. Bill Michael, you have said that, overall, they will improve audit quality. Let us look at one of the specific recommendations: joint audits. Bill Michael, starting again with you, what impact will joint audits have on audit quality, in your view?

Bill Michael: I would prefer market caps and I will explain that, but, on joint audits, they are more difficult to implement in practice. There is friction associated with implementation with another party. However, there are pros and cons with both of these. The benefit is it provides another pair of eyes. If you have two firms debating the significant judgment calls that management has to make, it addresses some of the potential asymmetry you have between management and audit. Again, divide and conquer, looking at different aspects of the audit rotation over years can provide another lens, so I can see benefits.

Q328 **Chair:** You can see benefits, but overall you have said that you do not think that is the right approach.

Bill Michael: For them to work effectively, one of the most important things on joint audits is that you need parties of fairly equal weight and strength. If you have a significantly lopsided approach, it lacks credibility that one firm does 90%, another firm does 10%, in terms of the execution of the audit, understanding the business, making those judgment calls. Again, you would need parties of equal weight. The recommendation in the report of the FTSE 350 being done by two firms and a small firm or a medium-sized firm is not practical or desirable from where we are.

Q329 **Chair:** You think a joint audit would be better if it was two of the Big Four rather than one Big Four and one challenger.

Bill Michael: No. The purpose is to have more than four firms, which we support, being capable and willing to audit. All I am saying is that, if we are going to implement it to have a second firm, a medium-sized firm, it would have to be of equal weight. It would not be practical for the largest companies, complex companies, global companies on the FTSE 100.

Q330 **Chair:** Would you support a market share cap?

Bill Michael: It is the most practical and effective way to get to a good result.

Q331 **Chair:** Do you think it would improve audit quality?

Bill Michael: If implemented well, yes.

Q332 **Chair:** What would that market cap be?

Bill Michael: Again, we need more analysis, but instinctively, from my perspective, maybe 20% of the FTSE, so, if we are talking about the FTSE 350, about 70 companies between three to five years. If we set up the framework right to be able to do that, we could have more than four firms, five, six or seven, auditing maybe 70 companies, which would be a big step from where we are today.

Q333 **Chair:** Within that 80%, would you say that none of the Big Four should be able to have more than 20% or could that 80% be divided up however the market decided?

Bill Michael: I would go, for the first step, to make sure at least, say, 20% of the FTSE is audited by another company. As for what would happen then, I would let the market run its course.

Q334 **Chair:** Let me bring others in. David Sproul, what do you think about joint audits? Would they improve audit quality?

David Sproul: We do not support them. As the CMA said, there is no evidence that joint audits improve audit quality and we think that is the determinant.

Q335 **Chair:** If not a joint audit, would you support a market share cap?

David Sproul: We would. Our response to the CMA went into some detail on a combination of shared audits and market share cap. We support my colleague's comments that the analysis we have done, which we have shared with the CMA, indicates that if you had a market share cap you could have 75 of the FTSE 350 being audited by challenger firms within five years. They could have 25% of the FTSE 350 audit fees, excluding those of the FTSE 30, the largest companies. That is a significant shift in market concentration from the current 11 companies audited by other challenger firms.

Q336 **Chair:** How would you decide which of those 75 companies were no longer audited by one of you four? Would you decide? Would the regulator decide? How would that happen?

David Sproul: There is clearly some detail in that, but the regulator has to play a role. There is a concern, which the CMA raised, about the risk of the firms cherry-picking which ones they would want to keep and which ones they would want to leave. There is a role there for the regulator and we see this as a mechanism whereby, over a period of time, you could use market share caps to cause that shift in the market concentration.

Q337 **Chair:** How many firms in the FTSE 350 does Deloitte audit, Mr Sproul?

David Sproul: Something of the order of 65 or 70.

Q338 **Chair:** Of the 65 firms you audit, would you be happy for the regulator to

say, "Those 10 or 20 will no longer be audited by you. We are going to take those away from you"? Would you be happy with that approach, that the regulator would decide?

David Sproul: At a basic level, yes, but one has to remember it is the shareholders of the companies who select auditors and, therefore, one has to work out the mechanism to achieve that.

There is a recognition that this mechanism reduces choice for a period of time. We are trying to increase choice here and, therefore, we recognise that in having market share caps over that period of time you are reducing choice for shareholders and companies to select their auditors.

Q339 **Sir Patrick McLoughlin:** Can I check what you said there? Did you say it is the shareholders of the company who decide who does the audit?

David Sproul: It is the audit committee, on behalf of the shareholders, that selects the auditors.

Q340 **Sir Patrick McLoughlin:** I was going to say I do not think shareholders have any say whatsoever, do they?

David Sproul: Well, technically, they vote on it, but obviously it is the audit committee that acts on behalf of shareholders.

Q341 **Sir Patrick McLoughlin:** Can you please inform us in reality rather than the technicality of things?

David Sproul: Of course.

Q342 **Chair:** Kevin Ellis, let me ask you the same question. Are you in favour of joint audits?

Kevin Ellis: No. We think joint audits would increase costs for the company in terms of audit fees, because you would have duplication, and in terms of management time. But we do agree with market share caps. We see that as an important transition—

Q343 **Chair:** None of you agree with one of the key recommendations. It is fine, but none of you agree with one of the key recommendations of the CMA.

Kevin Ellis: We do agree that market share cap could be an important transitional arrangement for increasing choice in the market, and that we support.

Q344 **Chair:** Would you be supportive of 70 or 75 FTSE 350 companies being audited by one of the challenger firms?

Kevin Ellis: Absolutely.

Q345 **Chair:** Would you be happy with the regulator, in its new guise, I expect, deciding which one of those firms you no longer audited?

Kevin Ellis: Yes. The way it would have to work is that the audit committee of the company and the challenger firm, with the regulator's oversight, would have to be comfortable that that challenger firm could

take that work on. If they could take that work on in their own right, they should do. If they needed support in doing that, shared audits, as also put forward in the CMA report, would be a way of achieving that and giving support for that transitional arrangement to create more choice in the marketplace.

Q346 **Chair:** Of the FTSE 350 businesses, how many does your firm audit?

Kevin Ellis: We audit 29%.

Chair: Okay, so about 100.

Kevin Ellis: Yes.

Q347 **Chair:** So you are the biggest of the Big Four. Would you support Bill Michael's suggested 80%? David Sproul gave slightly more to the challenger firms. Is it about 80% for the Big Four and 20% for the others?

