

Business, Energy and Industrial Strategy Committee

Oral evidence: Future of Audit, HC 1718

Wednesday 13 March 2019

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

Questions 647 – 717

Witnesses

I: Rt Hon Greg Clark MP, Secretary of State, Department for Business, Energy and Industrial Strategy; Debbie Gillatt, Director, Business Frameworks, Department for Business, Energy and Industrial Strategy; Alex Chisholm, Permanent Secretary, Department for Business, Energy and Industrial Strategy.

Examination of witnesses

Witnesses: Rt Hon Greg Clark MP, Debbie Gillatt and Alex Chisholm.

Q647 **Chair:** Thank you very much, Secretary of State, Alex Chisholm and Debbie Gillatt, for coming to give evidence to our Select Committee this morning on the future of audit. This is an important inquiry for the Committee, looking at the environment and landscape of audit post the work we did on the collapse of Carillion. We very much welcome the reviews that you commissioned from Sir John Kingman, and also the work that the CMA has done. We have also taken evidence from Sir Donald Brydon and welcome that as well.

If I could start, one of the things that we heard from a lot of witnesses was that it would have made more sense to have started with the review by Sir Donald Brydon, looking at the purpose of audit. In retrospect, do you agree that you should have made that appointment and got that inquiry going before the other ones? Is that not the crucial issue?

Greg Clark: I do not agree with that, Chair. It is a view, I can see that, but you and other members will recall it was your hearing, together with the Work and Pensions Committee when you were looking at some particular instances of corporate failure, which shone the spotlight on the FRC. I felt that it was evident from those particular cases and the way that the FRC had operated there that we needed to get on at pace with reforming it. If we were to consider the very important questions of the future of audit, and then come to FRC reforms much later on, we would not be in the position we are in, where we have an excellent report and some very far-reaching recommendations, and we are getting on with implementing them.

Q648 **Chair:** We are going to come on to questions from Sir Patrick shortly on Kingman and taking action, but you have spoken, Secretary of State, of the urgency of making those reforms. Will legislation be coming forward soon on implementing that?

Greg Clark: Yes. One of the reasons that I was keen not just to commission the report but to respond to it—and the consultation is there—is that we should be able to legislate as soon as possible. As you know, we have had previous exchanges in this room about the fact that I cannot guarantee a legislative slot—as a former Chief Whip, Sir Patrick will attest to that—but I am determined that we should be ready to legislate and to give the firmest push, if I can put it that way, to my colleagues who manage the business of the House. The last time we talked about this, it was in the context of the price cap Bill, and the Committee wondered, perfectly reasonably, whether we had a slot. It turned out—not least with the help of the Committee—that we found a slot, legislated, and that has now taken effect. That augurs well for this.

Q649 **Chair:** In the spirit of cross-party working—hopefully we will see more of



that this evening to stop a disastrous no-deal Brexit—can I offer the support of this Committee in doing everything that we can to secure a legislative slot for this, and to get cross-party support to take it through Parliament as quickly as possible, because the FRC has failed as a regulator? We need a tougher regulator in place. Sir John Kingman has shown you the way to do that, and we would like that implemented to ensure a robust regulation of the audit market, so as to give all stakeholders, employees, people saving for pensions and shareholders much more confidence in audit and in the health and stability of British businesses.

Greg Clark: I am grateful for that, Chair. Again, perhaps I can say that your inquiry is very timely, because I assume it will report soon. It will be a further piece of evidence that the House can consider when it takes into account the legislation that we will put forward.

Q650 **Anna Turley:** Good morning, Secretary of State. The Kingman review recommended that the FRC be rebuilt from the ground up with a clear and precise sense of purpose and mission. You are recruiting a new chair, a new deputy chair and a new CEO, which is quite a dramatic measure. Does that mean that you do not believe the current leadership of the FRC is capable of delivering the kind of reform that we need?

Greg Clark: I follow the recommendations of the independent report, and it made a shrewd judgment that, rather than start completely from scratch and, as it were, close down the FRC and build a new organisation from the beginning, there were some strengths in the organisation but it needed to be significantly reset. The approach and the specific recommendation was that there should be some continuity, but clearly, in terms of the leadership, a new organisation that is substantially changing will benefit from new leadership.

Q651 **Anna Turley:** Do you think that will be enough, if there is a change of personnel but the existing framework still continues?

Greg Clark: No. It is very clear from the independent review that the leadership and the staffing is part of it, but it is a very substantial report, as you know, and it makes many recommendations in terms of its powers, organisation and remit. It comes together, and all those things are required to give the confidence that we would like. It is very important, and I am sure all members of the Committee would recognise, that our international reputation as a place of high standards and a dependable place to invest and to do business in requires our institutions to be world leading. I am determined—as I know that Sir John was in his report—to live up to that. In fact, he says that in his introduction.

Q652 **Anna Turley:** What are you looking for in your new chair, deputy chair and CEO?

Greg Clark: There will be a formal process with interviews, but I think you would want someone who has the independence and the standing to make often difficult judgments. Again, given sometimes the commercial



HOUSE OF COMMONS

interest of people and organisations that are quite powerful, you will want to have someone who is clearly experienced in serving the needs of the users of financial information. It is someone that will need to be the inaugural chair, as it were, of a new organisation, to build a culture and make appointments. Obviously, the chair will be very instrumental in making other appointments, so I would want to see evidence and the prospects—the cultural aspect of this is very important. Those are some of the areas, but obviously they will be elaborated in the advert and job spec..

