

Business, Energy and Industrial Strategy Committee

Oral evidence: Future of Audit, HC 1718

Tuesday 5 February 2019

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Watch the meeting

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

Questions 492-646

Witnesses

I: Stephen Haddrill, Chief Executive, Financial Reporting Council, Michael Izza, Chief Executive, Institute of Chartered Accountants in England and Wales, and Maggie McGhee, Executive Director, Governance, Association of Chartered Certified Accountants.

Examination of witnesses

Witnesses: Stephen Haddrill, Michael Izza and Maggie McGhee.

Chair: Thank you very much for coming to give evidence this morning on the future of audit. As you know, we have been taking evidence from a number of people from the industry over the past few weeks and we will finish the inquiry with an evidence session with the Secretary of State shortly. We very much appreciate you coming to talk to us this morning to share some of your expertise. We have a number of questions and we will start with Stephen Kerr.

Q492 **Stephen Kerr:** Good morning. My questions will be directed pretty much exclusively at Stephen Haddrill. We note that for the most part you have been supportive of the Kingman review's conclusions. Can you tell us where you disagree with the recommendations?

Stephen Haddrill: First, I must stress to the Committee that we really support the review and the conclusions. There are a couple of areas where we need a bit of clarity going forward. One is that Sir John talks about the mission of the new regulator being very much there for investors. That is the emphasis that comes through in the report. Obviously the body should be there for investors, but a lot of work has been done over the past couple of years on the interests of wider society, the environment and so on. That is not specifically mentioned in the report, and I think it must not be forgotten. That must be built out as well.

There are some things that we will need to think about quite carefully in terms of some of the details. For instance, from an operational point of view, Sir John says that nobody should ever work in the FRC on a matter concerning a firm that they have worked at. We sometimes employ people who have had careers spanning two or three firms, so that would rather limit their ability. It is also very important that we move people around, so that they do not spend years and years focusing on the same firm, because there is a risk of going native there. We need to work out how we get a bit of operational flexibility, but that is a second order point, frankly. We can work our way through that.

Q493 **Stephen Kerr:** The FRC has been heavily criticised, particularly very recently—described as a “toothless tiger”, and a regulator that does not exercise any powers, et cetera. The Kingman review remarks that “the FRC’s work already can, and should, contribute at least to some degree to avoiding unnecessary and avoidable causes of major corporate failure.” Could you have done more in the past to prevent certain corporate failures?

Stephen Haddrill: It is very difficult for a regulator whose powers are focused on assessing the quality of an audit firm across the piece to achieve that. Can we do more in the future with the kind of powers that Sir John is talking about? Absolutely, yes.

Q494 **Stephen Kerr:** So your effectiveness has been limited by a lack of powers?



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Stephen Hadrill: Absolutely. I think Sir John brings that out. For instance, when we review the report and accounts for a company, we get the report and accounts, and we ask the company a lot of questions. We do not have the ability to really go into the company and test those answers, and he recommends a power, such as the one the FCA has, to appoint an expert—that sort of thing.

Q495 **Stephen Kerr:** You have been in your role at the FRC for nine or 10 years.

Stephen Hadrill: Nine.

Stephen Kerr: During that time you have been aware that you have inadequate powers to do the job that is your remit. Have you asked for more powers?

Stephen Hadrill: Yes, we have. In fact, I put proposals before the predecessor of this Committee back in 2016. The Committee supported much of that. I hope very much that with the extra impetus from Sir John's report the Government will take this forward as a matter of urgency.

Q496 **Stephen Kerr:** So you have repeatedly asked for these powers over those nine years.

Stephen Hadrill: I would say I have done so from time to time. It has not necessarily been on a constant basis, because if the Government decides that it does not wish to pursue a particular course, you—

Q497 **Stephen Kerr:** It would be very interesting, particularly given the work that we are doing as a Committee, if we could see the correspondence that you have had with the Government in particular, because in that correspondence you will have laid out what powers you feel you lack. That would be hugely informative for our work as a Committee. Will you share that correspondence with us?

Stephen Hadrill: Yes. The other thing I can share is the letter we wrote to Sir John, which set out the powers that we were looking for, and which I was very pleased to see Sir John picked up almost entirely.

Q498 **Stephen Kerr:** One of the things that I would like to raise with you relates to the response of the FRC to whistleblowers. I should disclose that I am co-chair of the all-party parliamentary group on whistleblowing. There have been whistleblowers who have come forward to the FRC, particular in relation to audit work, and been brushed off. I am thinking specifically of one example that has come up repeatedly over the past 10 years: HBOS. What is your general approach to whistleblowing, in relation to audit quality?

Stephen Hadrill: We take it very seriously. If we get any formal whistleblowing or any other expression of concern, we look at it very seriously indeed.

Q499 **Stephen Kerr:** Would it surprise you to learn that the APPG on fair business banking, of which I am a vice-chair, has had information from a



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whistleblower that as recently as April 2017, after the criminal convictions at HBOS Reading, they came forward with information about the quality of the KPMG audit in relation to HBOS Reading and they were ignored by the FRC?

Stephen Haddrill: If we are thinking about the same case, it is not true that they are being ignored. Indeed, we have been looking further into that information, as are other regulators.

Q500 **Stephen Kerr:** Turning to the recommendations of the Kingman review, what are you doing to get on with implementing the recommendations? First, when will we see the appointment of a new chief executive and board?

Stephen Haddrill: First, we absolutely agree that the board should be smaller than it is now. We certainly agree that the Secretary of State should appoint the board as a whole. Normally, a public body is set up in statute and the statute says what powers the Secretary of State has to make appointments. That could take some time, and we don't want it to take time, so we will change the articles of the company—curiously, we are a private company—to enable the Secretary of State to appoint the whole board, if that is what he wishes to do.

Q501 **Stephen Kerr:** When will that happen?

Stephen Haddrill: We could do that straight away, at the next board meeting.

Q502 **Chair:** When is the next board meeting?

Stephen Haddrill: In March. I want confirmation that the Government intend to accept that recommendation. I assume they will.

Q503 **Stephen Kerr:** Will we get a better gender balance on the new board? Currently, four out of the 14 members are female—that is 29%. Will we see improvement there?

Stephen Haddrill: I would like to see it at 50-50. I assume that that is where the Ministers would want to get to. Certainly on the executive committee we are there. We were at 60% female and 40% male until recently. We have had a change, but I am very committed to that personally.

Q504 **Stephen Kerr:** Have you started scrutinising annual reports in their entirety?

Stephen Haddrill: We have not started doing that yet. That is one of the areas where we can do it on a voluntary basis. We cannot do it on a statutory basis yet, as that would require legislation. We are working through exactly how we are going to do it and what our stance is going to be with the company if the company says, "We are not going to play ball with you on that because you haven't got any power to scrutinise us in that way."

Q505 **Stephen Kerr:** So powers might be needed. When are you going to



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publish audit quality review reports?

Stephen Haddrill: I think that is a great proposal and we want to get on with that. The publishing of the report in its entirety does require new powers. Well, it requires a change to the confidentiality provisions of the Companies Act. Sir John recommends that we publish the information without the company name, so we are trying to work through how we can do it without giving away confidentiality and in effect publishing the company's name by the back door. So we are working on that.

I am appointing a programme director. There are 83 recommendations altogether and quite a few for us to get on with immediately, so we are appointing an experienced programme director to make sure we get through the work as fast as possible.

Q506 **Stephen Kerr:** Have you started developing a market intelligence function that proactively identifies risks?

Stephen Haddrill: Yes, we did some work on that just before Sir John's report came out. We will be taking that forward and will be recruiting. There is one other thing that we need in order to do all this: we need to increase our budget. The FRC has a commitment to consult on its budget, so we will go out to consultation probably around late February to put forward a new budget for the coming year so that we can hire people that we haven't got in the budget at the moment.

