Overview

The Respondent thanks the CC for the opportunity to provide feedback on the CC's provisional remedies, and hopes that all responses received will be made publicly available. This was the informative approach adopted by the Parliamentary Commission on Banking Standards (rather than published in summarized form).

Make public the evidence which is collected

This enables others to pick up and run with the issues identified, and formulate follow on activity, in a manner which is co-ordinated across public consultations and evidence gathering. This is particularly important in times of rapid change and economic stress, when the commercial behaviour of large organizations is capable of changing, in particular in organized self-interest. By contrast, those who are charged with examining their conduct and taking appropriate steps to ensure alignment with lawful conduct, protection of the public and published paths for dealing with wrong-doers, are functioning in arrears, essentially reporting on what is a historic event, providing no empirical data and of limited interest prospectively.

There has been a tendency, especially by the Ministry of Justice (Chris Grayling, legal aid reforms etc), the FRC (sometimes), and now the SFO (in the context of deferred prosecution agreements), to publish (or propose to publish) a distilled summary of the evidence rather than the raw evidence itself, including without prior notification of the criteria for the distillation, or the identity and credentials of individuals who have carried out the exercise. This tendency has been challenged (Justice Committee re the re run of the consultation), for reasons which include public confidence in transparency, and a solid evidence backed basis for reporting back to Parliament/the public. The CC can benefit from this guidance.

Resilience to challenge when evidence is made public

The CC has been advantaged by the publication of the results of the Parliamentary Commission on Banking Standards and being in a position to be fully informed by it. Its final report will be considerably weakened if it were not to fully take this humongous effort of evidence gathering, distillation and focused challenge into account. In addition, the approach of the Commission under the leadership of

Andrew Tyrie has been to publish and quote from the evidence collected, giving resilience to challenge and a solid foundation from which to make recommendations. Second as the evidence was collected, specific streams of incremental investigation were kicked off and delivered. In other words the Commission did not fix in stone what it was doing from the start, but reacted to the evidence as it came in, leaving the whole lot fully documented such that it could be used efficiently to inform follow on work. The CC can benefit by adopting the same approach.

Danger: flexibility of scoping; the Leveson enquiry

This public enquiry went through a prolonged scoping exercise and relied on the legal profession. A feature of the model of work adopted by the judiciary, is that the judge sets out the exam question he considers before him, and then proceeds to dissect, analyze, rehearse the points, and decide them: if he comes across a point that he considers is not mainstream, he will flag it, and assert it is not core business, even though it may have been heard. He may record a view or an approach.

In this case Leveson J is assisting MPs with further questions because some of the issues laid at the door of the media are indicators of a wider malaise involving other sectors, and in the broadest terms, the use of illegitimate techniques, to be able to trade in personal data, including to achieve certain results in the crown and civil courts that could not be achieved otherwise.

The danger for the CC is that it has not fully assimilated and collated such evidence and which is core to the fundamentals of its work, and indeed the CC's raison d'etre. If an auditor is taking money to carry-out an independent audit (ie guaranteed by law to be free of its own commercial interests, such as burying evidence of its own defaults), but does not deliver that result, the proper price for this can only be zero.

Requirement for an iterative approach

The description of the CC project approach is set out below. On inspection, it does not permit for going back and revisiting earlier conclusions, which could then lead it down a different course of action (referred to as a "waterfall approach" in software

engineering standards). In particular it is unclear what happens in the event that the CC is provisionally recommending certain remedies, before addressing concerns raised at an earlier stage, in particular from the industry on which it is reporting, that it has not adequately assimilated raw evidence.

In addition it is now on the receiving end of additional concerns at the time taken to date, to get to a point, where it is provisionally making recommendations, when arguably, it may not be in a position to do so, if it has not fully assimilated the results of other public enquiries. Continuing revisiting of the work done to date by the CC is required in order to fully incorporate the results of all the public consultations which have taken place, in particular the vital part played by the statutory auditors of the banks. These reported in reliance on government bail-outs, but omitted to say so in their reports.