Kevin Ellis: Rather than picking out a percentage, the CMA put forward 80%. That is a sensible number. For me, it is about transition period.

Q348 **Chair:** Within that 80%, would you support none of you having more than 20% or would you, as the biggest of the Big Four, say that you should have more than 20%?

Kevin Ellis: It is up to the regulator to oversee the transitional arrangements, because it is going to be quite complex otherwise and, if that is us having 20%, that is fine. When the mandatory firm rotation was brought in, our share of the FTSE 100 fell from 43% to 29%.

Q349 **Chair:** Unless you want to say something radically different, Steve Varley, I do not need to hear from you.

The other recommendation of the CMA was that you have an operational split between the audit and non-audit parts of your businesses. Steve Varley, are you in favour of that operational split?

Steve Varley: No, we are not in favour of an operational split.

Q350 **Chair:** Right, so basically we have managed to find the two of the CMA recommendations that you do not agree with.

Steve Varley: Correct.

Q351 **Chair:** Kevin Ellis, are you in favour of that operational split?

Kevin Ellis: No, I am not. Do you want me to give you the reasons?

Q352 **Chair:** Let me just see where the others fall on that. David Sproul?

David Sproul: No, we are not.

Q353 **Chair:** Bill Michael?

Bill Michael: I support an operational separation of the audit function, but not a full, hard, electrified fence in a first case. The direction of travel is right: our business model is opaque; it needs to become more

transparent because it is impairing confidence in audit quality. We have heard before that there is scepticism as to whether large multidisciplinary firms are focused enough on audit, so some form of separation is the right direction of travel and we have started doing that.

Q354 **Chair:** KPMG and Deloitte have already suggested that you are going to stop doing non-essential non-audit work for your audit clients. Is that right, Bill Michael, for your FTSE 350 clients?

Bill Michael: That is right.

Q355 **Chair:** When are you starting?

Bill Michael: We have started.

Q356 **Chair:** How much non-essential non-audit work do you now do for your FTSE 350 clients?

Bill Michael: We hope to have it implemented over 12 months. We are not stopping work half way through, obviously, but we are talking tens of millions.

Q357 **Chair:** At the end of 2019 then, you will not be.

Bill Michael: That is correct.

Q358 **Chair:** David Sproul, you have also suggested that. Have you started?

David Sproul: No, we have not.

Q359 **Chair:** When are you going to start?

David Sproul: We have put that forward as part of a package of measures.

Q360 **Chair:** It is not something you are willing to do—it would not be unilaterally because KPMG is doing it—without being told you had to do it.

David Sproul: We want to wait and see the total package that is agreed.

Q361 **Chair:** Do you think that it will improve audit quality if you stop doing that work?

David Sproul: It is interesting, because in its interim findings the CMA decided that there was no problem with non-audit services.

Q362 **Chair:** Why are you saying you are going to do it if you do not think it matters?

David Sproul: There is clearly a perception of conflict between the audit and non-audit services.

Q363 **Chair:** But you do not think it will improve audit quality if you stop doing that work.

David Sproul: We do not think directly it will impact on audit quality. It will help trust in the profession in terms of—

Q364 **Chair:** I want trust in the profession to increase, but I really want audit

quality to increase, because we are not satisfied with audit quality.

David Sproul: As do I.

Chair: You have offered to do this thing, but you do not think that that will improve audit quality. Is that right?

David Sproul: It was not put forward as a proposal to improve audit quality.

Q365 **Chair:** PwC, are you going to stop doing this non-essential non-audit work for your audit clients?

Kevin Ellis: It was not part of the CMA inquiry, but we have looked at it and we will do a ban on anything for audit clients other than audit or audit-related services. We will introduce that.

Q366 **Chair:** When are you going to do that?

Kevin Ellis: I agree, though, with what Mr Sproul said. I do not think it is about audit quality. I do not think it changes audit quality, but it does change perception.

Q367 **Chair:** Sorry, I just asked when you are going to start doing that, Kevin Ellis.

Kevin Ellis: We will stop taking on work as work comes up now. We will put that ban in place.

Q368 **Chair:** When will you fully have rolled that out? Bill Michael said by the end of this year.

Kevin Ellis: There are jobs we are doing at the moment that the clients will need us to complete. We need to complete the work we are doing at the moment.

Q369 **Chair:** When do you think you will get to this place?

Kevin Ellis: Over the near future.

Q370 **Chair:** What is the near future?

Kevin Ellis: Six months. It will take a while for it to happen.

Q371 **Chair:** If we wrote to you in a year's time and asked you what non-essential non-audit work you are doing for audit clients, it would be none.

Kevin Ellis: It would be. It is not a significant sum of money today.

Q372 **Chair:** Do you think that will improve audit quality?

Kevin Ellis: No, I do not think it will improve audit quality, but there is an issue about public perception and public trust, and that transparency deals with that issue.

Q373 **Chair:** Yes, so the same as David Sproul. I know that I am rushing, but if you are going to say the same thing I do not need to hear it twice. Steve Varley, are you going to stop doing non-essential non-audit work for

audit clients?

Steve Varley: Yes, we will follow that.

Q374 **Chair:** Okay, and when will you have stopped doing that?

Steve Varley: We will be in consultation with our clients over the rest of this year to bring it to an end.

Q375 **Chair:** Okay, great. Do you think that will improve audit quality?

Steve Varley: I do not think it will improve audit quality, but nor do I think it will reduce it either.

Q376 **Chair:** That is fine. You do not need to repeat what other people have said. We have about another 45 minutes; hopefully we will come on to something that is going to improve the quality of your audit work, because that is where we all want to get to and we have not heard anything so far.

Q377 **Stephen Kerr:** Before we get there, the one thing that you seem to all agree on, where you are on the same page, is that you do not want to be broken up. You say it is too costly, too complex. You did not think that in 2002, three of you, when you sold your consultancy businesses, so what is the explanation for that? Maybe I can start with EY, Steve Varley.

Steve Varley: We are in a very different situation now. If I look at the complexity of companies today, they are hugely more complex than they were in the past. Our key point on operational separation—

Q378 **Stephen Kerr:** More complex than they were in 2002?

Steve Varley: If you look at the technology firms and many of the multinationals that we audit, they are a lot more complex and the world is a lot more complex.

Q379 **Stephen Kerr:** Do you agree with that, PwC?

Kevin Ellis: Yes. The world is a lot more complex and it is critical that you have a variety of skills. On average, 15% to 20% of the hours we spend on audit is spent by non-auditors providing the critical knowledge that you need to know to be able to complete the audit. Going back to quality, it is a critical part of delivering a quality audit.