Stephen Kerr: Thank you for that. I will be very interested if you will disclose to the Committee your policy on whistleblowing and the issue that I raised in relation to the HBOS whistleblowing that has recently happened, because that is now with Andrew Bailey at the FCA. Obviously, there is more to come on that front.

Q507 **Chair:** Just to follow up on a couple of things that Stephen said. In the first part of his question he asked whether you could have done more to stop some of these corporate failures and to improve the quality of audit, and you said that you did not have enough powers. Are you saying that with the powers you have, there is nothing you could have done better over the nine years that you have been chief executive?

Stephen Haddrill: I am certainly not saying that.

Q508 **Chair:** Give me some examples of things that you could have done better, reflecting on the nine years that you have been chief executive.

Stephen Haddrill: There are some things that we have introduced more recently that we should have done earlier.

Chair: Like what?

Stephen Haddrill: For example, we have recently introduced this new audit firm monitoring and supervisory approach, under which—and it is a voluntary thing—the firms have agreed to monitoring and supervision of them, beyond just the inspection of individual audits. We have done that because we felt that we were not seeing sufficiently fast progress in the improvement in audit quality, and therefore we needed to look at other



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issues—not just what was going on in the audit team, but the quality of leadership, the way that the firm as a whole was supporting the audit team, and so on. With hindsight, we should have done that earlier.

Q509 **Chair:** With Carillion, for example, I think you qualified the accounts or asked some questions about them in 2015, but then you didn't go back to look at them the following year.

Stephen Haddrill: We did check whether the points that we had raised had been dealt with.

Chair: But if you had had in place the sort of regime and framework you are talking about, do you think you would have paid a bit closer attention to what was happening there?

Stephen Haddrill: I think that if a combination of some of the things that Sir John has suggested—the deeper market intelligence and the powers to send somebody in to do an independent review of what is going on in the business—had been deployed in relation to Carillion, we could have identified the problem earlier than we did.

Q510 **Chair:** Do you regret that it has taken Sir John Kingman to do this review and suggest changes? Of course, some of them require legislation, but Stephen Kerr has just given a list of some that you yourselves could perhaps have started earlier, even if just on a voluntary basis. Do you regret that it took Sir John to come in and give you these suggestions?

Stephen Haddrill: I do not regret the fact that Sir John has done it.

Chair: But do you regret that you didn't do it, Stephen? That is my question.

Stephen Haddrill: Any organisation must be committed to continuous improvement, so yes, there are some things in there that it would have been better for us to have achieved.

Q511 **Chair:** Is there any reason why you couldn't have done some of these things?

Stephen Haddrill: We did an enormous amount and we changed a great deal. We introduced retendering of the audit. We were the first in the world to introduce extended auditor reports. We introduced this new monitoring and supervisory approach. We were doing a lot, but it comes back to the question about whether we should have done more to get some of the additional powers, and perhaps that is true. We raised the matter, but could we have done that more powerfully? Could we have got more attention given to us in that regard? I think we were operating in an area where the focus was very much on not going beyond a strict set of powers—not gold-plating, effectively. We perhaps allowed ourselves to be—and I personally would say allowed myself to be—too caught up with that.

Q512 **Chair:** Specifically on the question that Stephen Kerr asked about whether you have started scrutinising annual reports in their entirety,



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you said that at the moment that can be done only on a voluntary basis. Has anyone pushed back on you being able to do that?

Stephen Haddrill: We have had no pushback on that yet, but on the other hand I have not gone to a company and said, "I'm going to start asking difficult questions about this bit of the annual report." We will start to do that, and we will see what happens.

Q513 **Sir Patrick McLoughlin:** I have a quick question. You said that you are seeking an increase in your budget. Can you tell us what increase you are seeking? What is it at the moment and what increase are you seeking?

Stephen Haddrill: At the moment it is £36 million. We are not the biggest regulator in the world, but nevertheless it is a sizable sum of money. What we are looking for in the first year, 2019-20, as we bring these things in—of course, that will be before the additional powers come in—is an increase of around 10%, so £4 million to £5 million.

Q514 **Mark Pawsey:** Mr Haddrill, one of the bits of evidence we got was that the US equivalent of your body, the PCAOB, was much stricter. It causes concern when people are being looked at. Why is that?

Stephen Haddrill: First, that is about the one thing in Sir John's report that I think is incorrect. I know that other witnesses have mentioned that. If you compare what the FRC does with what the PCAOB does, the PCAOB is very much focused on the audit process rules. It is quite strict in ensuring that the auditor has followed those rules, and we also do that. What we do that it doesn't do is test the judgment of the auditor on the key audit matters. I think that is the key thing. It is not, "Has the auditor done a certain number of hours here, there or everywhere?" It is really, "Have you actually tested the judgment of the company, and does the regulator then test the judgment of the auditor?"

I think there are some things we can learn from the PCAOB. They have recruited more senior people—Sir John notes that—and I think that is an advantage.

Q515 **Mark Pawsey:** We were told that the PCAOB is much tougher and more thorough than the FRC when looking at something. You don't accept that?

Stephen Haddrill: No, I don't accept that.

Q516 **Mark Pawsey:** Sir John suggests that your organisation should be replaced by an "audit, reporting and governance authority". Do you agree with that proposal?

Stephen Haddrill: Yes, I do, because I think we need a statutory body to do this work. We shouldn't have a private company with a slightly disparate set of powers pursuing what is a vital national interest.

Q517 **Mark Pawsey:** And you support the greater powers that Sir John suggests?

Stephen Haddrill: Yes.



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Q518 Mark Pawsey: Turning to the accountancy bodies, is it your view, Maggie McGhee, that your members want a stronger regulator, that they want somebody with greater powers overseeing their work?

Maggie McGhee: Absolutely. In response to Kingman, we were very positive about the recommendations that were made, and we certainly approved of the increased focus that it would provide to the regulator. The strongest support for strong audit quality is the inspection regime for audit. Our members work across all sectors of business, so we have a minority who work in audit, but the impact of any reputational damage to audit is felt across all of our members, so they would be very supportive of it.

Q519 Mark Pawsey: Are your members taking advantage of pretty light regulation? Are they getting away with things that, in another regime, they would not be getting away with?

Maggie McGhee: I don't think it is a matter of getting away with anything within the current regime.

Q520 Mark Pawsey: Are they getting away with things they shouldn't be getting away with? I accept that it might be the regime that is at fault, rather than the body, but are they getting away with things? Are auditors not doing their job as well and as professionally as the public might expect them to be doing?

Maggie McGhee: Certainly, at the moment we have, as we have heard in other sessions, a challenge to audit quality in some cases. That is not to say that audit across the board is done badly. We ensure, for the work that we do, looking at the non-public interest entities, that auditors are held fully to account for the work that they do.

Q521 Mark Pawsey: Mr Izza, what is your assessment of the policeman who is controlling and managing your bodies, your accountants?

Michael Izza: First, we support a strong regulator, and we think that the FRC has done a good job in its time in existence.

Q522 Mark Pawsey: But there have been lots of failures, haven't there? We have heard about them throughout this inquiry. It can't have been doing that good a job if we have had Carillion, Patisserie Valerie and other failures.

Michael Izza: I agree that those don't read well, but I think we have to remember that there are an awful lot of audits that are conducted in the listed markets every year that are done extremely well and done to a good standard.

In terms of Kingman, Sir John made 83 recommendations and we think some of those are more important than others. We very much support the FRC and the Government getting on with some of those as quickly as possible.

There is one thing that I would like to correct in Sir John's report, which I think is incorrect. Sir John referred to self-regulation. Self-regulation in the



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accountancy profession ended about 20 years ago. The accountancy bodies have operated under a scheme of delegation from the FRC and we are subject to FRC review on an annual basis. In addition, we are also subject to the Legal Services Board, the Insolvency Service—

Q523 **Mark Pawsey:** But we have already heard from Stephen Haddrill that his powers aren't sufficient to regulate you properly.

Michael Izza: I'm not sure that was a reference to us.