Therefore the impact on the consumer which the CC is considering is devastating (ie on the tax payer, customer of the bank, investors including in pension, savings, insurance products which themselves are invested in any quoted security affected and possibly a director personally liable for whatever the auditor does or omits to do, whether the director knows about it or not). This is because they are going to be compelled to fund the bail-out, and were deprived of the opportunity to say “no” (ie the “choice” to make a decision on a fully informed basis).

The auditor’s statutory report, is a false report due to the omission and therefore not what the buyer (each director) has bought, ie independent. Indeed the true position did not come out until the House of Lords started asking questions.

The market price of a false report or one that is not independent is properly nil

The proper price of a false report is nil. Any price above nil is excessive. The enquiry is then one of **“price rigging**” (*an illegal action performed by a group of conspiring businesses that occurs when firms agree to artificially inflate prices in an attempt to recognize higher profits at the expense of the consumer*). The question is then, which is the appropriate authority for such investigation, and if the investigation finds such evidence, do they have the requisite prosecuting powers.

In the US the Department of Justice operates an anti trust division, which is currently investigating price rigging in the metals industry. In the UK the Ministry of

Justice, (Attorney General's Office, SFO), has mandated the SFO (with CPS), prosecuting authority, to investigate the pricing of money (LIBOR rigging). LIBOR rigging affects all financial customers of the auditors, and those whose activities are price sensitive to the price of money.

Whilst the CC must inevitable consider the impact of the need for the LIBOR rigging investigations on its work, it does not have to wait for the outcome of the LIBOR investigations. It can immediately find that the auditors had not severally and collectively identified the existence of a problem that required investigating, before they could properly conclude on the internal controls compliance audits. These are needed before deciding the auditor is sufficiently informed that they are in the position to report on an independent basis, and that the controls are in place and effective that a 100% substantive audit of all transactions is not required.

As matters stand, these tests, their definition, the results, are not part of the engagement letter of the audit, and the letter itself is not a public record. Therefore the public has no assurance that the auditor has attended, looked, or carried out any work. The auditor shall report if he has been unable to agree the underlying records (the true position) with the estimates in the accounts, but is not required to certify that he has looked ("positive reporting").

Accordingly an audit is a "secret" event, and known to be. This means that the CC must look to external indicators for evidence that the proper price for what is being delivered is nil. This is the recent history, in particular since 2000, and the introduction of the Limited Liability Partnership Act, which irreversibly changed the landscape, placing the final nail in the coffin of self regulation, predictable and predicted by civil servants working in investigations in the DTI.

Prima facie analogy with LIBOR rigging

The fact of the bail-outs of the banks is sufficient evidence to warrant investigation , on the grounds of suspected price rigging of statutory audits (non zero price). This is exactly the same type of work as LIBOR rigging investigations, by the SFO.

Evidence that has emerged since the investigations by the House of Lords

The evidence that is germane to STAGE ONE of the project approach of the CC, together with the knock-on effect of the protracted timescales and gaps from the

OFT finishing and the CC starting, means that the CC must constantly be revisiting the earlier parts of its work, as each step or stage depends on the first continuing to be valid and relevant.

However, essentially because other public investigations, enquiries, consultations, have provided relevant evidence, that was not before the CC when it completed earlier stages, there is the unassessed risk, that the conclusions of the earlier stages are no longer a robust basis for progress. In turn this risks the final conclusions and recommendations being out of date. Where this requires a revisiting of the first stage, it may mean that the results are not right, and cannot simply be "patched".

Consequently it is possible that an immediate extra step is inserted, before proceeding to the finalizing stage, to verify completeness of the evidence for the earlier steps, so that the recommendations which flow are the correct ones.

The text of the remit of the CC is below. It is a STAGED approach, with each stage dependent on the previous one.

STAGE ONE

the CC will consider

- *an adverse effect on competition …'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom' and,*

STAGE TWO

if so,

- *whether this is resulting in a detrimental effect on customers such as higher prices, lower quality or less choice of goods or services. If the CC finds that there is no adverse effect on competition, the question of remedies will not arise.*

STAGE THREE

- *The CC will then decide whether the CC should:*
  - *introduce remedies to tackle the adverse effects on competition or detrimental effects on customers or*
  - *whether the CC should recommend action be taken by other bodies to remedy the adverse effects on competition, and if so, what*

actions or remedies should be taken.

