

## **House of Lords Select Committee on Economic Affairs**

### **Supplementary note from Iain Richards**

Based upon my original written evidence and the Committee's session on 11 January 2011, I offer the following suggested proposals for reform for inclusion in, or as, a package of measures to address the audit and audit market related concerns that have been highlighted. The views and opinions expressed below are personal.

### **Options relating to the Department for Business Innovation & Skills (BIS)**

#### **Audit market reform**

- 1.1 To the extent appropriate, consideration should either be given to a broad based competition review of the FTSE350 audit market or, alternatively, BIS, working with the Office of Fair Trading and the Financial Reporting Council should be asked to develop proposals to give the Big 4 firms five years to voluntarily address the current level of concentration in the FTSE350 audit market (*over 90% of UK listed companies by market capitalisation*) and to articulate indicative measures and objectives against which progress would be assessed. If those objectives are not suitably achieved, it should be agreed and understood that measures to effect change would be brought forward. These might include, for example, the introduction of joint-audits or requirements that there be both mandatory tendering of the audit at least every seven years and mandatory rotation at least every 14 years, along with provisions and safeguards to ensure that the issue of concentration would be addressed.

[Note: See paragraph 12.1 of my written evidence provided on 11 January 2011]

#### **The Companies Act 2006**

- 1.2 BIS should be asked to review the Companies Act 2006 (the Act) and, as Parliamentary time allows, bring forward amendments to:
- (i) explicitly define the purpose and objectives of the statutory audit in the Act, building on the two principal purposes of the audit (to protect the company itself and to provide shareholders with reliable intelligence) that were articulated in the Caparo case (*Caparo Industries plc v Dickman*, House of Lords (1990), 1 All ER 568 [1990] 2 WLR 358);
  - (ii) amend the provisions of the Act, including those relating to the duties to prepare accounts (e.g. section 394 on individual accounts and section 399 on group accounts), the duties of the auditor (e.g. section 498 on the duties of auditor), the True & Fair View basis of accounts and the audit opinion (e.g. section 393 on the requirements for accounts to give a true & fair view and other related provisions and section 495 on the auditor's report on company's annual accounts) and the justification of distributions (e.g. section 836 on the justification of distributions, as well as related provision and those relating to available capital), with a view to explicitly reflecting the principle of prudence within those provisions; and
  - (iii) Significantly enhance the requirements on the auditor's report (section 495 et al) with a view to introducing more comprehensive and positive requirements for opinions and related disclosures.

[Note: See answer to Q.10, in particular paragraph 10.12, in my written evidence provided on 11 January 2011]

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[Note: See answer to Q.8 in my written evidence provided on 11 January 2011]

## **IFRS standards**

- 1.3 Recalling the steps taken after the publication of Terry Smith's 'Accounting for Growth', BIS and the appropriate body in the new regulatory structure being developed, should commission an independent and objective ('fresh set of eyes') review of IFRS standards (including, in particular, IAS 1), the issues and risk they potentially give rise to (bearing in mind the experience of the crisis), the concerns and problems that are apparent around the issues of prudence, substance-over-form, the true and fair view principle and their impact on the auditors ability to undertake robust and effective audits, as well as their contribution to pro-cyclicality, with a view to making any further recommendations required to address these issues.

## **European Dimension**

- 1.4 BIS should be asked to engage with the European Commission with a view to achieving similar reforms at EU level around the purpose and objectives of the audit, the adoption of the principle of prudence in accounting and auditing, as well enhanced audit reports. In doing so it should review the extent to which there is a clearly recognised separation in the European Company Law Directives and related regulations between the overarching true and fair view principle and the provisions on the adoption and use of standards, to ensure that the principle is not encumbered or perceived as encumbered, as essentially just requiring compliance with standards.

## **Monitoring progress**

- 1.5 BIS should be asked to monitor action on the proposal made and to report back to the House of Lords Select Committee on Economic Affairs on the progress being made.