Stephen Haddrill: I was talking about the regulation of the firms rather than the regulation of the professional body.

Q524 **Mark Pawsey:** But Mr Izza, you represent the firms.

Michael Izza: We do, but we are also part of the statutory framework in the UK.

Q525 **Mark Pawsey:** I was trying to understand the nature of the firms. Is part of the problem that directors, in preparing the accounts, are not doing their job properly?

Michael Izza: I think that directors and corporate governance have improved in the UK in the past 10 years, but they still have further to go.

Q526 **Mark Pawsey:** Should we be introducing a UK version of Sarbanes-Oxley, which makes company directors more responsible for their controls within the company?

Michael Izza: Directors already have a responsibility for the internal controls of a company. It is their obligation to ensure that those internal controls are maintained and conducted.

Q527 **Mark Pawsey:** So why do you think there is an argument in favour of bringing a UK version of that US system into UK business?

Michael Izza: Because I think we can take it to another level. What happens in the United States is that the CEO and the CFO actually have to sign that the internal controls are operating to a certain standard.

Q528 **Mark Pawsey:** Sure, but should we be doing that here? It's a very straight question: yes or no?

Michael Izza: I think yes.

Mark Pawsey: Maggie McGhee, yes or no?

Maggie McGhee: We believe that we should look at that, yes.

Q529 **Drew Hendry:** Stephen Haddrill, would you say that what you found with Carillion's audit quality review is worse than most other audit quality reviews?

Stephen Haddrill: I have to be very careful here, because it is subject to a formal disciplinary investigation. I will say that when we inspected the audit, the inspection team were seriously concerned about some of the things they found and therefore took the matter to the enforcement—

Q530 Drew Hendry: Would that be worse?

Stephen Haddrill: We certainly don't do that every time—we are not referring everything to enforcement. It is unusual to do that.

Q531 Drew Hendry: So the answer is yes.

Stephen Haddrill: Yes.

Q532 Drew Hendry: Bill Michael told us last week that Peter Meehan, Carillion's audit partner, had augmented the audit file that he gave to the Financial Reporting Council. How do you ensure that firms don't augment the files you inspect, and what is your understanding of the term "augment"?

Stephen Haddrill: That, too, is a matter of a separate formal investigation. That is exactly the question that I hope the investigation will answer.

Q533 Drew Hendry: Let's take it away from the investigation. What is your understanding of augmenting files, and how do you prevent firms from doing that?

Stephen Haddrill: In general terms—I'm not talking about that particular investigation—we expect the audit file to be in good shape, in the sense that all the relevant papers and the judgments that the auditor has reached are properly documented. That is locked down, then after a period it becomes available to the FRC.

Q534 Drew Hendry: If somebody was augmenting that, what would be your understanding?

Stephen Haddrill: If something is added to the file after that period when it has been closed, we would generally regard that as inappropriate, particularly if it was done with a view to creating any kind of deception. Again, I must stress that I am talking about the general situation.

Q535 Drew Hendry: I'm happy to take the line that you are talking about a general thing, but how would you, the Financial Reporting Council, prevent companies from doing that?

Stephen Haddrill: When we review the file, we are looking for a number of things. We are looking at whether the audit plan was satisfactorily set out and agreed with the company. We are looking at whether the key audit matters that the company, auditor and audit committee have identified are being properly reviewed by the auditor. We look to ensure that the file makes sense—that there isn't anything that appears to be in the wrong place or whatever. If there is, we will take action accordingly.

Q536 Drew Hendry: The ICAEW said to us, "It would be useful for the FRC to undertake and publish a root cause analysis of large recent audit failures to clarify the extent to which conflicts of interest were a driving factor." Do you agree with that?

Stephen Haddrill: Yes, I think it would be a good thing to do. We do a number of thematic reviews: rather than looking just at an individual



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inspection, we look at an issue across a class. I would be very happy to take that forward.

Q537 **Drew Hendry:** You are going to do that?

Stephen Hadrill: Yes.

Q538 **Chair:** Can I just ask a couple of follow-up questions—

Stephen Hadrill: Sorry, I was just going to add that we are reviewing all of our audit standards and one of the things that we are looking at in particular is whether the so-called independence rules—the rules that protect the independence of the auditor—need to be strengthened. In a sense, therefore, we'll do that work through that route.

Q539 **Chair:** I am just quite interested in this issue about augmentations. How many augmentations do you see in a year?

Stephen Hadrill: Oh, it's very rare—very rare.

Q540 **Chair:** What—one, two, three, none?

Stephen Hadrill: Possibly none.

Q541 **Chair:** How many did you see last year?

Stephen Hadrill: I can't say whether the inspection team found any last year but I doubt they did, because they would have referred any to enforcement. I will check.

Q542 **Chair:** Did we not just say that Carillion was an augmentation? It was just said that Bill Michael told us last week that Peter Meehan had augmented the audit file he gave to the FRC—

Stephen Hadrill: Oh, I see. Sorry. Yes—I was thinking about cases in addition to that.

Q543 **Chair:** Okay. Maybe you could tell us in the last five years how many times there has been an augmentation in each year. Was there an augmentation of the BHS file?

Stephen Hadrill: I don't think so. There were serious deficiencies in the BHS audit, as you know, but I don't think— No, sorry, that's not true. There were steps taken around the date at which the audit was signed off that were incorrect. So yes, there was in that case.

Q544 **Chair:** If you could give us the numbers of how many augmentations, and for what firms, that you have seen in the last five years, that would be useful. And how do you know that other files have not been augmented?

Stephen Hadrill: Well, you can't know unless you've inspected them, and—

Q545 **Chair:** But how do you know something has been added later?

Stephen Hadrill: We do forensic analysis of the documentation, and people make mistakes. You can look at the computer record. I mean, the technology may well show that something has been put on after the event,



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and on a paper file you can see that things don't seem to fit in. When we've investigated, we have found a small number of—

Q546 **Chair:** Who discovered that there had been an augmentation to the Carillion file? Was it KPMG or the FRC?

Stephen Haddrill: That was KPMG self-reporting.

Q547 **Chair:** I guess that this is the worry, really: how can you tell whether something has been augmented and are you discovering these things? As you say, it was KPMG that pointed out this augmentation, not the FRC. I presume that you were crawling all over the file after the collapse of Carillion, but it was not you—the regulator—who actually discovered this.

Stephen Haddrill: That is right. The other thing that we do is to make it very clear to the firm, or any firm, that if they find that there has been any wrongdoing of any kind, they self-report to the regulator. And it is our job to make sure that the firm is very clear about that.

Q548 **Chair:** But if KPMG hadn't self-reported it, how confident are you that you would have discovered it, Stephen Haddrill?

Stephen Haddrill: Well, since we are doing a full forensic investigation of that particular audit, we may well have discovered it in those circumstances.

Q549 **Chair:** How long is this full forensic investigation going to last, because it is over a year since the company collapsed?

Stephen Haddrill: Sorry, there are two investigations. There is the investigation on the matter that they self-reported, and then there is the earlier investigation that was started into the collapse of the company, and we hope to complete the investigation around the middle to the second half of the year. We set ourselves a two-year timescale.

Q550 **Chair:** Have you discovered anything so far?

Stephen Haddrill: I can't comment on that, I'm afraid.

Q551 **Chair:** There is just one other thing. You said in answer to Drew Hendry's question that Carillion's AQR was worse than other AQRs. On a scale of how bad it was—how many AQRs do you do a year?

Stephen Haddrill: We do about 150.

Q552 **Chair:** Was anyone's worse than Carillion's?

Stephen Haddrill: I don't think you can—

Q553 **Chair:** I'm only saying what you said, because you said that it was worse than, so I'm just asking where on the scale of the 150 it fell.

Stephen Haddrill: The fact that it was reported to our enforcement division and that we are mounting a full-blown disciplinary investigation shows that it was perhaps—in our view, it was a poor audit, but that is exactly what we are looking into now.