Q380 **Stephen Kerr:** KPMG, the world has changed so much since 2002, it is too costly and too complex to even consider breaking up, even though you did it in 2002.

Bill Michael: It is something that would have to be contemplated globally, in any case. It has become more complex. I do not want to hide behind the word "complexity", but we have become a far more interdependent, larger practice to deliver audits, to service audits, specialists. It may be uncomfortable, but the reality is that it has changed. It is much harder to separate these organisations today than it was in 2002, and there was a global push to do that back then.

Q381 **Stephen Kerr:** In 2001, the Big Five became the Big Four; Arthur

Andersen collapsed under the weight of the Enron scandal. What happens to the audit market when one of you becomes the next Arthur Andersen?

Bill Michael: One of the key focuses of the recommendations is on resilience of the model. The reason we are talking about having more than four capable and willing audit firms is to create a more resilient system that promotes trust. If we get down to three, we are in a very difficult situation, I would agree with that.

Q382 **Stephen Kerr:** In the event that there was a collapse of one of the Big Four and it became the Big Three—that is the danger, is it not—should the partners in the collapsing company be forced to go to the challenger firms rather than to one of the other big companies?

Bill Michael: I do not know how that would operate in practice. I have not scenario-played it in that sense, but I imagine people would, as they did in Arthur Andersen.

Q383 **Stephen Kerr:** What is your take on that, David Sproul?

David Sproul: The key is to build the resilience of the firms so you do not have that situation. When we look at this question, we are very clear that the multidisciplinary model is the right model for delivering increased audit quality. Audit quality increased from 52% to 81% last year under the FRC's measures; it has dropped to 73%, but there has been clear improvement in audit quality. The multidisciplinary model drives that. It also creates resilience. If I look at our firm, in the UK, we are a firm with revenues of about £3.7 billion, £500 million of which is audit. To me, it is very clear; if you have a separate audit business with £500 million of revenue, it is less resilient than a firm, which stands behind the audit quality and everything we do, of £3.7 billion.

Stephen Kerr: £500 million makes you less resilient. That is a fascinating thought for most of the businesses in my constituency.

Q384 **Chair:** On this issue of resilience, Bill Michael, how much work are you doing in South Africa at the moment?

Bill Michael: As a global firm? From the UK, a relatively small amount, but I do not know our South African revenues.

Q385 **Chair:** Has KPMG been banned from doing audit work in South Africa?

Bill Michael: We have not been banned. We are still conducting audit work in South Africa.

Q386 **Chair:** What is the situation of KPMG in South Africa?

Bill Michael: Clearly, we have had significant reputation challenges. We have made some very significant mistakes in South Africa. We have taken decisive action to try to fix them, but we are coming from a very difficult place. We are trying to rehabilitate the brand with the local policymakers and Government. It has had a significant impact.

Q387 **Chair:** The issue that Stephen Kerr is raising about resilience is not a

theoretical one. There are countries where you have had very serious reputational damage. I would argue that the UK is one of those countries as well, given what happened at Carillion. David Sproul, you were the CEO of Andersen in the UK at the time of—

David Sproul: I was the COO.

Chair: The COO, and you said, in December 2018, about the collapse of Enron, “We were making the case that of course this was serious, but it was containable. This was an issue in an office in Houston, Texas. And of course you couldn't defend the debacle, but it was containable”. But of course it led to the collapse of one of the Big Five, so what Stephen Kerr is talking about is not some sort of hypothetical; it is a very real possibility that, if we were here in a year's time, we may just have the Big Three.

Q388 **Stephen Kerr:** What about PwC?

Kevin Ellis: The resilience point is absolutely key. It is interesting that, when the CMA document was published, one of the earliest calls we had was from the chair of our staff pension trustees, asking how, if this split happened, we would view the pension covenant for our employees who are retired. The resilience is not just an issue for us, and it is a real issue, but a smaller firm just doing audit would have less of a portfolio spread and therefore, being a smaller firm, would carry more risk. The fact that our pension trustees picked that up straight away and queried it with us just shows it is a real issue in the wider market.

Q389 **Stephen Kerr:** So you need the multidisciplinary aspect of your business in order to sustain your resilience as an operation.

Kevin Ellis: It makes our operation more resilient, absolutely.

Q390 **Stephen Kerr:** What happens if there is a collapse of one of the Big Four? What happens to the partners?

Kevin Ellis: If there is a collapse of the business, the partners lose their investment, their business and their livelihood. The chances are they could move to another organisation. I suspect that, with the idea in the Kingman report of a more robust regulator, it would probably have a chance to intervene in that, to ensure that those partners and people who are available do not strengthen the existing Big Three, but probably go to the challenger firms to create more spread in the market.

Q391 **Stephen Kerr:** Probably.

Kevin Ellis: That is why choice is so critical. I am totally supportive and my firm is supportive of choice in the market.

Q392 **Sir Patrick McLoughlin:** Can I get a bit of background? For most of you, your global staff numbers are over 200,000, but your UK share of that is between 9% and 11% across the four companies. In the UK, how much of your business is audit?

David Sproul: For Deloitte, our audit business is about 14% of our total revenue in the UK.

Q393 **Sir Patrick McLoughlin:** That is 14% of £2.1 billion.

David Sproul: For Deloitte, our revenue is about £3.5 billion or £3.6 billion in the UK.

Kevin Ellis: Of my 20,000 people, 4,000, 22%, are in my audit practice.

Steve Varley: It is 20%.

Bill Michael: It is in the low 20s.

Q394 **Sir Patrick McLoughlin:** For every job that you advertise, how many applicants do you tend to get?

Kevin Ellis: Our annual number of applicants is 104,000 for our graduates or our qualified joiners.

Q395 **Sir Patrick McLoughlin:** How many people are you looking for?

Kevin Ellis: On average, we recruit about 4,000. About 1,500 of those will be school leavers and graduates and then there will be a number of qualified hires as well. We are a large graduate recruiter.

Q396 **Sir Patrick McLoughlin:** It is very competitive to get in; there is a lot of competition.

Chair: I would not worry, Patrick. You have a lot of skills.

Peter Kyle: I will be your referee, Patrick.

Q397 **Sir Patrick McLoughlin:** Are we turning the tables here? Right, thank you. Would you argue that the competition between you is very fierce?