Q653 Chair: Given the Kingman review and the obvious failures of the leadership at the FRC, is it right that we still have the same chairman and the same chief executive who presided over a failing organisation?

Greg Clark: Sir John and his colleagues do record some strengths in the organisation. As you know—you have taken evidence from him—they were completely independent; they were not constrained in what they said. They did not recommend, as it were, an immediate dissolution or a replacement of the current leadership team, but Sir Win Bischoff said, I think on Monday, that he would be coming to the end of his tenure there. There is a recognition that this is a time to make a change, but there cannot be a gap here. There needs to be good order. This continues to be a very, indeed increasingly important, organisation. Our response, as the Committee have seen in the document we published on Monday, is to get the FRC to take on, in advance of legislation, some of its new remit. To do that, you need to have people in post. That was the recommendation in the review, and we were happy to go along with it.

Alex Chisholm: Of the 83 recommendations in Sir John Kingman's report, we have been able to take forward 35 for immediate action.

Q654 Chair: We will come on to that in a minute with Sir Patrick's questions. Secretary of State, do you have confidence in the leadership team at the FRC at the moment?

Greg Clark: We have asked Sir John to review it and he has not recommended—

Q655 Chair: Do you, Secretary of State, have confidence in the leadership? Cards on the table, I do not have confidence in them. From what I have seen, from the evidence we have taken, and from what we saw with Carillion, I do not have confidence in them. Do you?

Greg Clark: There needs to be a change, but to the question of whether I think they should be removed, the answer is no. I have confidence in them continuing to be in place while the new organisation is built.

Q656 Chair: When will we have a new chair and chief executive?

Greg Clark: Perhaps I can ask Alex to talk about that.

Alex Chisholm: Both chair and deputy chair have been advertised, so we hope to fill those posts in the summer. We also want to use those two



HOUSE OF COMMONS

people to help advise on the chief executive appointment, which will be made as soon as possible after that. The current chief executive has already given an indication that he wants to step down in the autumn, so it is going to be an orderly handover as soon as we can accomplish it.

Chair: It is just that it is 14 months now since the collapse of Carillion and we are talking about the summer—it will be 18 months since the collapse of Carillion and we still have the same people in charge of an organisation that is responsible for the regulation of audit. I would have thought that there would be a bit more urgency in bringing in new leadership.

Greg Clark: Chair, in terms of the pace with which we have had such a substantial review and the response to it, I do not think many people—I hope on this Committee, but certainly outside—will doubt the scale and determination of the reform. We have moved very quickly and it has been a substantial set of reforms. This needs to be done in an orderly way. This is a very important institution and to simply remove a whole swathe of its current leadership—

Q657 **Chair:** I know, but we do not even have a timetable. You are saying the summer, hopefully, for a new chair and deputy and then a timetable after that to appoint a new chief executive. By the end of the year, will we have a new chief executive?

Greg Clark: Yes.

Q658 **Sir Patrick McLoughlin:** Secretary of State, we are not quite sure yet when this parliamentary session is going to end, so it is slightly difficult to ask you exactly whether you have yet got a legislative slot in the next parliamentary session. I fully accept that and I know the constraints around that, but have you been given permission to start drafting the legislation for the next session by parliamentary draftsmen?

Greg Clark: We have just published our response calling for measures, and as you will remember, Sir Patrick, to do that and to make the commitment to legislation requires collective agreement. I am not just giving my personal preference. It is the policy of the Government to enact this through legislation, and therefore, unless I am corrected by the Permanent Secretary, we have permission to work up the legislation.

Alex Chisholm: Absolutely. I should also point out that although we have been very clear, in the document published on Monday, about where the Government stand on it, it is a consultation for three months, so we need to make sure that we gather views. As you know, Sir Patrick, that is an ordinary part of good Government process. I would also point out that based on the interim report of the CMA, which came out in December, if its final report shows some of the same interest in the reforms that they showed at the interim stage, some of those might require legislation too, and that would have to be taken into account.

Sir Patrick McLoughlin: Yes. That is partly what I am thinking of,



HOUSE OF COMMONS

because you have the Brydon report that is going on and you have Kingsman, who has reported. You said just a few moments ago that of the 83 recommendations in Kingsman, you have enacted 35, so that leaves more than 40.

Alex Chisholm: 35 are already being done and there are 13 on which we will take interim measures, so there are 35 outstanding.

Q659 **Sir Patrick McLoughlin:** Do those 35 outstanding ones require parliamentary primary legislation?

Alex Chisholm: Quite a number of them. One or two are outstanding for different reasons because they require ongoing work by other bodies. For example, the review of the actuarial profession is a PRA matter¹.

Q660 **Sir Patrick McLoughlin:** When in the Department were there first concerns about the way audit is being done in this country? One of the things that has come through to me very much is just the sheer complication and the way, to a degree, that audits have changed. I had one other company telling me that 10 years ago they were perhaps spending £10 million on cybersecurity, but now they would be spending in excess of £200 million a year on cybersecurity enforcements. When did the first worries about audit and the way we do audit come into the Department?

Alex Chisholm: It is almost a historic question. I would say that people are always worried by audit, especially in times of recession or economic downturn, because they see more evidence of company failures. When there are company failures, although sometimes they are unavoidable or reflect bad decisions by management, it is natural for larger companies that are subject to public audits—that is around 200,000 of the 5 million or so businesses in the country—often to say, “Why did the auditors not do a better job?” It is particularly in downturns that you get that, but it is an ongoing issue.