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Q554 **Chair:** That is still not the answer to my question. How many AQRs were referred to enforcement last year?

Stephen Haddrill: I think—I will get you an exact number—it was probably around 15 to 20.

Q555 **Chair:** So about 10%, just a little bit more.

Stephen Haddrill: Yes.

Q556 **Chair:** The same the year before?

Stephen Haddrill: It is rising, partly because since 2016 the definition of what constitutes a case for enforcement has been changed through the new audit regulations.

Q557 **Chair:** Let's just go back to those 15 to 20 that were referred to enforcement last year of the 150 that you did. Of those 15 or 20, was Carillion worse than the other 15 or 20? How bad was it out of those that were referred?

Stephen Haddrill: The trouble is that you are asking me to make a comment upon the quality of an audit that we are taking disciplinary action over and I do not want to prejudice—

Q558 **Chair:** What are you doing with the other 14 or 19?

Stephen Haddrill: Those are under investigation, or many of them are under investigation as well.

Q559 **Chair:** Can you tell us the names of those?

Stephen Haddrill: No, I will see which ones have been put into the public domain and which ones are still under consideration and write to you.

Q560 **Chair:** Why isn't this information in the public domain? The whole point of this inquiry and the inquiry into the collapse of Carillion is that audits are incredibly important.

Stephen Haddrill: Yes.

Q561 **Chair:** And you are sitting on this information from last year of 15 or 20 audits that have been referred to enforcement, but the investors investing in those companies don't know it, the people working for those companies don't know it, the people who are subcontracted to those companies don't know it, the people saving for pensions with those companies don't know it. That is not good enough, in my view, Mr Haddrill. Do you think it is?

Stephen Haddrill: I think it is absolutely appropriate that, when a matter is referred to enforcement, the first thing that happens before the matter is publicised is that there is a proper consideration about whether there should be a disciplinary investigation. Some of those are in that category now.

Q562 **Chair:** Do you think there could be a little bit more speed with these things?



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Stephen Hadrill: As Sir John recognises in what he said about enforcement, we were slow and we have addressed that.

Q563 **Chair:** If you were working for one of those companies or if you were a subcontractor supplying one of those companies and next year it fails and then you find out that that FRC had been having a little look at it previously but hadn't told anyone about it, how would you feel if you were a subcontractor, Stephen Hadrill?

Stephen Hadrill: The audit is done after the report and accounts are produced and then the inspection happens after that. The disciplinary action follows from that. That is Sir John's point: the work of the FRC happens after the event. That is why there is a great limitation on what we can do currently to anticipate a problem, given that, generally, these things emerge relatively quickly.

Q564 **Chair:** But some of these companies will have published another annual report before you have actually done the due diligence on last year's one. Is that right, Stephen Hadrill?

Stephen Hadrill: No, we—

Q565 **Chair:** No, no. Sorry, that is not right. Within a year, you will, with all of these—

Stephen Hadrill: We complete the inspections within a year and we report to the audit committee on the findings of the inspection.

Q566 **Chair:** So they are all completed within a year?

Stephen Hadrill: Pretty much, yes. There might be the one—

Q567 **Chair:** Carillion collapsed over a year ago and you haven't reported on that yet.

Stephen Hadrill: No, sorry, I am talking about the audit quality inspection review, not the disciplinary investigation. The second of those has to be done to a standard that means the investigation will stand up in court. So there is all this legal process around disclosure and so on that has to be gone through, and that is why it takes such a long period of time.

Q568 **Chair:** The AQRs that have been referred to enforcement, you will, within a year of that referral, have in front of you—

Stephen Hadrill: The AQR reports—those inspection reports; that is what I am saying—are looked at and completed within the year and the findings are reported to the company. Then they go into our annual report on the quality of audit as a whole.

Q569 **Chair:** I am asking about the ones that go to enforcement. I think my questions have been reasonably clear. I am talking about the ones that go to enforcement.



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Stephen Haddrill: The ones that go to enforcement will be considered normally within a period of about six weeks as to whether they are going to be subject to a full disciplinary investigation or not.

Q570 **Chair:** If they are then subject to a full disciplinary investigation, how long does that take?

Stephen Haddrill: That is what can take up to two years, for the investigation phase, and then they go to court and that takes as long as the court takes.

Q571 **Chair:** Okay. I would like to know, over the last five years, which companies have been referred to enforcement, what has happened in the six-week period, and whether they are exactly six-week periods, and how long the investigation takes after that for all of the AQRs that are referred to enforcement.

Stephen Haddrill: Okay.

Q572 **Antoinette Sandbach:** I just want to know: how many people have been suspended or struck off from the big four as a result of augmentation of files in the last five years?

Stephen Haddrill: The BHS one was part of the case. I would have to check whether there were any others.

Antoinette Sandbach: So you think there is one—

Stephen Haddrill: Let me check. I regard that as an ethical breach, but it could be combined with many other sorts of breaches.

Q573 **Antoinette Sandbach:** Do you have that information, Mr Izza? Does your body take disciplinary action?

Michael Izza: We do, but we are working at a different level to the FRC. The FRC deals with the domestic sector. In the past three years we have struck off 20-odd members, but not necessarily for that same issue of augmentation.

Antoinette Sandbach: Could you let us know about augmentation, and any members of the big four that have been struck off for their audit quality? We do not necessarily need personal details.

Q574 **Drew Hendry:** Continuing with Stephen Haddrill: why do firms fall so short of your quality targets? Are the targets unachievable?

Stephen Haddrill: I think the reason they fall short—and the consistent theme through the analysis we do—is that they are failing to challenge the company sufficiently. Why does that happen? Sometimes, it is down to time.

Q575 **Drew Hendry:** Are these technicalities?

Stephen Haddrill: No they are quite serious. You have a major part of their report on accounts, and a major assumption is being made by the company. Evidence needs to be found to support that assumption or



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valuation. It is not evident that that has been done, so they failed to challenge the company and failed to be sufficiently sceptical. That is the other reason. Sometimes that occurs because the deadline for producing a report and accounts is basically too short, and the auditor does not push back hard enough on the company to make sure that more time is made available. It may be that the company has a dominance over the auditor in terms of the relationship with the auditor. The auditor may be being browbeaten and does not want to challenge the CFO or possibly the audit committee. Again, that is where we would hold them to account.

Q576 Drew Hendry: What you just said is quite concerning. How concerned do you feel we should be?

Stephen Hadrill: I think you should be concerned about that. You asked the senior partners and chief executives about whether they felt the audit quality was where it should be. That is the point. Are the firms challenging companies powerfully enough? They are not doing it to a sufficiently consistent extent.

Q577 Drew Hendry: Given that you just said that there is not enough challenge, that that is a key shortcoming and that auditors are not challenging management enough, are auditors setting the right tone?

Stephen Hadrill: I think the leadership of the firms need to set that tone for their teams. That is why I come back to the work we are doing looking at the tone at the top, and the firm's culture and so on. Sometimes that needs to be stronger. I worry that the considerable growth of the firms in relation to their consultancy businesses is a distraction from making sure that the tone from the top is right in relation to the audit practice.

Q578 Drew Hendry: Michael, you are nodding your head. How do we improve audit quality?

Michael Izza: I do not think audit quality is where it should be. We certainly need more scepticism and challenge on the audits, but a number of things can be done relatively quickly. Kingman, CMA and any other inquiries that take place are going to take a period of time, but there are some things that we could do now to improve audit quality. For example, I would like to see the auditors potentially required to make a presentation at the AGM. Many audit partners go through their career without ever being asked a question at an AGM. Getting auditors and investors closer together would be a good thing.

A small point, but one that I think goes to the heart of culture, is that within the firms, the firms that they audit are referred to as "audit clients". They are not the client; the client is the investor. The audit committee may do the contract, but it is the investor that this is being done for, so instead of calling them audit clients, why do we not call them the firms that they audit? Those are just a couple of examples of things that we could do to improve.