## **Options relating to the Regulators**

- 2.1 Effective two way dialogue between auditors and the regulatory authorities should be set as an objective for both. In doing so consideration should be give to the US model where, under the Federal Reserve system, banking supervisors are required to confirm to bank auditors that they are not aware of any matters that might impact upon the audit. In addition those standards applying to the auditors should be reviewed (i) in light of the crisis, to ensure that they operated effectively and ensured the regulators received appropriate and timely information from auditors as the crisis developed and progressed; and (ii) in light of the new regulatory structure being put in place.

[Note: See answer to Q.11 in my written evidence provided on 11 January 2011]

- 2.2 The FSA should be asked to amend its Disclosure and Transparency Rules (D.T.R. 7.2.8 R) to include the new provisions proposed, including pursuant to the proposals in 3.4 to 3.8 below.

[Note: the FSA rule 'DTR 7.2.7 R' requires a company's governance statement to include a description of the composition and operation of, inter alia, its audit committee. DTR 7.2.8 R then states that compliance with the Governance Code provisions it lists will result in compliance with DTR 7.2.7 R. This element of the FSA Rules effectively underpins key elements of the Governance Code.]

- 2.3 The regulatory authorities should progress and develop arrangements equivalent to 'living wills' to ensure that if another firm were to fail, the situation could be managed and addressed promptly. In taking this forward the authorities should give particular thought to the question of how to ensure that any such arrangements do not further exacerbate the current levels of concentration.

[Note: See answer to Q.1 in my written evidence provided on 11 January 2011]

- 2.4 The regulatory authorities should investigate and review what other types of market practice might create barriers to entry to non-Big 4 firms, such as covenants or other provisions included in credit agreements or other debt arrangements.

[Note: See paragraph 1.16 of my written evidence provided on 11 January 2011]

## **Options relating to the Financial Reporting Council (FRC)**

### **Audit Inspection Unit**

- 3.1 The FRC should be asked to review the Audit Inspection Unit's objectives and the scope of its monitoring, which currently give the appearance of only encompassing Regulatory Standards and Audit Regulations issued by the relevant professional bodies, to ensure it clearly encompasses relevant provisions of the Companies Act as they apply to auditors and the audit.

[Note: Given the concerns and potential limitations about some of the standards, as well as the proposal in 1.2 above, the Audit Inspection Unit should be given a clear mandate to include consideration of the Companies Act provisions in its work. See the answer to Q.10 in my written evidence provided on 11 January 2011]

### **Audit Committees**

- 3.2 The FRC should be asked to review and bring forward proposals on what steps it or others can and should take to address the apparent perception issues that exist (including amongst audit committee members, other directors, shareholders, advisers and other market participants) and that exacerbate concentration in the audit market, as well as creating unwarranted barriers to entry for non Big4 firms.

[Note: See paragraphs 1.7, 1.12, 1.13 and 2.5 to 2.8 of my written evidence from 11 January 2011]

- 3.3 The FRC should be asked to review and bring forward proposals to amend the *UK Corporate Governance Code*, to require pre-approval by the Audit Committee or, in de-minimis cases, the chair of the Audit Committee, of all non-audit services that are not activities arising directly from an audit of a company's financial statement or they are not services required to be provided by the auditor by law or in regulations (see also proposal 4.1, second bullet point).

[Note: At present the Code just requires the terms of reference to include a provision "to review and monitor the external auditor...." And the amendment seeks to enhance that and reflect the comparable proposal in the recommendations in ICAS Report 'The Future of Assurance' (Dec 2010). See paragraph 1.7 and the answer to Q.5 in my written evidence provided on 11 January 2011]

### **Audit Committee Reports**

- 3.4 The FRC should be asked to amend Provision C.3.3 of the UK Corporate Governance Code, to formally recognise and constitute the requirement for an audit committee report, which should be included in the annual report and signed by the Chair of the Audit Committee.