In any case where the auditor is charging the price of an audit, but is not delivering a proper result, the market clearing price must by definition be zero, and a non zero price is inflated. The comparison is not just the price of the audit, but the return to the vendor.

Take home pay comparisons part of a price and competition enquiry

In any case where a member in a big four firm has a take home package that exceeds an individual of similar years experience working in, say, BIS investigations or insolvency, on the civil service pay scale (excluding those on inflated pay to match those outside the civil service, on the untested theory that a higher pay package delivers better quality), there is a question to be asked. Similarly if an audit partner, member, director, in a firm where they are the sole licensee for audit certification (report), is taking home a figure materially different to the equivalent head of assurance in a Big 4, there is also a question to be asked: what are the latter being paid for?

What are the extra hidden benefits, eg the prospect of a non executive directorship two years after retiring as auditor? Can the audit be properly independent? What is the market price of an "audit" which is not independent (zero)?

Similarly, the FRC has for years complained that promotions to partnerships are awarded on the basis of salesmanship, rather than being a "safe pair of hands".

The same applies to hidden expenses, such as "learning on the job". In a small firm, an apprentice will frequently not have their time recovered, until they have learned the job. In a large one, an individual with a pedigee in, say, the automotive industry, can find themselves working in a different sector, and no one has told the customer, let alone asked whether the risk was acceptable or the learning time billable.

Disclosure: parity

Lack of competitive pricing reveals itself additionally in statutory disclosures, in particular the requirements for disclosing information about the supplier (the auditor) and their earnings, equivalent to those of a legal director, viz;

1. a permanent record in companies house, and the listing authority for those working in the public market;
2. address for service of documents, including after retirement;
3. contract of engagement, plus members agreements plus insurance arrangements;
4. earnings, appropriations, other benefits; basis of calculation of remuneration;
5. full CV and details of past and current posts;
6. criteria for promotion to post;
7. details of licenses held, and experience for all team members, including second partner, and complaints partner;
8. affirmation that each director severally has agreed that the auditor has satisfied the Companies Act requirement, and reviewed capital adequacy by agreeing the estimates in the accounts to the underlying record ("letter of representation" without which an auditor is forbidden by law from reporting).

Unless the supplier can show parity in transparency with those personally responsible for what the auditor does or omits to do (the directors), there is not a level ground, and the conditions for "independence" do not exist. The proper price for an "audit" which is not independent, is zero (because it is not an audit and there ought properly to be no market).

Assurance reporting

There are two forms of assurance reporting, direct access (audit) and the rest. These are identical in the applicable standards. The first involves the auditor looking at the raw data (eg books of prime record, contracts, bank statements, cash book, interviewing staff etc) and carrying out their own calculations etc to check (eg reperforming a bank reconciliation), reviewing, if a contingent liability is being litigated, the basis on which it is thought any resultant liability is covered by insurance, and the appropriate disclosure, if any. The second involves working "second hand" using information from other sources and derived from the prime records. (Examples: a tax return; a valuation exercise; management accounts/reports; cash flows; insolvency work; independent assurance work; due

diligence and investigative work; M&A work; reporting accountants work; capital adequacy work (eg for a share repurchase).)

Evidence required for a notional market which does not currently exist

The CC's work is focused on audit and the operations of the audit market. However it cannot examine this on the basis of the current status quo, since the vendors are vendors of assurance reporting (including audit), and sell both assurance and non assurance business. The CC requires a model of the dynamics of the operation of the current market; the factors which are prima facie indicators of lack of independence; and a comparison of this with the outcome of a competitive market, operating efficiently in delivery of a regulated statutory function.

It needs to report positively on whether it has been able to model the audit market in isolation of the assurance and non audit market where the vendors do all three, and none of the large ones have chosen to do audits only.

Factors affecting independence

These factors affecting the independence of the auditor are those whose indicators have come out of the recent years, public investigations and enquiries, cases in the courts. They include:

1. multidisciplinary practices including such business as **tax advice**. In this case the tax team on the audit must form an independent view of the work they sold from the tax advice team; in particular the tax advice team may include those with tax qualifications and experience but who are not accountants nor auditors. Google is a public example, paying little UK tax on the basis of trading "with the UK" rather than "in the UK".