Kevin Ellis: It is extremely fierce. To take as an example a large financial services audit tender, the team will have visited, in one of them, over 62 countries as part of that tender process. It is a very expensive and competitive process.

Q398 **Sir Patrick McLoughlin:** Yet all four of you have been fined in the last few years, so what does that say about quality of work?

David Sproul: It says it is not good enough. I would not sit here and say that audit quality is where it needs to be. I mentioned the statistic earlier that audit quality has moved from 50%, based on the FRC's measures, up to the low 80s last year and dropped down, but it is not good enough.

Q399 **Sir Patrick McLoughlin:** If it is not good enough, should we not have more competition and should we not be forcing that competition? Should we not be making way for more challengers? You are sitting here as the four leading companies, very important companies both globally and in the United Kingdom; I fully accept and appreciate that. But there is a bit of a cartel going on, is there not?

David Sproul: There is no cartel at all. I agree with your point, Sir Patrick. We support more choice if it drives audit quality. I would agree with Mr Ellis's point that it is fiercely competitive. The evidence since mandatory tendering came in is that competition has increased quality, because quality has improved as there has been more competition. We support more choice. We have been very clear in our submission to the CMA that we would support a mechanism of shared audits and market share caps, which, as I said earlier, we would see creating the opportunity for over 75 companies of the 350 being audited by challenger firms. It is critical, to play back your question, that that drives quality, and therefore it can only be done where delivering audit quality is within the remit of those challenger firms, so that it does drive that improved quality.

Q400 **Sir Patrick McLoughlin:** Does anybody else have any points on that?

Kevin Ellis: I would agree with that.

Q401 **Sir Patrick McLoughlin:** You were a bit dismissive earlier on about shared audits and not very keen on them, but do you not do them in France?

David Sproul: I was dismissive of joint audits, not shared audits. It is a technicality, but "joint audit" essentially means that two firms take joint responsibility for the audit opinion; "shared audit" means the work is shared. We, of course, do them in France because that is the legislation. The point is that there is no evidence that that has increased audit quality. The French market is a different market. There was a large challenger firm at the time they brought in joint audits, Mazars, which participated in that. It has not brought any other market participants into the market from the large French audit firms. There is also a pooled fund for liability in France, which deals with the concern some of the challenger firms have on liability. It is a very market-specific solution. As far as I am aware, it is the only significant market that has brought in joint audits and, of course, joint audits are not banned in the UK. Companies could choose to have joint audits and they choose not to, at the moment, in the UK.

Q402 **Peter Kyle:** Kevin Ellis, if you were an audit-only firm, would you struggle to get talent?

Kevin Ellis: I think we would. I visited a number of universities and apprenticeship groups over the course of last September as part of our normal recruitment. This is the most common question I was asked: "If the firm splits, will I have to remain in the area I have joined or can I still move around?" Talent is attracted to choice. My global head of assurance started off as a consultant. My European head of consulting started off as an auditor. People like choice. If the ultimate aim is to have the best possible people—this is a human business; it is about human judgment—we want to attract school leavers, apprentices and university graduates, who want choice. I do not think an audit-only firm will do that.

Q403 **Chair:** What is the biggest barrier to recruiting talented people, the

separation between audit and non-audit or the reputation of your firms, given the scandals we have seen?

Bill Michael: The most important is the reputation of our firm. That is unequivocal. On the challenge of separating, there is a dilemma. A trade-off is what we are really talking about here.

Q404 **Chair:** I recognise that. I am going to move on. It was a rhetorical point really. It is fine. There will be consequences of any change, but the consequences of not changing, it seems to me, are really quite serious for your businesses and you need to face into that a bit more than perhaps we have seen so far.

Q405 **Mark Pawsey:** Could I ask you some questions about fees? Kingman suggested that the regulator might have more power over fees. Each of you has told us that you would like to see better audit quality. Are you simply undercharging?

Steve Varley: No, we do not believe that we are undercharging. There is an incredibly competitive market among the six and that is not leading to undercharging at all.

Q406 **Mark Pawsey:** Mr Ellis, are you charging enough?

Kevin Ellis: We are charging enough. Audit is a profitable business for us and we believe we charge enough. The strength of the audit committee is that they are focused not on fees but on quality, which is absolutely the right thing to do.

David Sproul: I agree with the comments made.

Q407 **Mark Pawsey:** Can I ask you about the structure, then, which is an issue I raised with the previous panel? You tender and it is a fixed price. If you uncover additional work during your audit, we have been told that you have to go back and chat to the audit committee, and maybe get it approved. Would it not make sense to have some variable element of fees, so that when you uncover something untoward you have time to dive into it a bit more deeply without worrying about losing profit on the audit? Mr Varley, what is your view on variable fees?

Steve Varley: By the very nature of the audits that we execute and that we work on, if you find issues you go after them and you look into them. There is a discussion at the end of the day with the audit committee chair—

Q408 **Mark Pawsey:** Why would you do that if it takes extra time and you are not going to recover those costs?

Steve Varley: Fundamentally, you are focused on audit quality and protecting investors and others.

Q409 **Mark Pawsey:** You are happy that that outweighs the return to the firm in the price that it has negotiated for the work.

Steve Varley: Oh, yes, significantly.

Q410 **Mark Pawsey:** Would you all tell us the same thing?

Kevin Ellis: Absolutely. Audit opinions are signed personally and therefore the reputation of the person signing the audit opinion is critical.

Q411 **Mark Pawsey:** How have the failures occurred, then?

Kevin Ellis: There will always be an element of failure where sometimes we do not manage, through human error or mistake, to spot a judgment error by management in preparing the accounts. When an audit fee is set, if there are findings, we often go back to the audit committee and discuss with them those findings, and there will be variations on the fees.

Q412 **Mark Pawsey:** Mr Ellis, you told us about the huge amount of work that is necessary in preparing a tender and we have heard that also from challenger firms. There is an enormous amount of work that needs to be done, which is not recoverable if you are successful, but do you sometimes get it wrong? Do you sometimes bid the wrong price, because you have not properly assessed the amount of work that is involved in these businesses, which you have told us are much more complicated now than they were 20 years ago?

Kevin Ellis: That can happen, but the audit partner will still want to do the work properly and, if that means we have a loss on it, we do. If we find something—and regularly we do find material errors or misstatements in the management accounts that we are auditing—we will discuss it with the audit committee and the audit committee will usually be supportive of us doing further work to get the evidence right so that we can do the audit properly.

Bill Michael: From my experience, if we have challenges with clients—we have to do more work, something has been uncovered—we renegotiate. It is rare that we have a fixed fee and we just do not change anything if we are doing a significant amount of work.