[Note: At present the provision only requires that a separate section of the annual report should describe the work of the committee in discharging those responsibilities. See paragraph 4.1 of my written evidence provided on 11 January 2011]

- 3.5 The FRC should be asked to introduce new provisions on the audit committee report in the *UK Corporate Governance Code*, building on the recommendations on disclosures set out in the ICAS Report 'The Future of Assurance' (Dec 2010) and other disclosures in relation to:

- risk management, including: (i) any other key areas of sensitivity or risk, including the choice of accounting policies, that they identified to the integrity of the Annual Report and Accounts, and (ii) the conclusions of its review of the effectiveness of the company's internal audit function;
- the appointment of the external auditor, including: (i) an explanation for any change in that expected timescale or if they do not comply with the policy explain why on that occasion they have chosen not to; (ii) its policy for ensuring an effective external audit process; (iii) any additional considerations not otherwise disclosed for the recommendation to appoint or re-appoint (as the case may be) the company's external auditors;
- the external audit process, including details of any other relevant key matters included in reports by the auditors, but which have not been discussed with them.

[Note: See paragraph 4.1 of my written evidence provided on 11 January 2011. To create an effective and robust model of disclosure and accountability, which is linked to the FSA rules (see recommendation 2.2), I would not propose including

the ICAS option that some of this could be relegated to the Guidance on Audit Committees (which only "contain further suggestions as to information that might usefully be disclosed" or that parts might be addressed to risks committees, which are not covered by the Code and may be constituted with executives and other senior employees. ]

- 3.6 The FRC should be asked to review Provision C.3.7 of the *UK Corporate Governance Code* with a view to making the requirement to explain to shareholders how, if the auditor provides non-audit services, auditor objectivity and independence is safeguarded, part of the content of the audit committee report.

[Note: At present the requirement is only that the annual report should contain this explanation]

- 3.7 The FRC's review of the Turnbull guidance on risk and internal controls should examine what elements of that guidance should be elevated into the UK's Corporate Governance and what related additions should be made to the content of the audit committee report to improve transparency and assurance, in keeping with and to enhance the approach proposed in recommendation 3.5 above.
- 3.8 Similarly, the FRC should review its 'Guidance for Audit Committees' with a view to including any other key provisions from it within the UK Corporate Governance Code.

### **Annual Report**

- 3.9 The FRC, working with BIS, should review the proposals set in the ICAS Report 'The Future of Assurance' (Dec 2010), on assurance on the corporate annual report (Other than the Financial Statements), with a view to developing and consulting on them.

[Note: See paragraph 9.1 of my written evidence from 11 January 2011]

### **Stewardship Code**

- 3.10 The FRC should review the UK Stewardship Code with a view to suitably reflecting and building on the recommendations made in Part 8 of the ICAS Report 'The Future of Assurance' (Dec 2010), in an appropriate form, to address institutional investors role in relation to the quality of reporting and the audit/assurance.

[Note: See paragraph 6.6 of my written evidence from 11 January 2011]

### **Options relating to the FRC's Auditing Practices Board**

- 4.1 Given the clear concerns that exist over non-audit services and their potential to create mis-aligned incentives in the audit market and around audit quality, as well as unnecessary, potential conflicts, the FRC's Auditing Practices Board should, in addition to implementing its proposed, enhanced disclosures around the types and level of non-audit fees:
- produce a more detailed report on the concerns raised by respondents to its recent consultation on non-audit services and in the academic literature, with particular emphasis on the views of and potential effects for shareholders, audit quality and the dynamic of the audit market.
  - re-examine those non-audit services that may be provided by auditors, which are not activities arising directly from an audit of a company's financial statements or are not services required to be provided by the auditor by law or regulation. Where there is not a compelling case that the provision of such services is likely to be compatible with and contribute to achieving the purpose and objective of the audit, such as in reporting on prospectuses, or providing reports pursuant to the requirements of capital markets regulators (e.g. working capital reports), those services (including, but not limited to, tax planning and advice) should be not be allowed to be provided by the auditor.

[Note: See paragraph 1.7 and the answer to Q.5 of my written evidence from 11 January 2011]