Q661 **Sir Patrick McLoughlin:** When was the last major restructuring of the way audits are done?

Alex Chisholm: The FRC is a very unusual body. It goes back to 1990 and is really a survivor from the post Financial Services Act regime of self-regulatory bodies, which members of the Committee will remember. It has evolved quite a lot. In 1992, it got responsibility for reporting added to its responsibilities for accounting standards. In 2005 it became an audit regulator, and only in 2016 did it become designated as a public body. It has evolved a long way during that time, and I think the approach of Sir John Kingman and of the Department is to say that it is time to take stock now and put it on a proper statutory footing, because it has such an important public role.

Q662 **Sir Patrick McLoughlin:** In terms of running costs and how it is going to

¹ Note by witness: should be “HMT is working with the PRA and TPR.”



HOUSE OF COMMONS

get its revenue, obviously the Department will not want to pay for it. Have you come to a view firmly on that?

Alex Chisholm: Yes. It is a very curious body, and at the moment it raises its money from the sector that it regulates—that is not that unusual, and it is replicated in energy, telecoms and financial services. In this case, however, it is not compulsory for firms to make that contribution. Again, when we looked at that as a group, we felt that did not seem appropriate and we welcome the fact that Sir John said that that should be put on a statutory footing if necessary.

Q663 **Sir Patrick McLoughlin:** That is one of the things that you require primary legislation for.

Alex Chisholm: Yes, indeed.

Q664 **Sir Patrick McLoughlin:** As you will be raising some money and relieving the Department of an asset, there might be a warmer welcome for it around the Treasury. Getting Treasury backing for a measure like this would be quite important.

Alex Chisholm: It does not currently consume Treasury money because it is through this voluntary levy, but it is peculiar, to say the least, that a regulator should charge a voluntary levy to the bodies it regulates.

Q665 **Albert Owen:** Good morning, Secretary of State and your team. We referred to the CMA's preferred remedies in December. What conversations have you had with the chair of the CMA about its recommendations

Greg Clark: It touches on Sir Patrick's point about the interest in reform. This Committee is aware that I believe that in order to enhance our reputation as a good place to do business, a lot of the institutions that are responsible for that regulation need a bit of a refresh. I was very pleased to appoint Andrew Tyrie to lead the CMA. I have also appointed Professor Martin Cave to lead Ofgem. I asked Sir John Kingman to conduct the review that we have been talking about, and of course there is Sir Donald Brydon on audit. It is part of a pattern, and each of these are good reforms. In this case, after Lord Tyrie was appointed in June, as part of my discussions, I expressed concerns about the performance of the audit industry. Some of those relate properly to competition matters.

Q666 **Albert Owen:** Secretary of State, since this paper in December, have you had dialogue with Lord Tyrie on the actual principal recommendations?

Greg Clark: He has described the recommendations to me. Quite rightly and properly, both Lord Tyrie and his organisation observed that they are in the middle of a market study and in the middle of the investigation. These are interim proposals and they are independent; they are not for agreement from me. Things need to be done in a proper way. "Conversation" is not the right word, but he has briefed me on his recommendations.



HOUSE OF COMMONS

Q667 **Albert Owen:** Will you be looking seriously at those recommendations? Are they likely, as you indicated, following up from Sir Patrick, to be part of the legislation that you are bringing forward, so that you would seriously consider outline recommendations now? If they were fully developed, would you seriously consider them for parts of legislation going forward?

Greg Clark: Indeed. It is not a coincidence; it is deliberate that they should be reporting around the same time. Sir John reported in December. I invited the CMA in October to consider. It was its decision to have the investigation. It published its interim findings on the same day as the Kingman report, which again was not a coincidence. Whilst it obviously has some further work to do, exactly as the Permanent Secretary said in response to Sir Patrick, the idea is that it will conclude at a time in which any legislative requirements can be made in the same Bill.

Q668 **Mark Pawsey:** Secretary of State, you have spoken to us about the reforms that will arise from both Kingman and the CMA. What I would like to explore is what the situation will be in five or 10 years' time, once those reforms have been enacted. One of the biggest concerns is the lack of competition and the number of people that are able to carry out an audit for the FTSE 100. How many more audit companies would be available to carry out such work in five years' time if these recommendations are implemented?

Greg Clark: I very much appreciate your question, Mr Pawsey. I have got to be careful here when it comes to the CMA investigation. They are objectively looking at the current level of competition in the audit market and its prospects. As Mr Owen was indicating, I should not steer them as to their findings, and neither, it seems to me, since I would have to take those findings and possibly legislate, should I have a prior view about how many firms there should be.

Mark Pawsey: Secretary of State, it is unquestionable that the fact that only four firms are able to carry out these audits demonstrates a lack of competition. We have taken lots of evidence that suggests that one of the benefits would be if more companies were able to do that. I am trying to get a feel from you as to how many more companies would be desirable.

Greg Clark: I quite understand that, and prima facie that is true. Four companies is not a high degree of competition, but we do have a specialist and dedicated competition authority to look at that, and to consider whether there are reasons why that has to be or is likely to be the case.

Q669 **Mark Pawsey:** Would a doubling of the number of companies represent more effective competition, in your view?

Greg Clark: It would certainly represent more competition, but the key question that I dare say the CMA is asking is whether this would be more effective competition.