The tax auditor must consider whether UK based salesmen, commission based, who conclude contracts in the UK, subject to a price calculation performed on software located outside the UK, are trading in the UK (ie the price calculation is an artificial device) or the commercial conclusion of the agreement is outside the UK, where the salesmen are not. Can the auditor offer themselves for re-appointment, when logically they are not independent of that which they are to audit?

Collusion and corruption: market distortions

2. Auditors who know they have **defaulted.** In these circumstances the auditor will usually stay in situ, to protect their own risk, and notify a resignation after the next balance sheet date, thereby "de-risking" the audit for a successor. Since the knowledge of the default is not symmetrical, can they be said to be independent, and is the conduct, prima facie evidence of collusion?

3. Auditors who audit a sector, as **banks**, where a public enquiry has concluded early on that "***the extent of collusion and corruption beggars belief".*** There are two points. First the fact that those auditors are the ones who omitted to issue a disclaimer or a report that asserted the enterprise is as resilient as the expectation of government bail-outs, and otherwise the extent of interdependence means that a failure by one will bring down the rest (or, we do not know what will happen). Therefore they are already in default and not independent.

Second it is impossible to have carried out an audit and failed to spot extreme collusion and corruption, the existence of which means that an internal controls compliance audit simply cannot be passed because the controls potentially relied on are corrupt.

In these circumstances, they will be knock on consequences: for example in the case of the banks, the discovery of the lack of credentials, and/or licenses of the senior employees at least. These factors all indicate that internal controls are not working and may not exist.

4. Auditors who **trade in burying evidence of their defaults** and provide certificates to those whose **defaults they assist to bury**. This practice is prima facie indicative of collusion. The CC must be in a position to report on how widespread the practice is.

5. Auditors who access the **underwriting markets,** which precludes independent assurance reporting, through arrangements with lawyers, who are able to access the markets the assurance vendors cannot.

6. Auditors who:

6.1. seek to use **the courts** to convert **uninsured and uninsurable** fatal contingencies into "professional negligence claims";

6.2. manage contingent liabilities off balance sheet including by dealing in personal data and contingent civil reliefs neither of which belong to them;

6.3. exploit "litigation weapons" and/or use the courts to launder and layer transactions;

6.4. convert to LLPs or merge, at a time they had undisclosed fatal contingent liabilities, or had asset stripped their business; and auditors

6.5. whose accounting policies allowed them not to reveal contingent liabilities; or

6.6. those who are auditor of an entity about which they have received notification of evidence not incorporated in the accounts, and which has not been notified and properly ought to have been. The recipient auditor has no statutory obligation to report immediately the receipt of such intelligence or report to BIS (ex DTI), in particular if the enterprise elects not to do so. Before the regime of LLP, the auditor would either frog-march the directors to the DTI and watch that they have self reported, or resign issuing a public notice of his reasons.

7. In all these circumstances, the auditor is not independent, and not in a position to report the true position. The price is zero.

Profit made outside the audit business deriving from the audit license and techniques for preservation of reputation

8. The profit made from the audit business, directly or indirectly derives from at least the following sources, the audit license and acts of preservation of reputation:

8.1. the fact the auditor is licensed as an auditor (assurance business more widely and non assurance business): business they would not get, but for being an auditor;

8.2. the success the auditor has in warding off matters that would give rise

to reputational damage, including by techniques of threatening, bullying, collusion; shifting damage mitigation burden on their witnesses; and taking advantage of the fact the auditor does not reveal contingent liabilities, on an accounting policy adopted by all LLPs by tacit agreement between them, and do not reveal the identity of their auditor until after they have filed, an extraordinary and highly unacceptable approach; the next points are further examples of this

8.3. the success the auditor has in building a market "impression" that it is the directors who are the crooks, and they are part of the "outside" reporting on them. The jailing of the AIT directors in 2005 is a spectacular example, a case of directors being bullied into making pre close statements they were not comfortable in making, and a self fulfilling set of circumstances, in which contracts effectively awarded did not get final sign off. This is closely aligned to offering partnerships to enforcers who have failed to enforce, giving the hope to those in prosecution positions of such offers in the future;

8.4. The success the auditor has in persuading the FRC in putting them through a "tribunal" and impose a paltry fine, with counsel prepared to represent that accepting mixing client monies in an audit is an "honest mistake" rather than reckless conduct within the meaning of FSMA 2000 (PwC, JP Morgan, Tim Dutton);

8.5. the public sector, including both internal and external audit, and those supplying the public sector;

8.6. the limited delivery model for the supply of audit services, where the depth of insurance cover is the single most important factor to the buyer;

8.7. The success the auditor has in use of "complaints" as a device to precipitate civil litigation, rather than honour commitments to provide an independent team on evidence of default.