Q579 Drew Hendry: Maggie McGhee, what are your thoughts on how to



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improve?

Maggie McGhee: The key driver behind the quality of audit is the exercise of correct professional scepticism and robust challenge. In terms of that, the tone at the top of firms is critical. With professional scepticism, it is all very well and good if you find something—if you exercise professional scepticism, find an issue, and it turns out to be true. Actually, the vast majority of times you will exercise professional scepticism and it will not turn out to be an issue. Firms have to be supportive of the fact that, often, exercising professional scepticism will not raise an issue, but raises the quality of the overall audit.

It is also critical that we provide full transparency as auditors to the audit committee, and that we ensure that we are having a proper dialogue with audit committee chairs. I would echo the point about how we engage more proactively with investors to ensure that the ultimate recipient of the audit opinion, and the person who ultimately pays, gets the service that they need.

Q580 **Drew Hendry:** So you agree that they should be the client?

Maggie McGhee: Yes.

Q581 **Peter Kyle:** We heard last week from one of our witnesses who was from an audit committee that the single most important measure that could increase quality would be stiffer penalties. Does any of you believe that we do not need stiffer penalties?

Stephen Hadrill: I think we need to start applying a wider range of penalties. I am quite interested in what has been done in one or two countries where the audit firm has lost the right for a period of time to take on new business. Compared with a fine of £10 million to a very large business—our fines are bigger than the Americans, so how far are you going to push them?—some measures like that are worth considering.

Maggie McGhee: The strongest driver of audit quality of an individual audit file is strong oversight of that audit and monitoring, and that has to be backed up by proper enforcement. I would agree that the wider range of measures in addition to fines should be considered.

Q582 **Peter Kyle:** Do you think it should be progressive, following on from Stephen's point—the larger the company, the larger the fine?

Maggie McGhee: It has to be reflective of the status of that company, so yes.

Stephen Hadrill: Which is true today.

Q583 **Peter Kyle:** Yes, but it could perhaps be more accelerated.

Stephen Hadrill: It could be more progressive perhaps.

Q584 **Peter Kyle:** Yes. Stephen, you are on record as saying that organic growth is not going to solve the market problem—that you are not going to get the No. 5 in the market to become a member of the big four. What



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do you think could deliver the kind of market change that is needed to deliver more variety in capacity at the very top?

Stephen Haddrill: At the very top, I think that will take a very long time indeed, if we are talking about the FTSE 100 and so on, but I think we can make progress within the FTSE 350. The CMA proposal for the introduction of joint audit has real merit. The question there is whether the next tier of firms is ready to step up to the plate. We would like to see them produce some sort of capability report about how they would go about it, and when they would be ready, and put that into the CMA so that we have a realistic assessment of what we can achieve through that route.

There is something to be said for the market share cap idea in conjunction. The CMA has left that on the table, but it is not their principal proposal. The joint auditing thing is a pretty slow burn on its own. If we take a segment of the 350—not just the largest companies—and say that in that area we will take an additional step to create some space, as well as the joint audit, we might move forward a bit faster and progressively move it up. The market share cap idea has some serious disadvantages as well; potentially it disenfranchises the audit committee and so on, and you could end up with problems with the company not having an auditor, so the role of the regulator needs to be considered. I think we just need to put some of these ideas together. There is no single idea here that is the magic bullet.

Q585 **Peter Kyle:** Maggie, I think it is fair to say that you are not overly keen on any of the CMA's recommendations. What positive proposals do you have to increase competition in the market and effectiveness?

Maggie McGhee: We looked at all the CMA proposals very much through the lens of audit quality. We did not want to take the risk of lowering audit quality, even in the short term, because we think that that could have an impact on the longevity of reforms.

We did put forward three additional proposals for consideration by the CMA. One in particular was a response to the separation of audit functions within firms. We looked at where the potential for a conflict of interest or independence could come through. There are already controls before an auditor is appointed, so that they cannot undertake non-audit services. During the course of audit, there are strong controls on the non-audit services that they can now undertake, and we have seen voluntary movement by the firms to reduce that further.

The one area that has not been addressed is the potential conflict that arises when an auditor rotates off an audit and then moves into providing non-audit services. We put forward a proposal for a cooling-off period to address any perception of lack of independence. We proposed two years, which we felt was a balance between independence and competition.

The other element was that we felt it could increase the number of non-audit services for challenger firms, offer a different route to market and allow them to grow their experience.

Q586 **Peter Kyle:** Thank you. Michael, how would you solve the challenge of choice?

Michael Izza: We think it is a complex question, but we have been working on this actively for about nine months now. Joint audit has some merit, but we think the proposal to effectively convert all the FTSE 350 to joint audit would take quite a long time, as Stephen said. We are not convinced that the capacity is there in the market. If it were to take five to 10 years, our view would be that that is far too long. We need to be looking at something that has a much quicker impact from a timescale perspective, so we think the way forward is a segmented market share cap. If you were to say, for example, that 20% of the FTSE 350 had to be divested by the big four, you would want to make sure that it was not all the smaller audits: there would have to be some of the FTSE 100, some of the FTSE 101 to 200 and the balance from the remainder.

The reason we need that is that the fees that come with those audits have to be big enough for the challenger firms to develop a sustainable business. We want this intervention to be sustainable, and we want it to change the market; we do not want to be back here in five years.

Q587 **Peter Kyle:** That is very helpful. Finally, Stephen, you have been doing this job for nine years. From your perspective, have the expectations of Parliament and the public about what you should achieve and how you should act as a regulator changed over those nine years?

Stephen Hadrill: Yes. I think there is much more concern, partly because of some of the significant failures that we have seen. I think the audit profession was perhaps not sufficiently challenged back in 2008 around the financial crisis. We didn't—well, I say "we", but the kind of regulator was not created then for this area that was created for financial services.

Q588 **Peter Kyle:** Is this a problem of culture or practice within a regulator? You are not the only regulator that is facing these challenges.

Stephen Hadrill: No. I think about this quite a lot. The FRC—and Sir John recognises this—has been very successful in areas such as corporate governance, the code and some of the setting of the standards. Culturally, that is about reaching out and building consensus. I think we have done that pretty well. I think the corporate governance code in the UK is world class. The stewardship code was a good example, and we have now refreshed that. It is about consensus-building with the stakeholder community.

The expectation now is that, on the more purely regulatory side—the inspection and enforcement side—you have a very different attitude, so you sort of have two cultures operating side by side within the same organisation. Regulators get over that, and we are getting over it, but that is one of the things the new regulator will need to achieve.

Q589 **Peter Kyle:** One thing I cannot get over is the number of regulators that come before our Committee and apologise. We have never had a



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regulator that comes before our Committee and apologises for going too far, acting too soon, or pre-empting a problem and going a bit too far, but doing it with all good intentions. Do you think that the culture of regulation is just too passive and reactive, and we are now moving to a culture where we expect regulators to be proactive and assertive?

Stephen Haddrill: To give you one example, in my time at the FRC we have not lost a tribunal case—a court case. I can take some pride in that, but I can also say, “Perhaps we should have lost some, because we should have taken on some more.” There is a fear of losing in court that somewhat holds you back. More recently, we have taken a lot of cases, so I do not apologise too much for the record there, but that is a factor, particularly if you are a relatively small organisation with a relatively small budget. If we really mess up a case, we can have a big cost awarded against us.

Q590 **Peter Kyle:** So if you could have your time again, knowing what you know now, you would clearly be a slightly different chief executive of the FRC. What would you do?

Stephen Haddrill: What I would say to my successor is, first, there are a number of things that are customer practice within the profession. The Committee discussed one of those last week on this whole question of fraud. The auditor is clearly responsible for pursuing fraud in the company, but there is this mythology that has grown up of, “We’re not going to find it,” and that sort of thing.