Q670 **Mark Pawsey:** Do you think more companies would be more effective?

Greg Clark: The reason the CMA is looking into it is to determine that. I do not know. Hypothetically, and perhaps in a different industry, if you had a large number of relatively weak companies without the degree or depth of knowledge to be able properly to consider a complex client, that could be a reason to think that although it might be competition it is not effective competition. As I say, it is very important I do not have a prior view on this. The CMA is approaching this very rigorously, but you can take from the fact that I asked Lord Tyrie to consider this market that I share your view that, *prima facie*, this is one of the features of audit that requires investigation and possibly action.

Q671 **Mark Pawsey:** Secretary of State, is there a difference between FTSE 100 and FTSE 350 companies? If 350 companies are smaller, would it be advantageous for more challenger firms to carry out the audit on companies that are not as big as those in the FTSE 100?

Greg Clark: I understand, Mr Pawsey, why you are drawing me into giving a view as to how the market should be, but it would not be fair to do that. However, let me answer it by saying that if you look at the industrial strategy, one of the core principles of that is that we should have a contestable business environment in which insurgents can challenge competitors, even if they are very venerable and have been there for many years. That is the business environment I want to create, and the CMA is aware of that policy preference.

Q672 **Mark Pawsey:** Should we get away from a situation in which we have received evidence that the challenger companies are spending enormous amounts of money in bidding for business—sometimes £1 million in preparing a bid—but are very rarely successful? How can we help them be more successful?

Greg Clark: I would imagine that economists would regard that as a barrier to entry that can put off people.

Q673 **Mark Pawsey:** How can we reduce the barrier, Secretary of State?

Greg Clark: It may be that we can, but there are certain requirements that you need if you are to have an audit. Even FTSE 350 companies are often complex. They might operate in different countries and in different sectors. If you are not to have an imbalance between the capability of the auditor and the firm—that is clearly an important balance that has to be struck—you need to make sure that the smaller firms are able properly to scrutinise and investigate that, and that is something that I am sure the CMA will consider.

Q674 **Mark Pawsey:** May I follow up Sir Patrick's question about the legislation that is necessary to implement, in this case, the CMA proposals? How many of those proposals require legislation? Again, I suspect your answer will be the same as the one given to Sir Patrick, in terms of availability and parliamentary time to introduce legislation if and when it is



necessary.

Alex Chisholm: The process that we went through when we got Sir John Kingman's report was to go through it quickly and see which of these measures we could act on now, right away, and which required legislation. That is very much the way we structured the report that we published on Monday. As soon as we get the CMA report, which we would expect in a matter of weeks, we will go through the same process there and ask which recommendations require legislation and which we can act on now.

On your earlier questions, we were encouraged by the fact that the CMA were looking very much at options to try to bring more competition and choice into the market. They looked at, potentially, things like market share caps, joint and shared audits, giving people access to technology assets, and trying to change the appointment process. The evidence that this Committee has heard, again, from different firms in the market, both challenger firms and more established ones, shows an acceptance that there needs to be change.

Q675 **Mark Pawsey:** In terms of bringing forward these changes, we now have a third inquiry underway, with Sir Donald Brydon. Do you expect that any proposals will need to await Sir Donald Brydon's review?

Alex Chisholm: Not necessarily. It depends on what he comes up with.

Q676 **Mark Pawsey:** He is not expected to report for some time. He has only just started. If we want to effect change here—the Chair has set out a clear interest in ensuring that change is brought about, and the Secretary of State wants to see change—what is the point in waiting for a third report?

Alex Chisholm: We will have good indications from Sir Donald and his advisers over the course of the year about the likely shape of those reforms.

Q677 **Mark Pawsey:** Nothing is likely to even be thought about until the new year.

Alex Chisholm: No. I think we would go much before that. We can start preparing the legislation in relation to the Kingman report now. We can add to it in a few weeks' time whatever is necessary from the CMA part.

Q678 **Mark Pawsey:** You will then need to wait for Brydon before you decide to do anything.

Alex Chisholm: We have to wait in any case for the consultation to close on the Kingman report. We want to hear advice from this Committee as well, and we will put all that together and say what the shape of legislation is.

Q679 **Chair:** Your consultation ends in June, is that right?

Alex Chisholm: Yes.



HOUSE OF COMMONS

Q680 **Chair:** We will be reporting before that. There is a strong view from the evidence that we have taken, including from Sir John Kingman and indeed from Sir Donald Brydon, that it is not necessary to wait until Sir Donald reports to implement the recommendations of Sir John Kingman.

Greg Clark: Chair, can I say that I completely agree with that? There is absolutely no intention of waiting. We will have the CMA report and we will have the Kingman report. Once we publish the legislation, as the Permanent Secretary says, anything that is emerging from the Brydon review can be communicated—that would be to this Committee as well as to me—and can be considered, but we are not going to hold back from legislation.

Q681 **Chair:** Is it your intention to bring forward legislation on the CMA and Kingman recommendations before Donald Brydon reports?

Greg Clark: Yes.

Q682 **Sir Patrick McLoughlin:** Are you drafting that legislation now? Have you got parliamentary draftsmen working on those clauses? Have you got approval for that?