9. In assessing "pricing" and competitive behaviour, the fundamental elements are **the audit license,** granted by the Secretary of State through the relevant licensing body, and **the return and profit** stream derived from it, directly and indirectly and after the deployment of devices and arrangements to protect the reputation that allows business to continue.

10. This means the whole business model of the audit vendor must be examined, and not simply the audit business, which does not, in fact, exist alone.

11. The corollary is that without revealing the full and true picture, the audit vendor cannot be said to be "independent". Common sense says plainly they are not and that therefore the proper price is zero.

12. The question of whether a statutory function can simply be left to the self interest of "the market" must be addressed. The basic function is similar to a border agency checking papers; an MOT garage inspecting a car; a policeman checking papers at a road checkpoint. It is capable of tight definition, positive reporting (X who is licensed and qualified has looked at Y, and found it exists and accords with the estimates in the draft accounts), and government published price lists for unit labour at specified experience and skill level. It is capable of live inspection. There are no supply constraints nationally, although there are barriers to entry, and pro rata high fixed costs for small players.

13. The consequence of this is that, although the license relates to a regulated function, the resource to fulfill the statutory function, is plentiful and therefore this aspect is capable of "mimicking" a competitive market, so long as all have access and none may take it to build up business profit streams doing other things; especially those which are carried out by the Big 4 and those seeking to emulate them, and which operate to render them not independent, and therefore wholly unable to deliver an independent audit, as the circumstances of independence simply do not apply.

14. Obvious points:

    14.1. Acting to jail directors is not the answer.

    14.2. Total separation of audit businesses from the rest can logically be the only model that can hope to succeed, for delivery of a statutory function where the return that is earned equates to the relevant civil service pay scale.

    14.3. Live inspections ought to take place with published certifications, but do not exist.

    14.4. Alternative delivery models must come into existence, and access

pricing investigated to facilitate entry those who have been excluded.

14.5. Continuing dilution of the Companies Act (branded “reducing red tape”) must stop and reverse.

14.6. Regulation and licensing of LLPs must be brought in line with the regime for main market listed companies, including retrospectively.

14.7. Non executives who have not served as executives should not be classed as “independent” since they do not have the competence and experience to be “independent” in regard a job they have never done (equivalent to someone examining a prospective driving instructor for a license, who has never driven a car).

14.8. Auditors must report evidence they receive from outside the enterprise; and those audited (in particular LLPS and banks), must be compelled to disclose all contingent liabilities and not exclude them, relying on off balance sheet activity; using the courts to convert exposures to insurance claims, when they are not; and other devices.

14.9. Auditor’s must report on their own form of risk register and reporting, in particular whether all risks and their disposal move to the top and final reviews, or whether risks purportedly disposed of are removed, such that a sanitized risk register is all the person signing the report sees.

14.10. Audit engagement letters must be public records with the work carried out documented; the existence and role of internal lawyers must be explained, and auditors who refuse to commit to their exclusion in audit assignments must record that refusal, and publish that refusal in their standard terms of business.

Delivery models and access pricing

15. Industry comparables must be identified so that a view may be formed by the CC on alternative models of delivery and ensuring the supply side may continue abundant, once the initial access hurdle is overcome. The software, systems and engineering sector is appropriate as a comparable for the supply of labour. The telecoms sector is an appropriate comparable for access pricing.

16. There is no prima facie reason why "teams" assembled for delivery of an independent audit, cannot deliver on even the biggest audits in the same way they deliver on large distributed engineering projects. There is no prima facie reason why access pricing principles cannot be applied to enable new entrants and those who have been excluded for some time. The longer it is left the greater the polarization solidifies, to the point of becoming insurmountable.