There are other areas where the auditor reports by exception. The auditor in those circumstances feels, “We’re not really on the hook for those things.” The public expectation has shifted, so as you come in and take over a regulator, you should think not, “What am I hearing about the way the profession works now?” but, “Where is the public interest? Where is it going to be?” and “I need to have the foresight to do that.” Frankly, I think I should have had more foresight in the wake of the financial crisis than I did in that respect.

Q591 **Stephen Kerr:** Just building on the questions that Peter asked you about your reflections, one of the issues that the public are concerned about is conflict of interest. I raised earlier the issue of KPMG’s audit of HBOS and the FRC’s reluctance to fully investigate the whistleblowing concerns that were raised to the FRC. Four of the 10 board members at the FRC are partners at KPMG. That conflict of interest, as perceived by the public, surely must concern you.

Stephen Haddrill: On the numbers, I think it is three, and they are not all KPMG. I think it is necessary for the regulatory board to have some serious accounting experience or auditing experience on it, but that should be pretty limited. Maybe one, or at most two, is enough. Also, in law there must be a three-year cooling-off period. We are moving towards more of a five-year cooling-off period. You need somebody who is technically strong to make sure that the regulator is as demanding as possible. There is nothing more powerful than someone who can say to an audit firm, “I have been there. I have done it.”



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Q592 **Stephen Kerr:** But the next regulator cannot have the perception in the public mind that it is a creature of the profession.

Stephen Haddrill: Yes, but I think it would be a mistake to have nobody with the experience of the thing that you are regulating.

Q593 **Mr Liddell-Grainger:** Can I ask about the separation of audit and non-audit that you touched on before? Last week KPMG expressed support for operational separation. They said that “audit partner remuneration could not be maintained based on the current audit prices...economic support from the non-audit business may be necessary.” Do you agree with that statement?

Michael Izza: I think that, as a result of some of the changes that may come to pass, particularly the CMA recommendations, there may well be a re-pricing of the audit market.

Q594 **Mr Liddell-Grainger:** Just expand on that. A lot of colleagues here have been asking about this. It was mentioned about the 350. You will have to take some of the bigger ones to pay off. Let’s look at it as a spreadsheet. Where do you cross the line between being efficient and being non-efficient? Can you give a figure or a percentage of turnover?

Michael Izza: I think that is actually very difficult to answer. If I can put my earlier comment in context, I think that, certainly for the FTSE 350, audit pricing has been very competitive. Some of those audits, certainly given the environment in which people are auditing today, might benefit from perhaps more time spent on them.

Q595 **Mr Liddell-Grainger:** That leaves a whole load of things hanging in the air.

Michael Izza: It does, but I am giving you an observation.

Q596 **Mr Liddell-Grainger:** Okay, let’s take it a bit further. If organisations such as KPMG are saying that this is going to skew the market, the big four—let’s be honest—will try and make sure this doesn’t happen, because they couldn’t possibly do it, for obvious reasons. We will take the 350, as that is the obvious one. What can you do to push back to say that this has to go ahead? If you all agree with it, how are we going to push back and do it? Is there a mechanism, other than breaking up the big four?

Michael Izza: In terms of making change in the market—

Mr Liddell-Grainger: In the marketplace.

Michael Izza: I think the Committee heard last week from the chief executives that they recognise they have to make a change. I think we have passed that Rubicon.

Q597 **Mr Liddell-Grainger:** You think it has to be passed on. You bite the bullet and you take the pain.

Michael Izza: Yes.

Q598 Mr Liddell-Grainger: Do you both agree with that?

Stephen Haddrill: First of all, as I said earlier, we are reviewing the standards around independence. I hope that one of the outcomes will be that we have a complete separation of audit and non-audit services within the firms. Then there is the question of whether you build some sort of ring fence, and what stays on one side of the firm and what stays on the other. It is important to remember that the audit practices are profitable, so some element of ring-fencing makes sense. The firms can either do that voluntarily or we can have some legislation to achieve it. But making sure that the audit practice is pretty independently run of the firm as a whole, but has as a safeguard the firm as a whole behind it, is valuable.

The market is effectively represented by the audit committees, so the question is: in what way do we strengthen the commitment of the audit committee to make sure that they are buying enough time, as Michael said? That comes down to the information that we give them as a result of the audit inspections. If we have had a poor audit inspection, we expect the audit committee to review it very carefully and think about it for the next year, because they know we will look again at that audit. The publication of information on the inspection, as Sir John has recommended on the individual one, will be quite a wake-up call.

The last thing the audit committee will want is the publication of a poor inspection report. I think that will change some of the atmospherics in the market and make the customer—I hear what Michael said about the customer as the investor, but in effect the hiring entity is the audit committee—much more demanding and willing to pay for that.

Q599 Mr Liddell-Grainger: Do you agree?

Maggie McGhee: Largely. I think we have reviewed all the proposals against audit quality and not considered costs within that. We have picked up from the CMA report that they have not seen a reduction in audit costs as a result of retendering. We believe that audits should be fairly priced to ensure that you get the thoroughness with the timeliness that the market needs. Audit committee chairs are pivotal in that, as are investors. On the separation of firms, our comments in our response clarify that we want to ensure that you do not see that separation just on paper. That is why we focus very much on the cooling-off period following completion of the audit, in terms of the ability to sell on non-audit services that would be banned immediately during the audit.

Q600 Mr Liddell-Grainger: That comes down to it—we are talking about the auxiliary services. Stephen, you tantalisingly mentioned legislation, which is obviously our job. Take that a little bit further: what do you think the legislation—providing it was primary legislation—should look like?

Stephen Haddrill: If you take Sir John's report, the CMA report and potentially Sir Donald Brydon's report, we need to construct an integrated and coherent package that effectively reviews company law in many respects. I would hope the legislation could come forward reasonably quickly, but the advantage of doing it next year would be to make use of



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all three reports to set out a new strategic framework for the expectations of audit, including directors' expectations of reporting; the standards they will meet; whether there is a Sarbanes-Oxley-type overlay; the regulator's duties and expectations; and some of the regulator's operational requirements. It is really quite a big package.

Q601 Mr Liddell-Grainger: So it is an enormous piece of legislation, based on what you are saying.

Stephen Haddrill: I wouldn't redo the whole Companies Act, because that would take about 10 years, but I think this needs to be put together and thought through as a single package rather than our having three bits of legislation—one bit on competition, another on regulation, and so on.

Q602 Mr Liddell-Grainger: May I ask—literally just yes or no—whether you both agree that we need to look again at the Companies Act and perhaps tighten it up?

Maggie McGhee: We believe that it should be tightened up and that whatever can be taken without legislative cover should be taken as quickly as possible to ensure trust in auditing.

Michael Izza: I think whatever comes forward has to be coherent, but we cannot wait to make some of these changes, because we need to see a change in culture and practice now.

Chair: I am going to bring in Mark Pawsey.

Q603 Mark Pawsey: Can I ask just a quick question about audit pricing, because Mr Izza raised it? You have told us that it is competitive, and the big firms allocate so many hours to a particular audit. One thing that bothers me is that that is a fixed fee. If something untoward is uncovered during the audit, there is no additional opportunity for the company carrying out the audit to be reimbursed for the cost of doing that. You said that an audit is done for the benefit of investors. I am sure that they would be willing to pay a little extra if something untoward is uncovered. Should there be a variable element to the fee in addition to a fixed element?

Michael Izza: My experience is that if the auditors uncover something during the course of their work that requires them to undertake extra procedures, they will go back to the audit committee and ask for an extension of their fee in order to cover that. I believe that is normal practice.

Q604 Mark Pawsey: Is that happening regularly?

Stephen Haddrill: Yes, quite a bit. We would expect the audit committee to be sympathetic to that if it is a real issue. There is always the question—audit committees can get sceptical about whether they are just being upsold.

Q605 Mark Pawsey: Is it happening enough?



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Maggie McGhee: Absolutely. What we have to remember is that the fee is fixed on the basis of the risk assessment at the time, so it can change. There is a requirement on auditors under the standards that, if they identify something, they must pursue it. If they are prevented from doing that, they have to limit the scope of their audit.