Q413 **Mark Pawsey:** That is interesting. For what proportion of the audits that you carry out does the fee end up being something different from the fee you originally tendered?

Bill Michael: I will come back to you on that. It is a material number. It is not an immaterial number for the large audits. I will come back to you.

You talk about getting audit fees right. There is no right number. We have a mixed business model and one of the things we have to move towards in a more separated practice is greater transparency over our audit practice. It is a point that Sir John Kingman made here last week. If we are going to have to move to a greater level of separation to answer that question properly, that is an important question but it is not an easy one to answer: are we charging the right level of fees?

Q414 **Mark Pawsey:** We know that your non-audit work is generally more profitable than your audit work. Mr Ellis, you told us that you made a profit on your audit work, but to what extent is your audit work a loss leader that opens the door for a relationship that provides these

additional services? If you lose the ability to do that other work, to what extent are your audit fees going to have to go up?

Kevin Ellis: Every year, in our transparency report, we share the profitability of our audit business. My audit business has a margin of 18%. It is a profitable business and it is not our least profitable business; nor is it a loss leader.

Q415 **Mark Pawsey:** Is that 18% higher or lower than your non-audit work?

Kevin Ellis: There is some non-audit work that is lower than that and there is some that is higher.

Q416 **Mark Pawsey:** Across your business as a whole, is the margin you make on non-audit work higher or lower than 18%?

Kevin Ellis: It differs. There is lots of different non-audit work we do; some is higher and some is lower.

Q417 **Mark Pawsey:** Is that across the piece.

Kevin Ellis: Yes, across the piece, so 18% is a good return for the work we do.

Q418 **Mark Pawsey:** Does that apply to all firms? You are suggesting it is broadly the same return.

Kevin Ellis: No, I am saying there are parts of my business that are more profitable than that.

Q419 **Mark Pawsey:** Sure. I had a business and we made more money on some products than others, but I knew what my overall margin was, so what is the margin—

Kevin Ellis: It is 26%.

Chair: Well done, Mark.

Q420 **Mark Pawsey:** Does that apply across every firm, that your non-audit work is pretty significantly more profitable than your audit work?

Steve Varley: Yes. On a majority basis, if you take our audit business versus the rest of the business, the audit business would be marginally less profitable than the rest of the business.

Q421 **Mark Pawsey:** Mr Sproul, would the same apply?

David Sproul: Over a business cycle it has been very similar. In the last two or three years, audit has been less profitable in a similar way to Mr Varley.

Q422 **Mark Pawsey:** Therefore, is there a concern, if you are not able to do the same amount of non-audit work with the clients you are doing audits for, that the audits might become more expensive?

David Sproul: Can I make one point of clarification? From our point of view, the reason audit has been less profitable is because of the investment we have made in both winning new audits, as we have gone

through the audit tender process, which, as you alluded to, is a very expensive process, and the investment in quality. We expect that to come back to a more normal level of profitability over the next couple of years. We certainly do not see audit as a loss leader. There is no advantage to the rest of the business in winning the audit. Our audit partners are rewarded only on audit quality.

Q423 **Antoinette Sandbach:** Can I just check? Were all the witnesses here for the previous panel's evidence?

David Sproul: I was, yes.

Kevin Ellis: I was.

Q424 **Antoinette Sandbach:** Knowing that you were in here, you will have heard the evidence from Mazars around capital maintenance rules and the fact that checking a company was sticking to its legal requirements under the Companies Act and capital maintenance rules was an essential part of audit. Do you agree with that?

David Sproul: I do agree. It is a very technical point. It is a legal requirement in terms of distributable reserves, and it is a very clear black and white legal requirement. Auditing standards are catching up with that, but is a very important point, I agree.

Q425 **Antoinette Sandbach:** Does anyone on the panel disagree?

Bill Michael: Sorry, I missed the previous session. The point was—

Q426 **Antoinette Sandbach:** The point was around the legal requirements on company directors to ensure that, under sections 830 and 831 of the Companies Act, companies can only pay dividends out of past realised profits that are available for distribution in the company's distributable reserves.

Bill Michael: I am familiar with that point, thank you. This has been a big debate around accounting standards. There is a difference.

Q427 **Antoinette Sandbach:** This is not an accounting standard; it is a legal requirement on the company that you, as auditors, I would suggest, are required to audit, to check whether or not—

Bill Michael: We audit in accordance with accounting standards. The debate, however, is—

Q428 **Antoinette Sandbach:** Are you saying that legal standards that apply to companies' directors are not checked by you when it comes to, in effect, income, which you are auditing, accruals, which you are auditing, profits, which you are auditing? Are you saying those legal standards play no part in your audits?

Bill Michael: No, we do look at them. I am saying that distributable reserves are driven from the accounting result, the international accounting standards. There is a body of opinion that says that what is distributed is inconsistent with company law. That is a different technical

point and one that has been open for a number of years. We audit in accordance with those accounting standards and we are saying that that is the law.

Q429 **Antoinette Sandbach:** If a company director is committing fraud or you see evidence of fraud, which is against the law, in a company, do you see your obligation to expose that? If not, if accrued income is treated as realised income for the purposes of distribution, is there not an equal problem where, effectively, dividends can be paid when legally, under company law, they should not be?

Bill Michael: In connection with fraud, we have an obligation under auditing standards. We are not responsible for the material detection of fraud.

Q430 **Antoinette Sandbach:** Fraud is when a company does something illegally. If you are not auditing to the standard required by the Company Act, you are effectively saying that a technical notice that has been issued by the ICAEW takes precedence over a legal requirement that is imposed on company directors about the way in which their income, profit and dividend is declared.

Bill Michael: I am saying that we are auditing in accordance with the standards. We believe they are consistent with UK law. There is a body of opinion, a group of people, taking the view that it is sometimes inconsistent, that accounting standards are not realised profit, so if you are distributing from that that is not accurate. All of us are signing off on accounts that we believe are in accordance with the law.

Q431 **Antoinette Sandbach:** I can understand why you might be shifting shape on this requirement, because of course KPMG was responsible for Carillion paying a £54 million dividend one month before it announced an £845 million hit. The excuse for that has been the accountancy regulations rather than the applicable standards in the company law rules; is that not right?

Bill Michael: I cannot specifically talk about the live situation in Carillion, but I understand where you are coming from on your question. All I am saying is that there are different views on whether this is in accordance with the law, according to some investors. We are saying that what we have done is in accordance.