Licensing

17. License applications and supporting documentation and renewal are not currently publicly accessible and ought to be, at individual level and firm level.

18. Contingent liabilities of limited liability partnerships are not disclosed with full details under accounting policies providing for secrecy to "protect reputation" and properly ought to be. The practical application of the legal and reporting framework pertaining to public listed companies must be imposed on limited liability partnerships, including retrospectively; and permanent records filed and retained at Companies House in regard AIM companies whose prospectus is not currently filed.

19. Failing to do this means there is no reputational damage to an auditor who is party to an opportunistic float that could be predicted to flop having extracted value for the opportunists from the innocent public.

20. CC ought properly to recognize the link between protection of reputation and profit stream, and the irreconcilable difference between self interest and independence. The unit labour price can only be one that is regulated with reference to a benchmark, the relevant one being that of the civil service before inflation to "buy in" outsiders, with perceived value add.

The feedback is in bullet points, adopting the key paragraphs of the CC for convenience.

Mira Makar MA FCA (Miss) 13 August 2013

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Please note that points already made are not repeated each time and that points made in one place relevant to one provisional remedy, which are relevant to another are not necessarily repeated. This document is to be considered as a “whole” to be of most use.

TENDERING: AUDIT BUSINESS ACQUISTION AND RETENTION

FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation to go out to tender by up to two years in exceptional circumstances. There will be a transitional period of five years before the measure comes into full effect.

1. Transitional period is too long. Clock on how long an auditor is in office must start from the position as it is to-day, and not "as though" this is Day 1 of Year 1.

2. Competition Competition must record why the argument is valid that periodic mandatory rotation does not increase cost, compared with the seven year mandatory team rotation inside an auditor, currently in place.

3. **Letters of engagement** must be made public documents, ratified by shareholders in meeting, available on inspection at the registered office address and filed at Companies House. These are the equivalent to directors service contracts, and must be treated the same under the Companies Act.

4. Letters of engagement must include for the relevant period of account a description of the **internal controls testing** that is to be carried out, and the relevant names recorded of those carrying out those tests. Those books of prime record that must be inspected ought to be listed and the audit deemed not completed until the team member responsible for agreeing the underlying true position with the estimate in the accounts, has positively reported.

5. **Auditor's reports** must be clarified to assert positively (a) that the auditor has looked; and (b) that, as a result of looking, the auditor can confirm that the underlying true position is recorded in the estimates in the accounts, together with narrative.

6. Auditors who convert to **Limited Liability Partnerships**, or who have converted, must pass through the same rigorous testing as a company which is preparing for a main market listing, with a three year track-record of audited and published accounts and a prospectus, with vetting equivalent to the new issues department of the Listing Authority.

In particular the auditor must:

6.1. make public the members' agreements;

6.2. undertake to exclude or remove any provision which requires individual members to cede conduct to the centre in the event of the perception of risk;

6.3. make public details and terms of all insurances;

6.4. make public details of other arrangements which allow access to underwriting markets, including those involving third parties, and which those hiring them might wish to know about, in considering whether the auditor is properly independent;

6.5. explain the role and responsibilities of the internal lawyers, identify the team by name and agree that proceedings may be commenced in circumstances where an internal lawyer interferes in the audit or complaints process.

These points are fundamental to a systematic analysis of ***how*** the current auditors (especially of larger enterprises), acquired their existing business. Unless this is properly dissected and understood, CC cannot hope to establish characteristics of what is optimal, and therefore identify the most efficient tendering model/approach.

In all cases without exception, a preceding unincorporated business was the incumbent. In all cases these businesses have converted to limited liability partnerships (LLPs). Customers were not told in advance. There were no published audited accounts for several years by way of track-record. There was no data provided on contingent liabilities pre incorporation, fatal or otherwise. There was no declaration that the tax free basis of incorporation applied or that it was proper to be signing VAT indemnities post incorporation, which themselves are not public documents, but ought to be. The "audit" was gifted or inherited, but not won.

In other words, there was no independent assurance whatsoever that the audit vendors, charged with independent verification of capital adequacy of the businesses of others, were trading solvently both pre and post incorporation. They could not report independently without such examination.