Q606 **Mark Pawsey:** But there is a disincentive, isn't there? If they are not going to be able to cover their costs, they are going to end up losing a lot of money on a particular audit.

Maggie McGhee: But issues will be raised with audit committees, and they will not want to take that risk.

Q607 **Antoinette Sandbach:** Mr Haddrill, I want come back to what you said about company law. I want to read something to you: "It is the auditors' function to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order, first, to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing (by, for instance, declaring dividends out of capital) and, secondly, to provide shareholders with reliable intelligence for the purpose of enabling them to scrutinise the conduct of the company's affairs and to exercise their collective powers to regard or control or remove those to whom that conduct has been confided." What in that statement needs rectifying?

Stephen Haddrill: In that statement, I am not sure anything does need rectifying. There are some questions about how the company reports on its ability to pay dividends, for example.

Q608 **Antoinette Sandbach:** No, there aren't. This is a judgment. This is the standard that currently applies, and the law is very clear that the point of the audit is to make sure the financial information about the company's affairs, prepared by the director, accurately reflects the company's position.

Stephen Haddrill: Yes.

Q609 **Antoinette Sandbach:** Ms McGhee and Mr Izza, do you believe the IFRS standards can be relied on to ensure compliance with the law as it stands—I have just read to you what the standard is—including the capital maintenance regime?

Maggie McGhee: We believe that, as a global standard, the IFRS is absolutely appropriate. In terms of the capital maintenance, it is not the group account but the company account that we need to check. There is a requirement on auditors to look at a company's articles of association and the Companies Act requirements to confirm that there were distributable profits available to meet the dividend. Obviously, that is going on the dividend paid, which is reflected in the annual report and accounts. A company can make interim dividends during the year. Under the Companies Act, they are not required to prepare accounts at that stage, but they are required to have a process to ensure that they still have distributable profits to meet the dividend.

Q610 **Antoinette Sandbach:** Mr Izza, what is your view?

Michael Izza: In addition to what Maggie has said, you are aware that we produce the guidance for directors.

Antoinette Sandbach: Yes, I am.

Michael Izza: That is something we have done for nearly 40 years.

Q611 **Antoinette Sandbach:** My concern is that your guidance doesn't take into account the obligations as stated by the law. What we are told in the evidence we have been given is that—forgive me if I am wrong—Parliament passes the law and the courts interpret it; it is not the ICAEW that does it.

Michael Izza: Correct. Ours is guidance; the law is the law. We wrote to the Committee last summer on this subject, and it was our suggestion that the current capital maintenance regime is not fit for purpose.

Antoinette Sandbach: I am going to come back to that.

Michael Izza: BEIS has also got a consultation open at the moment on insolvency.

Q612 **Antoinette Sandbach:** The evidence we had from Mazars, BDO and George Bompas QC was that the IFRS standards cannot be relied on to ensure compliance with the law.

Michael Izza: We have been providing this guidance for 38 years, which means that we were doing it when UK GAAP prevailed, before IFRS was ever introduced. This is not an IFRS problem. This is a problem around the definition of distributable reserves in accounting language.

Q613 **Antoinette Sandbach:** Yes, absolutely. So do you think that directors and auditors should make supplementary disclosures to satisfy the UK's capital maintenance requirements?

Michael Izza: I think the FRC, through its financial reporting lab, has done some—

Q614 **Antoinette Sandbach:** It is quite a simple question; it is really a yes or no.

Michael Izza: Yes, it would be helpful.

Q615 **Antoinette Sandbach:** Ms McGhee, do you agree with that?

Maggie McGhee: Yes

Q616 **Antoinette Sandbach:** In relation to your 2005 briefing paper—I think the Companies Act is 2006—you said that there are “many issues that companies within the capital maintenance regime will encounter in determining their profits available for distribution using accounts prepared under IFRS”. That is a clear admission, isn't it, that the two regimes—the capital maintenance requirement regime and the IFRS standards—are different?

Michael Izza: There are inconsistencies.

Q617 **Antoinette Sandbach:** Was there something in particular in 2017, Mr Izza, that made you change your mind about the applicability of the law? Because you are now saying that the IFRS is almost always fine.

Michael Izza: I am not sure whether there was anything specific, but I will write to the Committee if there was. Can I just point out that when the Companies Act 2006 was being prepared, we also made representations to the Government at that time that the UK capital maintenance regime needed a review, and that was not taken into account?

Q618 **Antoinette Sandbach:** I am not entirely sure that the capital regime does need a review. What it needs is disclosure about compliance with it. What we saw with Carillion were issues about how goodwill was accounted for, and what assets were considered, effectively where profits were written as realised when they weren't. That was not an issue with the capital maintenance regime. It was an issue with the way that IFRS standards were applied.

Stephen Hadrill: On goodwill, there are two issues. There is goodwill and there is the definition of the distributable profits. On goodwill, I think IFRS has a rather better approach than the UK GAAP approach. Carillion, being a public listed company, applied IFRS.

Q619 **Antoinette Sandbach:** There was not write-down for goodwill in Carillion for over five years. Goodwill was put at £1.5 billion. Are you saying that was effective, particularly when the goodwill was stated by the company to be in the people, the staff? There was no audit of which staff were there from when they bought a company eight years before and how many had remained there.

Stephen Hadrill: Under UK GAAP, you amortise goodwill year by year. Under IFRS, you should work out on an annual basis whether your number is still justifiable. The question is one that our investigation is looking at in depth: should the company and the auditor have done more to write that number down, year by year, over that period?

Michael Izza: There should be an annual impairment test.

Q620 **Antoinette Sandbach:** But it wasn't written down.

Stephen Hadrill: Exactly.

Antoinette Sandbach: And Carillion was trading while insolvent effectively, and auditors wrote off those accounts. Auditors audited those accounts.

Stephen Hadrill: That is a big part of our investigation.

Q621 **Antoinette Sandbach:** You didn't call it in, did you?

Stephen Hadrill: Earlier on? No. That is part of the problem of not being able to see it from the face of the report, and why we—or the new



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regulator—needs the ability to go into the company and find out more about what is going on.

On the other side of things, the distributable reserves, I entirely agree that there should be more disclosure, as you asked just now. I am very pleased that the Department has set up a working group to look at whether it is not just a matter of disclosure but whether the definition in the Act should be reinforced. Because the question is whether profits that are going to come through from contracts running out into the future should be allowed into the definition or not.

Q622 Antoinette Sandbach: Mr Haddrill, are you aware of the judgment in the AssetCo case yesterday?

Stephen Haddrill: Yes.

Q623 Antoinette Sandbach: You are? So you accept, for example, that Grant Thornton accepted that an auditor might be liable for dividends unlawfully paid, if such a payment was made in reliance on negligently audited accounts, and that effectively operated around the capital maintenance rules, didn't it? Yes. Grant Thornton lost that case yesterday. Do you think that is why the big four are so defensive and try to use the ICAEW guidance as an audit standard, rather than applying the legal standard that they are required by law to do, in the way that they audit the accounts?

Michael Izza: Let me say again that our guidance is not an audit standard; it is guidance for directors. You must always apply the law of the land.

Antoinette Sandbach: Well, that wasn't the evidence that we got from the big four.

Q624 Chair: Why provide that guidance, Michael Izza, if it is not consistent with the law? Shouldn't you be clearer in your guidance about that?

Michael Izza: This guidance is to help people navigate through it, because the directors are the people who must take the judgment ultimately as to whether or not a dividend is payable.

Q625 Antoinette Sandbach: Yes, but this is what the law says. There is a long-standing judgment from a case called Caparo that the auditors' function is "to ensure, so far as possible, that the financial information as to the company's affairs prepared by the directors accurately reflects the company's position in order," for example, "to protect the company itself from the consequences of undetected errors or, possibly, wrongdoing." Possible wrongdoing would include capital maintenance requirements where, for example, realised profits were overstated, in terms of contracts going forward, wouldn't it?