Q432 **Antoinette Sandbach:** What do you think the ordinary member of the public who has their pension fund money invested in a company would expect? Do you think they would expect accountancy firms to apply the law or would they expect them to apply a technical standard that is not as strict as the law?

Bill Michael: I would expect them to apply the law and I believe that we are applying the law.

Q433 **Peter Kyle:** I think the panel would agree that one of the quick wins we could have here is if we all just started applying the capital maintenance rules in a more rigorous way. If I could turn to you, Steve Varley, when

we look at the example of Domino's Pizza, £85 million of unlawful payments were made over a 16-year period. Did you just forget the capital payments rules or did you ignore them? It can only be one of the two.

Steve Varley: On Domino's Pizza, it would be inappropriate for me to comment on the detail of the investigation. Let me speak more broadly. Part of the issue here is that five changes need to come together to improve the overall audit market. The one on audit expectations, which might be part of the discussion here, is the work that we hope Sir Donald Brydon will do to make sure—

Q434 **Peter Kyle:** You cannot go down that path. I want to know why you have not been applying capital maintenance rules. It is as simple as that. You have been ignoring the rules, you have not been aware of the rules or you have been choosing not to. What is it? You are not aware of the rules or you are not applying them.

Steve Varley: I am not sighted on that particular case for Domino's Pizza, I am afraid.

Q435 **Peter Kyle:** Are you saying now that in every other audit you are applying the rules in a rigorous way?

Steve Varley: I am very clear that we are applying the applicable accounting standards and the auditing standards as well.

Peter Kyle: But you have not been.

Antoinette Sandbach: Where is the challenge to the audit committees to check that the company has been complying with the law? If it has not been complying with the law, its directors are not complying with the law and you are not exposing that, you are complicit in fraud, are you not, on the shareholders?

Q436 **Peter Kyle:** That is the capital maintenance rule. You must be paying dividends and payments to shareholders out of current profits, not future profits. That has not been applied in the Domino's Pizza case and it was not applied in the Carillion case. Clearly, these rules are not being applied at the moment, either wilfully or through lack of appreciation of the law. Which is it?

Steve Varley: I am very clear that we will be applying the accounting standards, the audit standards.

Q437 **Peter Kyle:** You said "we will be". I want to know whether you have been.

Steve Varley: We are and we have been, but we are not lawyers. Where we find indications of something unlawful we will flag that up to the audit committee chair and then to the relevant authorities.

Q438 **Peter Kyle:** But you must be doing due diligence to make sure that you are operating within the law.

Steve Varley: We complete an audit. This is not a full-on legal review of a company's operations. We are auditors.

Q439 **Antoinette Sandbach:** This is about how accrued income is treated as realised income, which is a significant part of your audit process, is it not? Is that right, Mr Sproul?

David Sproul: Sorry?

Antoinette Sandbach: There are value judgments about when accrued income should be treated as realised income, which is an integral part of your audit process.

David Sproul: And you would expect the audit to focus on that and form an opinion, as others on the panel have said.

Q440 **Peter Kyle:** Kevin Ellis, what work do you do to make sure that, in PwC, you are applying the capital maintenance rules?

Kevin Ellis: We spend hundreds of hours on every audit we do. Our whole team spends hours. We make sure that we are complying with the law, as has been said. I am not an auditor, but I am confident that the work we do is to apply those rules.

Q441 **Peter Kyle:** You are proactively ensuring that.

Kevin Ellis: Yes, absolutely.

Q442 **Peter Kyle:** I am hearing from the others that you are not proactively ensuring that you are operating within the law. That is the thing that is frustrating for me. That is what I am hearing. It seems so passive.

David Sproul: You should not have heard that in my comments.

Q443 **Peter Kyle:** It was not from you; it was from Bill Michael and Steve Varley. It sounds like it is a passive process. If you were proactively seeking to operate within the law, I cannot see how the Domino's Pizza situation or the Carillion situation would have happened. Am I wrong?

Bill Michael: Going back to the point where there is a fraud associated with this, where a company is paying money out of reserves that it does not have and it is material, we do have an obligation to detect that. I do not disagree with that. I honestly cannot talk about the specifics of Carillion right now, but we do, as a firm, have an obligation to make sure that the accounts are materially correct and, if there are material movements out of reserves that are not earned, we should be detecting that as part of our work.

Q444 **Peter Kyle:** When you sign off a company's accounts, you say that you comply with the requirements of the Companies Act 2006. I am quoting. That is a legal requirement of you. Within that Act is the requirement to adhere to the capital maintenance rules.

Bill Michael: You are right. I agree. Our work is designed to do that. That is what we are supposed to do.

- Q445 **Peter Kyle:** So it is just happening by accident that you are not.
Bill Michael: Again, I cannot comment on that case.
- Q446 **Peter Kyle:** You are not proactively checking.
Bill Michael: We are proactively checking. We proactively check for any material misstatement in accordance with the law. Our work is designed to do exactly what you are prescribing.
- Q447 **Chair:** Bill Michael, you said in an interview in February last year, when talking about your company, "We conducted a proper audit, but it's right that following a corporate collapse of such size and social significance, a proper independent investigation is performed, so lessons can be learned". In January, you suspended Peter Meehan and three of his team. What lessons did you learn and why did you suspend those four people?
Bill Michael: That is a very important question, if I can respond to that. What happened with the audit partner suspension is that we had been conducting a thorough forensic review of our 2016 audit, which is of course under current investigation. During that review, we included the way our audit team dealt with the FRC's audit quality review, which was conducted routinely during 2017. Our review identified a number of irregularities on a small number of documents provided to the AQR to supplement information on the audit file. We immediately, as soon as we identified this, notified the FRC of this matter and we suspended the four individuals, including the lead partner Peter Meehan. We are now conducting an independent review using outside legal counsel and we are sharing our findings with the FRC. We are also fully co-operating with the FRC on this matter. Again, it is a live investigation; it is difficult for me to make any further comment. However, it is important to note, from the work that we have performed so far and the evidence that we have, we have no indication that these actions in any way have impacted our audit conclusions on Carillion.
- Q448 **Chair:** You still believe that you conducted a proper audit of Carillion.
Bill Michael: I stand by those comments I made at that time.
- Q449 **Chair:** How long has Peter Meehan been suspended for?
Bill Michael: Two months.
- Q450 **Chair:** That is not very long.
Bill Michael: No, it was uncovered at the end of last year.
- Q451 **Chair:** How long are you suspending him for?
Bill Michael: He is suspended until this investigation is concluded.
- Q452 **Chair:** And it is the same for the three other colleagues.
Bill Michael: Yes, that is right.
- Q453 **Chair:** Taken together, the big audit firms meet the targets. Of the Big Four FTSE 350 audits, 23% required improvement and KPMG scored the

worst on that; the FRC found that half of the firm's FTSE 350 audits required improvement. Do you recognise those figures, Bill Michael?