Greg Clark: As the Permanent Secretary said, Sir Patrick, this is a consultation and the process for this is that you need collective agreement on the consultation, including the recommendations. Once the consultation closes, then, as you will recall from being on the PBL Committee, you then turn the final—

Q683 **Sir Patrick McLoughlin:** You have not had that approval yet and you hope you will get it fairly quickly after you have concluded the consultation. This is quite important and getting the draftsmen's time is not easy; you have not yet got approval for that.

Greg Clark: It is not such a binary thing. As you will recall, in drafting the legislation, the parliamentary draftsmen are the final stage of that. They have briefs that are prepared to inform that and they are proceeding.

Sir Patrick McLoughlin: They are proceeding.

Greg Clark: Yes, from now, in shadow form as it were.

Chair: I am very pleased to have you on the Committee, Sir Patrick. Your knowledge and expertise is of great use to us, as is that of Vernon Coaker.

Vernon Coaker: I just wanted to follow up on what Mark Pawsey was asking about competition. You have one of the great offices of state. You are an elected Member of Parliament to a Government that are supposed to represent the people. Why would you not express a view? You said in answer to Mark Pawsey's question, "You are trying to get me to express a view". That is exactly what we are trying to do, because it is important that as the Secretary of State you have a view, notwithstanding the consultation, about what the overall position should be with respect to



HOUSE OF COMMONS

competition and the big four. It is not pre-empting the consultation to say, as the Secretary of State in one of the biggest offices in the country, what your view is about the way the big four are operating, and whether you think that competition would help drive forward a process that would, at least in part, reflect the public's concern with the way the current system operates.

Greg Clark: I commissioned the CMA to look into that.

Q684 **Vernon Coaker:** What is your view?

Greg Clark: The reason I did was because I do not think the performance of the audit market is sufficient. There are the regulatory aspects that the Kingman review looked at, which I commissioned. I asked the CMA to look into that, so it is obvious I think there is a problem there.

Q685 **Vernon Coaker:** Is that a problem of a lack of competition?

Greg Clark: The lack of competition is clearly a potential contributor to that. There are two reasons why it seems to me that I should not crystallise my view into saying how many firms should operate in the sector.

Q686 **Vernon Coaker:** No, but you talked about a lack of competition in answer to me much more directly than you did to Mark Pawsey.

Greg Clark: Absolutely. Mr Pawsey made a point about effective competition. It needs to be genuine. It needs to be genuine choice. It needs to be competition that drives up standards and that delivers a high quality service. That is what the CMA, at my request, is looking into. It is right to allow it to do that.

Secondly, it will make recommendations to me, which then have to be consulted on. You are a former Minister, Mr Coaker, and you know that there are always legal challenges. When consultations are done, they have to be done properly. If you have made up your mind in advance, that can be cited and can frustrate the reforms that everyone wants to see.

Q687 **Vernon Coaker:** You have talked about a lack of competition now in a way that is much more open and transparent than it was. It is the context that you set and not the actual conclusions.

Alex Chisholm: One other feature that is very important about the market is the resilience. If we look back even 20 years, Coopers & Lybrand became part of PwC through a merger, but Arthur Andersen ceased to exist because of firm failure. Four firms control something like 99% of the FTSE 350 audits. If one of those ceased to exist for one reason or another, then you have an even more concentrated market. As well as competition, resilience in the market is a very important factor.

Chair: Yes, and we are very concerned about that. That is one of the issues that came up often during our inquiry.



HOUSE OF COMMONS

Q688 **Antoinette Sandbach:** We interpret Sir Donald Brydon's terms of reference as being quite broad, but some stakeholders have referred to them as too narrow. Can you tell us what your interpretation is?

Greg Clark: I take a broad interpretation. This is a moment in which someone with the experience and independence of mind that Sir Donald has should look at the expectations that are broadly placed on audits, and at how they are currently met, and address that gap between them. That is the approach that I take—in evidence to you he has reflected the fact that we have encouraged him to allow his inquiry to go where it needs.

Q689 **Antoinette Sandbach:** One of the things he said in evidence to us was that he is going to look at the capital maintenance regime. Do you welcome that, and have you been following the evidence to this Committee about the capital maintenance regime and the possibility that current UK domestic law is not really being applied when looked at with the IFRS standards?

Greg Clark: I welcome it. It is appropriate that he is looking at it. In terms of the evidence to the Committee, I am aware of it. I cannot say that I read every word. Can I ask Debbie Gillatt, who we have not been making use of so far, to say a bit about this, because it has been something that we have spent some time on?

Debbie Gillatt: It is something that we welcome and it is also something that we picked up from the consultation on the insolvency and corporate governance proposals last year. In the Government response to that, there was a commitment also to look at whether there was a case for reviewing the UK's dividends regime more generally. We are doing that and we will dovetail that work with what Sir Donald is doing.

Q690 **Albert Owen:** Just building on the previous question, we know that Sir Donald's advisory board and the advisory group include several members who have worked for or are members of the big four, and it is not very diverse. Do you think that is an error, because when your statement came out in December you said it was building on the work of the CMA and the FRC? One of the things you wanted to do was to improve public confidence in the audit system. Surely a good way of doing that is having greater representation from other bodies; otherwise, it could be seen as being captured by special interests.

Greg Clark: As with Sir John Kingman, I appointed an individual to conduct the review; it is his review and it is his choice as to who he wants to have as a sounding board and to help.