Consequently an auditor of these LLPs could only properly issue a disclaimer of opinion and compliance with the Companies Act. The accounting policy "*it is all about what you can get away with*", is not disclosed in any LLPs accounts. It is not enshrined in the watered down Companies Act in some other form. LLPs accounts exclude contingent liabilities, with no impact by their own reporting auditor as to how this undermines the whole of the financial statements, potentially fatally.

In these circumstances, there was not openness in the offer of appointment of the new auditor, the LLP. These took over from the old "as though" they were the same legal person, essentially trading on the same basis. Directors were deprived of a full open and transparent tendering exercise, with three years of audited results, including audit of the tax rolled over incorporation, and full disclosure of the conduct of the LLP to protect its reputation, revenue continuity and profits. This profit could not be achieved in a competitive market for supply of commodity labour for a statutory function, with no distinguishing features, beyond licence and competence.

The objectives of reform must be to overturn the current unacceptable status quo of uncompetitive acquisition of audit business, inherited or effectively gifted. The predictable and predicted resultant lack of parity between those audited and those auditing, is indicated by the fact that the auditor can exercise financial muscle, relationships, interdependencies and leverage due to assymetrical knowledge, exploiting what they know from their special rights of access, granted by law as well as obligations by law on others to inform them, in order to close down or severely financially prejudice those suffering the consequences of their defaults. This latter is not an organized group. The key control in law, the director, ought to be effectively protected by the indemnities for costs in articles of public companies and float commitments. However such indemnities are buried, as though they never existed, by the collusion of the LLPs, insurers and banks, acting together in collective self-interested organized groups. The financial rewards will not be given up willingly.

Attempts to avoid mandatory rotation and tendering by lobbying the CC/BIS by "auditors" and their bankers customers are predictable. The market however votes with its feet, and the CC will have to take a position and justify it publicly.

Indemnities, counterindemnities and audit certificates (report)

If these indemnities have become meaningless pieces of paper, buried and replaced by secret communications between the LLPs/banks and representations to enforcers, that the director does not know about, but made in their name; if the auditor "reports" without a letter of representation of statutory compliance from each director, accepting their work ("factory testing" in software engineering terminology), where does that leave the audit certificate, apart from as a dangerous and misleading indicator of an independent check that has not, in fact, taken place?

Asymmetry

It is obvious that if the law grants rights of access to knowledge to one side (auditor) and no fast-track rights to extract that knowledge to the other, as it is implicit not explicit law (rights given only to the SFO, under s2 of the Criminal Justice Act), regardless of who "owns" the knowledge, being the disadvantaged under this assymetry, the rational self interested behaviour of the first will provide any outcome, apart from that required by law, UNLESS there are other pressures in the opposite direction to bring about such parity.

In other words, if the audit vendor acquires knowledge in order to deliver an independent assurance report, takes the money, but delivers something which is not independent, Trading Standards must have something to say on the subject, under the law protecting consumers from unfair and rogue traders.

Current mandatory rotation plus plentiful supply

Mandatory rotation of teams every seven years where the team is an independent team in the true sense, is absolutely identical in predicted outcome to an audit supplier, using contract labour sourced from a plentiful supply, operating according to a regulated unit labour price, subject to licence and experience. This mandatory rotation should have been incorporated in the 2006 Act but lobbying excluded it.

Had each auditor gone through an independent selection process (tender") on incorporating, had they fully revealed their own trading position on a par with those audited, it is a moot point as to whether they would have been selected or not. That is a hurdle and challenge they must currently overcome under the seven year rule.

Enforcement of current seven year mandatory rotation

The FRC has yet to report on whether compliance with the seven year rule has been executed with the full rigours of an open market tender on each occasion. If not, it follows there have been no truly independent audits by LLPs. This is at least for the last seven years, plus the legacy of the opening balance sheet seven years ago, of the enterprise purportedly independently audited by the LLP.

The FRC has also yet to report on the extent to which the rotation rules in practice have led to throwing the baby out with the bath water, the exiting team going off, client not told, and uninformed others presenting "as though" a qualified informed team, relying instead, in fact, on the post incorporation approach to prioritizing their own risk management over any independent result.