Bill Michael: I do.

Q454 **Chair:** But you still think you provided a proper audit at Carillion.

Bill Michael: I put myself forward as chairman in our firm because I recognise the challenges that we face. I have been in role for about 15 months now. I accept those results. Those results are unacceptable and we are working hard to resolve them. We went through a lot of soul searching as an organisation over the last 15 months, because we have a number of challenges that we acknowledge and recognise, and we are taking action to resolve them, including the separation of our audit practice.

Q455 **Chair:** If half of your FTSE 350 audits required improvement, how many other people have you suspended for poor-quality audits?

Bill Michael: The particular case for suspension relates to a specific action that we uncovered during the review, so that is the only case we have. It was not as a result of a poor audit; it was the result of what we uncovered during our investigation of our work.

Q456 **Chair:** How many FTSE 350 audits do you do?

Bill Michael: About a quarter of them.

Q457 **Chair:** That is 18 or 19, and about 45% of those were deemed by the FRC as not being of sufficient standard.

Bill Michael: It was 45% of the 21 that they reviewed as a sample. They did not look at all the FTSE 350 audits, but that is the percentage of the sample that they did look at.

Q458 **Chair:** You have only suspended one person. If it had not been Carillion, would you have suspended Peter Meehan?

Bill Michael: Yes.

Q459 **Chair:** Why have you not suspended anybody else?

Bill Michael: Again, we found irregularities in what was provided to the AQR. It is a specific instance of what we have discovered on our file that we—

Q460 **Chair:** Obviously the FRC did not discover the issues with Carillion.

Bill Michael: No, we did; that is right.

Q461 **Chair:** If we ask them next week about all their AQR scores and all their analysis of KPMG's audits, would they say that what they found at Carillion was worse than in the others?

Bill Michael: I do not know what they would say.

Q462 **Chair:** But you have seen the results, so you must know.

Bill Michael: We have not suspended him because of the result of the audit or his opinion on the audit. It is because we have found irregularities with a small number of documents and then the way they augmented the audit file.

Q463 **Chair:** Were they worse irregularities than what you found for other audits?

Bill Michael: Yes. If we had found the same irregularities elsewhere, we would have taken the same action.

Q464 **Chair:** Then how can you say you conducted a proper audit if you found these irregularities that are worse than what you did in any other FTSE 350 audit?

Bill Michael: It is a live investigation, so it is difficult to comment. I have said, however, that out of the work that we have done—

Q465 **Chair:** But you have commented, Bill Michael, because you have said, “We conducted a proper audit”, so you cannot say, “I will not comment; we conducted a proper audit. I will not comment; we conducted a proper audit”. Which one is it?

Bill Michael: Specifically on the investigation, I am saying that what we have uncovered we do not believe has impacted the audit opinion on Carillion. We do not believe the opinion has been impacted by the irregularities we found and the reason for suspending the partner.

Q466 **Chair:** You said that you came into the business 15 months ago as the chairman and you recognise that there are issues. Do you think that audit quality at KPMG is good enough, Bill Michael?

Bill Michael: No, that is what we are trying to fix. I am committed to fixing it.

Q467 **Chair:** You do not think it is good enough.

Bill Michael: I am not happy with the results that we have achieved. We recognise we have challenges and we are working hard to resolve them.

Q468 **Chair:** Is anybody happy with the quality of the audits in their businesses?

Steve Varley: Last year, if I can use the comparable figures, 18% of our FTSE 350 audits were reviewed by the FRC, which was 11 audits. They reviewed 11 audits and they found two issues that caused them to mark us down.

Q469 **Chair:** The FRC has been found wanting at moments of crisis as well, but are you happy with the quality of audits, not what the FRC says on the limited number of checks it has done? Are you happy?

Steve Varley: We have significant improvement plans in place to improve our audit quality, for sure.

Q470 **Chair:** Presumably that is because you are not happy with the quality.

Steve Varley: Yes. We know we need to work harder on our audit quality.

Q471 **Chair:** I know you are talking to politicians but, if one of you could just give a straight answer it would really improve things. Are you happy, Steve Varley, with the quality of audit at EY?

Steve Varley: No, I am not. We need to improve our audit quality.

Q472 **Chair:** Thank you. Kevin Ellis, are you happy with the audit quality at PwC?

Kevin Ellis: You can always improve on audit quality. I am happy with the standards of the audit quality of my firm.

Q473 **Chair:** You were fined £24.5 million last year and you are happy.

Kevin Ellis: I am never happy with any failure whatsoever, but I am happy that the work that gets put into the audit and the quality of the audit is strong. That came across from both the FRC reviews and the US regulator reviews of our work, which are independent. They have high findings of our work.

Q474 **Chair:** What would it take for you to not be happy?

Kevin Ellis: We do 4,500 group audits a year and in 4,500 cases we had to make material restatements of the management figures they put in front of us. We go about our audits in a very sceptical and challenging way.

Q475 **Chair:** How long do you think a senior partner should spend on an audit?

Kevin Ellis: In general, for the 350 audits, they spend over 300 or 400 hours.

Q476 **Chair:** It is not two hours, then.

Kevin Ellis: In the case of BHS, we apologised before; they did not follow the methodology we set down and we have taken steps to ensure that that does not happen in the future in my firm.

Q477 **Chair:** Despite the £24.5 million worth of fines, despite what happened at BHS, you are going to say to me that you are happy. Steve Varley is not, but you are happy with audit quality at PwC.

Kevin Ellis: We can always improve.

Q478 **Chair:** Too right you can. David Sproul, are you happy with audit quality at Deloitte?

David Sproul: We have set a very high standard, we are not achieving that yet and therefore I am not happy, no, but I am happy with the investment we are making and continue to improve it.

Q479 **Chair:** Okay, but you are not happy with your quality at the moment. Bill Michael, are you happy with the quality at KPMG?

Bill Michael: No, we need to improve.