Michael Izza: *indicated assent.*

Antoinette Sandbach: I see you nodding, Mr Izza, so perhaps the record can reflect that.



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Q626 **Chair:** Instead of nodding, could you just say yes or no, so that we have it on the record?

Michael Izza: Yes, I think that is correct.

Q627 **Antoinette Sandbach:** Mr Haddrill, Carillion asked for £10 million to survive in January 2018. Don't you think they would have survived if they had not paid a £54 million dividend in June 2017?

Stephen Haddrill: That is possible. I cannot say for certain.

Q628 **Antoinette Sandbach:** And would you support AGA becoming responsible for tightening and enforcing the capital maintenance regime?

Stephen Haddrill: Yes, I think that should be part of the role.

Q629 **Antoinette Sandbach:** As a principle, would the regulator and the two accountancy bodies accept that prudence, as enshrined in the law, should be dominant, rather than IFRS? Prudence protects the assets of investors and shareholders, which are normally pension funds that my constituents have worked really hard to be part of. That way, there would be accurate information rather than recklessness and we would not see, for example, goodwill and large amounts not being written down, discounted or whatever the technical term is.

Stephen Haddrill: The FRC has put it, over quite a period of time, to the International Accounting Standards Board that they should have prudence as a principle. They wrote it out of their conceptual framework a while ago, and they have now put it back in. There is a balance, as always, between protecting the shareholder from a company that is being imprudent and protecting the shareholder from a company that is salting money away to be able to smooth its profit line over time. The reason prudence was effectively downgraded in the accounting world in the 1990s was that people had seen too much of the latter. Now we have seen too much of the former, and it needs to be rebalanced.

Q630 **Antoinette Sandbach:** Do you agree with that, Mr Izza?

Michael Izza: I agree.

Q631 **Antoinette Sandbach:** And do you also agree, Ms McGhee?

Maggie McGhee: I would, but I would also say that it is very important, as the investors stated, that there is a global standard for financial reporting. We live in a global economy, so we are a very strong proponent of international financial reporting standards.

Q632 **Antoinette Sandbach:** But if we require UK companies to disclose additional, supplementary information—

Maggie McGhee: That is absolutely no problem whatsoever.

Michael Izza: And there is no problem doing that under the current regime.

Q633 **Chair:** Would it still be possible for a company to account for goodwill in



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the way that Carillion accounted for it, without any depreciation?

Stephen Hadrill: If there was no reason for depreciation, yes, but is it possible that they could do that erroneously? It is for the auditors to make sure that does not happen and for us to try to spot it as well.

Q634 **Antoinette Sandbach:** Sorry, may I intervene? In relation to the AssetCo case—

Stephen Hadrill: Yes, which we also prosecuted.

Q635 **Antoinette Sandbach:** How many members of the audit firm have been suspended or barred from practice for failing to—

Stephen Hadrill: I think it is three, but let me check.

Q636 **Antoinette Sandbach:** And had that audit had an AQR report on it from you previously?

Stephen Hadrill: It was subject to a formal investigation and a disciplinary matter. I cannot recall whether there was an inspection beforehand or whether it came from a different source.

Q637 **Chair:** I am concerned about this issue of goodwill. Obviously, the company was audited. You went in in 2015 and had a look at the audit. I do not think you specifically referred to that goodwill or looked in more detail at that when you did your assessment—unless you want to correct me.

Stephen Hadrill: I think we did look at goodwill. I am a bit hazy now on the details of what we actually said about it.

Q638 **Chair:** Maybe you can come back to us and let us know what you said about it. Do you think it is okay for companies to keep goodwill on their balance sheets five years or eight years after they acquired a company at the same level?

Stephen Hadrill: I think what is important is that, if they have acquired a company and paid shareholders' money out for something that includes within the purchase price an element of goodwill, they report that. The question then is whether they review that each year and make sure that what remains on the balance sheet is an appropriate figure.

Q639 **Chair:** Would you, as a matter of course, look in much more detail at the audit of any firm where goodwill was not being written down?

Stephen Hadrill: I think it would depend on the circumstances of the company.

Q640 **Chair:** But you wouldn't know unless you looked into it in more detail, would you?

Stephen Hadrill: When we look at the report and accounts of any company, we will look at the goodwill statement as part of that.

Q641 **Chair:** When you get back to us with answers to other questions, will you also let us know how many of the audits you have looked at in the last



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five years did not depreciate goodwill, and what further action you took in those cases?

Stephen Haddrill: Okay.

Q642 **Chair:** I have a couple of questions about graduated findings. KPMG suggested that instead of just being able to qualify, or not qualify, a set of accounts, they could give an assessment with graduated findings, which is also referred to as the grading of key audit matters. Do you think that would be a good idea?

Michael Izza: I think there is a lot to be said for that. At the moment, most audit reports are a binary pass or fail, but things are very rarely black or white. Giving more information to the investors would be a very positive step.

Maggie McGhee: We believe it is a positive development. The key audit matters—changes in the audit report—have really improved transparency. There is more that they can do. Our comments back in response were that we would like the pull to be from investors themselves, because we think that will impact on the quality of the disclosures, rather than it being mandated, but we understand that speed of change may be easier in terms of—

Q643 **Chair:** We heard evidence from audit committee chairs, and one of them could not even name the biggest investors—he said he has no interaction with them and they never ask any questions—so if you are asking the investors to ask for something, you might be waiting for some time. Without investors, would you be happy to introduce a system of graduated findings?

Maggie McGhee: Yes.

Q644 **Chair:** Do you have any other ideas to make audit reports more useful, both to investors and to other stakeholders?

Maggie McGhee: One of the elements that needs to be addressed is the use of plain English. An audit report is a very complicated read. I think we can make things much more accessible, although I recognise that the CMA response said that members of the public are very unlikely to ever read one. I think we could make it easier if they did read them.

Michael Izza: I refer to the comments I made earlier. It would be very helpful if the auditors were required to actually present at the AGM.

Q645 **Chair:** Stephen Haddrill, what do you think about graduated findings and the other ideas?

Stephen Haddrill: When we introduced the extended auditor report some years ago, the requirement was that the auditor would talk about the key audit matters and also materiality—the threshold that they had adopted. I think we need more information about the auditor's view of the future prospects of the company, not just its current position.

Q646 **Chair:** What do you think the key focus of Sir Donald Brydon's review



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should be?

Michael Izza: I would be very keen for Sir Donald to explore the expectation gap, with a particular emphasis on fraud. I think he should do work around going concern. I certainly think there is starting to be a lot of demand from investors for ESG—environmental, social and governance—and climate change measures. There are things we could do on things that appear in the annual report but are not audited. Things like the viability statement and, in the financial world, risk-weighted assets—arguably the most crucial number for a bank’s security—are not audited.

Maggie McGhee: There should very much be a focus on the expectation gap. We have standards that apply to the current scope of audit. It is very clear from the public that we need to look at the scope of the audit and expand that scope. We need a very honest discussion about how we evolve audit for the future. I very much appreciate the comments he made yesterday on technology, which has changed the opportunities available to auditors. We need to really grasp those opportunities.

Stephen Haddrill: I agree about the expectation gap. First, in terms of the work the auditor does now that is not a formal part of the full audit, the review should look at whether that could be made a full part of the audit opinion as a whole. There are parts of the annual report that they review by exception, and I would make many of those part of the formal audit. That is the first thing.

The second thing is that, as colleagues have said, investors are looking for more information, particularly around these alternative measures of performance that companies are developing. In the retail sector, there are different measures from almost every company on their sales performance and so on. That is important to investors, so do we need those to be properly externally tested and assured? The other thing I hope he looks at is the future of audit in terms of technology.

Chair: Thank you all very much. There are a number of things we look forward to receiving, especially from you, Stephen Haddrill, and from you as well, Michael. Thank you very much for your time today; it has been very interesting.