Q691 **Albert Owen:** I get that. You are not going to make the appointments, but I am asking whether you are comfortable with the fact that many of these members have worked for or are part of the big four. It looks a little like a closed shop. You have the former chair of the London Stock Exchange running this, and he is drawing on board a narrow group of people who have vested interests in this in many ways. The question



HOUSE OF COMMONS

from Vernon Coaker was basically that you are here to represent the people. The small employees and the small companies took a massive hit when Carillion went down and their voices need to be heard. Having them inside this group and inside these advisory things would be a good thing. Do you agree?

Greg Clark: I do not want to undermine the independence of Sir Donald on this. We have asked him to conduct a review.

Q692 **Albert Owen:** I just want your opinion. As the Secretary of State from this massive Department, which is looking very seriously at this issue, it is fair to ask your opinion in general terms.

Greg Clark: Having seen the advisory board, I think it is quite diverse. It has people from the investor side. It has people in operational roles. It has the Finance Director of Forth Ports.

Q693 **Albert Owen:** What about employees, supplier representatives, workers and small businesses? Again, I repeat that it is those small businesses in the supply chain that took a big hit with Carillion, for instance.

Greg Clark: I would expect that Sir Donald would consult people in the supply chain and in small businesses.

Q694 **Albert Owen:** Do you understand the perception that there might be a disconnect here between those who are being hurt by some of these big crises and those on the audit committees? Really, I would like you to say on record that you agree with me.

Greg Clark: You are always inviting me to say that, Mr Owen; often I oblige. I do not want to be pedantic about it, but it is an independent review by Sir Donald. If I start saying, "You must have this person and you must have that person", that would be wrong. This is an open meeting of the Committee. It has expressed a view, and the Chair and I can share it with Sir Donald. Having asked him to do it, I should not start—

Q695 **Chair:** You may not be able to pass a view on this, Secretary of State. I understand that, but perhaps when we have the replacement body for the FRC, it is really important that the board does not look like such vested interests in the way that it does at the moment. We have the board now for Sir Donald Brydon. He is doing his review and we welcome the evidence he gave to us. When the replacement body for the FRC is appointed, can you assure this Committee that it will be much more representative of all those groups that Albert Owen spoke about, and not like the FRC board?

Greg Clark: I can, Chair. That is a perfectly reasonable request. It is something that Kingman recommended and one of the changes in the regime is that these will be public appointments.

Albert Owen: Just for the record, I did not mean just the board, but the advisory group.



HOUSE OF COMMONS

Q696 **Peter Kyle:** Secretary of State, one of the things that we have noticed on the Committee in the course of the testimony is that clearly the public is losing faith in audit companies in the wake of some of the serious incidents we have seen in the private sector. When the companies themselves came to give evidence there was a huge frustration among them that the public misunderstood what the audit companies did. They felt that there was a perception gap, which was the problem. What is your analysis of that? Is the public wrong to start losing faith in the audit companies and to demand change, or are the audit companies wrong for blaming the public for not understanding their roles?

Greg Clark: The public are not wrong when you see instances such as Carillion and BHS. If you were to read the FRC report into the audit of some of these companies, you cannot fail but to be determined to act, which is one of the reasons that I am doing so. There is an important duty to the public, because they are the employees. As Mr Owen was saying, they are the suppliers in the supply chain and they are the people who depend on them for pensions.

There is a huge public interest in this. Antoinette Sandbach referred previously to the small investors who depend on auditors. They do not have the resources of the organisations to pore over the details of the accounts. They rely on the opinion and the communications of the auditors. It is absolutely right that the public interest in this should be served.

Q697 **Peter Kyle:** The big four will know this from their meetings with you, will they? They will be very well aware of this.

Greg Clark: Anyone who has seen the changes and appointments that I have made in our response is under no illusion, whether from the energy companies or the audit industry, that I believe that we need to upgrade our standards to be a beacon of excellence around the world in the years ahead.

Q698 **Peter Kyle:** Only 73% of audits at the moment are meeting the service standards that are required. What should we be aiming for in, say, five years?

Greg Clark: The target is higher.

Alex Chisholm: Yes, the FRC target is 90% and it had been improving year on year, but in the last reported year, which was 2017-18, it fell from 81% to 73%. We are not satisfied with that and happily neither is it, so that is one of the issues it wants to address.

Q699 **Peter Kyle:** Not being happy with a fall in standards is one thing, but being quite assertively unhappy about it is another.

Alex Chisholm: That is why we have proposed to put the FRC on a completely different body, with the formation of ARGAs with new powers as part of that.



HOUSE OF COMMONS

Q700 Peter Kyle: I notice we have a lot of students in the room today. Would they have detected your unhappiness at this fall, and the passion of your Department? Clearly, some of them might be in detention, given that they have been sent along to a Select Committee hearing on audit for an hour. Would most people in the public understand the strength of feeling your Department has about this?

Alex Chisholm: Perhaps you should ask for evidence from the schoolchildren behind me. Maybe they are unlucky with their choice of subject matter today. I cannot remember how interested I was in accounting standards when I was at school.

Chair: I believe they are doing a business GCSE.

Alex Chisholm: Is that right? Very good.

Chair: I believe so. There are some nods there.

Alex Chisholm: I would hope that, listening to this, they get a clear sense not only of the interest and enthusiasm of MPs for reform but also of the Department. It has taken us 10 weeks to respond to this very good report from Kingman with our own comprehensive set of reforms. We are very eager for change.

Q701 Peter Kyle: Do you think, though, that the reforms are going far enough that it might affect profitability? Are you weighing up the damage that this might do to the sector itself? Is that a concern? Is that a reason to be cautious? How far will you go in order to bring the changes that you need?