Q480 **Vernon Coaker:** In the couple of minutes that we have left, I want to try to bring all this together. As we were saying to the challenger companies that came before us, we have the Kingman review, we have the CMA saying this and now we have Brydon. Many people will be watching this and it will be reported. You are the Big Four companies, representing billions of pounds' worth of business. There is lots of dissatisfaction, as we have heard from the some of the questions and some of the dissatisfaction you, yourselves, are displaying. How are we going to get on with this? Everybody is aspirational; it is going to happen. "We are not happy; it has to change". All these things are laid out and now we have Brydon. Goodness knows when that will report. When is it going to change, how and how quickly?

Steve Varley: There needs to be a lot of change in this market, for sure. There are five changes that we have identified that need to happen, and it is complicated. As this Committee has identified, there is no silver bullet here. First, we need the review by Paul Druckman to modernise corporate reporting. We need Sir Donald Brydon to complete his work on audit products. We need our new regulator, ARGA, to be stood up, to become a lot stronger and a lot more powerful. We agree with Sir John Kingman and recommendation 51 that he has on Sarbanes-Oxley. At its core, Sarbanes-Oxley is a protection Act. That needs to be implemented. Then we need to continue to change as well, to stay up to date with the technology and improve our audit quality. Those five changes are all really important.

Q481 **Vernon Coaker:** But it is the speed, is it not? Is that not the point, Kevin Ellis? People are dissatisfied now. Shareholders are worried. KPMG talked about graduated findings, et cetera, but when is it going to change?

Kevin Ellis: I totally agree we need to get on with market reform now. There are loads of steps that can be taken literally immediately and we can get on and do those, as Sir John Kingman said. There are lots of other things that need to happen as well.

Q482 **Vernon Coaker:** But you disagree with some of Sir John Kingman's findings.

Kevin Ellis: We disagree with some of it, but there are a lot of things that we absolutely support and we think we should be getting on with now.

David Sproul: My views are similar. There is a lot happening. This is a once in a generation opportunity to both set audit for the 21st century and deal with the issue around trust. It needs to be done properly, but it does not need to be delayed. It can be done in a very sequential way.

Q483 **Vernon Coaker:** The public out there are demanding change. They are completely and utterly frustrated, and you four are really powerful people. You are at the top of the business, and they are looking to you to change it and to get on with it, not in a year, or two or three years.

David Sproul: Absolutely, and we would like to be part of that, to ensure that the UK profession remains the most respected profession globally, as

it is at the moment. The public look to two fundamental things and it goes back to the earlier debate about the expectation gap. The public, perhaps understandably, believe an audit is a guarantee that a company will not fail in the future, and a guarantee that it will find fraud.

Q484 **Vernon Coaker:** We heard earlier on that it was not a guarantee that fraud would be detected. People will be incredulous.

David Sproul: I agree. That is the whole point about the expectation gap. It seems to me that that is the fundamental thing to deal with and that is within the remit of the Brydon review. It would be remiss to ignore the Brydon review. I do not think you need to wait for it to be fully completed and digested, but it would be remiss to try to push ahead with proposals before one has heard his conclusions.

Bill Michael: This profession is moving away from self-regulation to regulation. That is what is happening here; the collection of all these changes are absolutely in the right direction. The single most important thing, if there is one, right now, that is going to help accelerate things is the appointment of the new regulator, at least the leadership of it, because it has a critical role to play. As for our role, I am taking a leadership role, at least for our firm. We have separated our audit business, one of the recommendations in this report. We have banned non-audit fees on the FTSE 350; we did that voluntarily, to promote confidence and avoid conflict. We are pushing hard on graduated findings, which is best done and implemented across the organisation.

We know the direction of travel. It is forums like this that are hugely important because, while they are uncomfortable, they are going to take us in a better direction. I am committed to getting this right for our firm and for the profession. I care deeply about it and I am hurt by where we have got to. Things that we can do I will do, and I will take a leadership role in anything that is profession-wide.

Q485 **Vernon Coaker:** What you said about greater regulation is right, because if you are going to have competition you have to have it regulated. But what we hear a lot of the time on the regulators is that they do not regulate effectively, they do not use the powers they have. When we say "regulation" we have to mean it: that people are held to account and held to a standard that the public would expect. Is that agreed?

Bill Michael: I could not agree more.

Q486 **Vernon Coaker:** When we get a regulator with real teeth and it starts to use them, all of you people will be saying that is a good thing, yes?

Bill Michael: It is important for the stability of the system, absolutely.

Q487 **Chair:** How important is the challenge that you give to audit committee chairs and CFOs? How important is that to the work you do and how effectively do you think you do that?

Steve Varley: It is an incredibly important part of being an auditor.

Q488 **Chair:** Does anyone disagree? Does anyone have anything they want to add?

David Sproul: No. It is a very robust relationship.

Q489 **Chair:** Can I ask you how much you spend on corporate hospitality with your audit clients every year? Does anybody have that number to hand?

David Sproul: I can tell you it is very limited, because the regulations limit it to de minimis amounts.

Bill Michael: I do not know the number, but there are strict limits on how much and what you do.

Q490 **Chair:** I would like it, for each of your audit clients, if you could write to us and tell us how much you spend on corporate hospitality. You probably do not have it to hand, but I also wonder how much you spend on corporate hospitality in the year ahead of somebody becoming your client. For somebody who was not your client a year ago but now is, how much have you spent on corporate hospitality with them? Is that a number that you could provide us with? Thank you very much.

Finally, I want to ask you something, not on the subject of your audit work per se. Listed companies with more than 250 people, from next year, will have to publish their pay ratios and pay quartiles. You did, all four of you, in the end, publish your gender pay gaps, including your partners in that. This Committee thinks that was the right thing to do and we are pleased you did that. Despite the fact that you are a partnership and not a listed company, given that you employ so many people, will you publish your pay ratios and your pay quartiles next year? Steve Varley, you are nodding. Will you do that?

Steve Varley: Yes. We led on gender pay gap reporting, among not just our profession but all partnerships. We also published, at the same time, our ratios for our BME colleagues and we will follow the same legislation. We would encourage Government to make sure that legislation applies to all partnerships as well.

Kevin Ellis: I am not aware of the absolute plans, but we have been at the front end of publishing on gender and BAME, so I expect us to.

Q491 **Chair:** Will you write to us next week and let us know?

Kevin Ellis: I will write to you and let you know, for sure.

David Sproul: Yes, we will.

Bill Michael: Yes.

Chair: Thank you very much. I am glad that we have ended on a positive note. Thank you very much for your time today; it is very important evidence and we appreciate you coming to give us that evidence this morning.