Alex Chisholm: I would say yes and no. The approach that we have wanted to take recognises that auditors and the accounting profession make a very important contribution to economic life as a whole in the UK. It is a huge source of gross value added that employs hundreds of thousands of people and is admired the world over. It is not a disaster area at all, but we do think that there can be improvements in the quality of audit, as we discussed earlier in choice and resilience as well, and importantly in public trust. If public trust was at a high level, then we would not all be here today and the Committee would not be taking evidence on this issue.

Greg Clark: Can I just come in on that, because this is important? My ambition is very clear, which is to upgrade the standards and public confidence in audit, but it is very important that we send a message and recognise that audit and other professional services in this country are widely admired around the world. The reason we are taking these steps is so that continues to be the case.

Many people who work in audits and in professional services get a very good training in business from that. We promote education, including GCSE or A-level business studies, but a lot of businesspeople are well trained in our audit companies. I do not want anything to be thought to



HOUSE OF COMMONS

imply that the quality of our profession here is anything less than world leading, but you need to anticipate developments in the future, including in technology, and you need to respond to evidence where there are deficiencies.

Q702 Mr Liddell-Grainger: Very briefly, if you take Patisserie Valerie as a prime example of where nobody spotted there was a black hole, Grant Thornton was subject to a £21 million fine. The point is that every investor group has an accountancy firm attached to it somewhere along the line. Nobody could spot that. There is a flaw in the way that accounts, yearly, and half-yearly reports are put out in this country. Following on from what Peter and Antoinette said, is there any plan to make them more user-friendly? You cannot miss black holes that size and they suddenly come as a surprise. What are the plans to make them more friendly?

Greg Clark: Sir John Kingman, in his report, suggests one of the proposed responsibilities for ARGA as to improve the comprehensibility and transparency of company reports. That is a recommendation we accept and will be placing on ARGA. It is a very perceptive one.

Q703 Mr Liddell-Grainger: Can I just follow this up? One of the things is that Grant Thornton either knew about this or they did not. They were fined heavily. Somebody covered something up. I am just taking that as an example. There are plenty of others, but it is a very recent and good example, because it was a very set group. There was only one thing in it, which sold very high-quality doughnuts, basically. Therefore, there is something wrong. No matter what Kingman says, if you look at any company report, it is almost impenetrable. Somewhere along the line that has to change, and that is not going to take it far enough, if I could be so bold.

Greg Clark: The intention is that it will change, and that it will make it much more transparent. The Permanent Secretary has just reminded me that there is a duty to not just be passive but to be alert.

Alex Chisholm: The international standard on this is that you have to obtain reasonable assurance that financial statements as a whole are free from material misstatement, whether caused by fraud or error. The standard seems quite clear, so this may be more a question of enforcement rather than the actual standard.

Q704 Vernon Coaker: I just have a very direct question, because the big four audit companies seemed a bit confused about this. Should they be looking for fraud?

Greg Clark: Yes.

Q705 Vernon Coaker: That is an expression of view, on the record, that they should be. I know you will have looked at the evidence and been as surprised as we were that it did seem that there was confusion about whether they should be looking for fraud or not. That is an absolute



HOUSE OF COMMONS

requirement.

Greg Clark: Yes.

Q706 **Vernon Coaker:** That is a very clear message. Moving on from that, when we asked the chief executives about the capital maintenance regime, there was confusion about whether they should be operating according to international accountancy standards or company law. As we have all said, frankly, the first thing you all operate under is the law, is it not? We had the chief executives saying there was confusion about whether it was standards that mattered or the law. Is that not something that these reviews should look at and clarify? Surely we should start from the point that we should obey the law. Why were they confused about that?

Debbie Gillatt: I cannot answer for that, but the point is that there is no inherent conflict between the standards and the law. If there is a situation where just following the standards would not bring you completely into compliance with the law, you must do what you need to do to comply with the law. We recognise that there is concern and some confusion in this area, and that is why we have said we are going to look at it, as will Sir Donald.

Q707 **Vernon Coaker:** The capital maintenance regime clearly identifies what you should pay dividends out of. Is it illegal to pay it out of money that is not realised past profit?

Debbie Gillatt: The Companies Act is the law.

Q708 **Vernon Coaker:** It is illegal, is it not?

Debbie Gillatt: Yes.

Alex Chisholm: Yes, it is.

Q709 **Vernon Coaker:** Why was it happening?

Alex Chisholm: Again, that is a question of enforcement and, I suspect, interpretation, because although it seems very clear the way you state it, the Institute of Chartered Accountants in England and Wales' guidance on the capital maintenance regime runs to 170 pages, which is part of the problem here. It has grown incredibly complex and difficult, and a lot of these things end up in litigation as well. What we want to see from Sir Donald's review is a simplification, so that people have a much clearer idea of their responsibilities.

Q710 **Vernon Coaker:** Can I just make one further point? What was also astonishing was that one of the witnesses talked about hidden accounts. Good luck with the review, but I do not think I am misquoting. Certainly somebody spoke about hidden accounts.

Chair: Yes, that was Grant Thornton talking about Patisserie Valerie

Vernon Coaker: That has to be illegal as well. It is not standards. You



HOUSE OF COMMONS

are saying that the starting point should be the law, and then the standards are about how you apply the law. Is that right?

Alex Chisholm: Absolutely.

Q711 **Antoinette Sandbach:** Can I go back to the capital maintenance regime? Is the attempt to sow confusion about audit firms not wanting to have legal liability for their mistakes potentially?

Debbie Gillatt: I cannot speak for their motivation, but the difficulty is that this guidance has grown up over time, and it is time that it was clarified.

Q712 **Antoinette Sandbach:** The law is clear. It is quite clearly briefly and succinctly stated in the Companies Act, and it is there to protect consumers and small shareholders. Secretary of State, can you confirm that, even though Sir Donald Brydon has said that he is looking at the capital maintenance regime, it is not your intention to weaken that regime?

Greg Clark: It is certainly not.

Q713 **Chair:** Thank you. That is very welcome. Secretary of State, the last time you came before us and gave evidence to our Committee you told us that the deadline for a deal with the European Union should not be regarded as 28 March or 29 March, and that the last minute for important British exporters was fast approaching over the next few days and weeks. That, Secretary of State, was on 6 February. What damage to our businesses do you think has been done since then?

Greg Clark: There has been damage. I am afraid to say that I know for a fact that the uncertainty that continues has stopped investments being made that otherwise would have been proceeded with. It has caused firms to have to—"invest" would probably be the wrong word—waste money on projects such as warehousing and stockpiling of inventory where there is just-in-time production that is not productive investment and therefore is diverted from other investment.

We have just been talking about an important contribution to our positive reputation as being a dependable and reliable place to do business, but I am afraid the failure to resolve our relationship with the European Union counts against that reputation. It is immensely damaging.

Q714 **Chair:** The Federation of Small Businesses has said just this morning that confidence is now at rock bottom. It goes on to say that a last-minute no-deal Brexit would be disastrous for small firms faced with customs chaos, loss of tariff-free trade and market access. Do you agree with them, and what assurances can you give to small businesses that we will not leave the European Union without a deal that would have such catastrophic consequences for them?

Greg Clark: Chair, I have always been clear that to leave the European Union without a deal would be disastrous in terms of the disruption and



HOUSE OF COMMONS

the consequences for businesses large and small in every part of the country. It would not be consistent with what was promised in the referendum campaign, in which it was clearly stated that we would leave with a deal in an orderly way. If we were to breach the commitment that has been given, that counts very strongly against us.

All members of the Committee are Members of the House of Commons, and it is a matter of huge regret to me that last night we could have had the opportunity to resolve this matter in a way that business was very clear urging us to do. Virtually every business organisation gave advice that parliamentarians should approve the deal. They did not. We will have some votes today that will establish the House's view that we should not leave without a deal on 29 March. My view is well-known to this Committee. We should vote to not leave on 29 March without a deal.

Q715 Chair: You speak very powerfully on the devastating impact that leaving without a deal would have on British businesses, and your colleagues around the Cabinet table will hear that. Will all of the Cabinet be voting this evening against leaving without a deal?

Greg Clark: As the Prime Minister said from the Dispatch Box yesterday, this will be a free vote. That is a good indication of how this matter should be resolved. We all have constituents who work in businesses that will be affected. The House needs to come together very quickly, not over a long period of time, to resolve this matter.

Q716 Chair: I have a huge amount of respect for you, Secretary of State, and for what you are saying and doing to try to support British businesses, but I asked you a very clear question. Your colleagues around the Cabinet table will hear the passionate case that you make for ensuring that we do not crash out without a deal. Will all of your Cabinet colleagues vote this evening to avoid that catastrophic result for small businesses and all businesses?

Greg Clark: Chair, I do not know that, but in voting to prevent that myself I would strongly urge not just my colleagues in Government but colleagues all across the House to reflect. Whichever sector you are in and whether you are talking about large firms or small firms, the evidence from business is that this would be disastrously damaging to the livelihoods of people right across the country, and it seems to me that this is a good moment for the House of Commons to come together, which I am afraid it did not do last night, to rule that out today.

Q717 Chair: I very much hope that the people running the country in the Cabinet come to that decision as well. Secretary of State, this morning some announcements have been made on what will happen to tariffs if we leave without a deal. Did you consult with businesses on the tariff schedule announced today, and what would be the impact on British businesses if these tariffs were introduced?

Greg Clark: It is principally a matter for the Treasury—tariffs are a customs and excise responsibility—and DIT. We have talked extensively



HOUSE OF COMMONS

to businesses in those sectors for which my Department is responsible. There are a couple of important things to say about this. First, there are no easy choices on this and what has been published today is published as a contingency if we were to leave on 29 March. In my view, it is a very powerful reason for why we should avoid doing that, because there is no easy choice to either apply tariffs to imports from the European Union, increasing costs for consumers and manufacturers, or going immediately and abruptly to zero tariffs for other nations, disrupting arrangements there.

Neither is palatable and it is very important that businesses who may be watching these proceedings do not regard these as being facts that will happen in a definite way. They are put out there and they need to be put before Parliament, but they are there as a contingency. My determination, and that of many people in this House of Commons, is to ensure that they never have to be enacted in this emergency way. That is the most important requirement on all of us.

Chair: Thank you, Secretary of State. I share that wish and hope that colleagues will join us this evening in voting against crashing out of the European Union without a deal. Thank you very much, Secretary of State, Alex Chisholm and Debbie Gillatt for giving evidence. It was very useful and very informative, and I hope that everybody watching it found it so as well.