Plainly if the status quo is fatally flawed, more is required than merely changing "supplier". Opening up the labour supply chain is an essential pre requisite to an efficient outcome for competitive supply in delivery of a state function for which no competitive market by definition can exist in its purest form. If the rotation rules are not effective under "self regulation", it follows the corrective steps will not emerge without intervention.

In other words, where appropriations in firms which are predecessors to the LLPs, have been made out of unaudited profits, and there existed from the same periods contingent liabilities that had not been audited, prior to the incorporation, those appropriations themselves could/would have contravened /risked contravening the creditor preferment rules. This is unless pre incorporation underwriting arrangements were in place that covered all eventualities, including contingencies for corporate indictment, that ordinarily would be expected to decimate reputation, in addition to other financial claims, including from HMRC.

Similar considerations apply to mergers between LLPs (eg BDO/PKF), where each side offers themselves up for re-appointment without any report to those audited on independent due diligence on the contingent liabilities of each pre merger, allowing assessment of the impact on the ability to recover on default. The principle is the same in regard the auditor of law firms which merge (eg Herbert Smith or Pinsent Masons and McGrigors) or are taken out (Russell Jones Walker, Slater & Gordon LLP, Australia), where contingent fatalities pass from one to the other, and

thereby to the auditors in the chain.

Put simply the interdependence between the banks and financial institutions, is mirrored in, and extends to, those “auditors” who manage their own risks in the same way, off balance sheet, by transfer, reciprocity, layering and laundering. Consequently the same “concertina” effect applies (the failure of one, pulling down the rest) and will be a feature of the LLP and “auditor” market and not independent.

Since TBTF (too big to fail), the justification for bail-outs, leads to TBTP (too big to prosecute), the dynamics of the banking and insurance markets, which puts them practically above the law, the question for the CC is whether the concentration of big and middle firms is seeking to mimic this market, by adopting the same behaviour patterns, essentially abiding by the law when it suits, and not otherwise. The complexity of the inter-relationships indicates it is not capable of separate modeling ie independence does not apply. The delivery model is predictably fatally flawed and neither works as required nor is capable of repair.

Integrity and independence are the core of the FRC’s business, under the ethical and assurance standards it publishes on its website. However to date the FRC has not published a matrix of who audits who of the LLPs, a fundamental piece of empirical data, without which the CC could not properly start its work. If Joe Public (director) thinks they are hiring an independent auditor, and actually they are locking into a complex network of relationships, reciprocity, trading secretly in personal and statutory data, representations made in the directors’ names they do not know about, using banks, insurers and the courts, in ways not disclosed, (conduct itself requiring an access data base and a team of teenagers to model), should this not be made public? Ought someone to have told each of the Business Secretary and Chairman of the Treasury Select Committee, if not the Lord Chief Justice?

7. Unless there is true parity between the auditor and those audited, and absolute independence, there is no assurance the result will be optimal ie if the auditor cannot or will not get their own housekeeping independently verified, how can they be relied to check that of someone else and come out with a proper result?

FRC POST EVENT AUDIT REVIEWS – frequency

The Financial Reporting Council's (FRC's) Audit Quality Review (AQR) team should review every audit engagement in the FTSE 350 on average every five years. The Audit Committee should report to shareholders on the findings of any AQR report concluded on the company's audit engagement during the reporting period.

8. The FRC's post event reviews are not a substitute for live inspections of audits. They must properly be the equivalent of the FSA's active involvement in inspecting compliance, including a permanent presence on site for bigger enterprises.

9. Live inspections are not currently undertaken and ought to be.

10. The FRC has no SARs reporting; members of the public reporting financial crimes by public accountants to the FRC have no trodden path to follow. The FRC has no route to the Witness and Victim Protection schemes of the police. It is not signed up to the Victims Code under the Domestic Violence, Crime and Victims Act 2004. The FRC does not sponsor police to investigate and prosecute financial crimes by public accountants, as do the banks and insurers for specified crime affecting them (identity theft, insurance fraud etc).

11. The FRC does not publish records of type of incident reported to it, nor a backlog report on what is passed to police to investigate and prosecute and what type of incident it retains to investigate itself. The FRC has not published with police (and/or other enforcers, as BIS, Trading Standards, SFO), the possible events that are indictable and simultaneously give rise to a form of civil relief, nor the path to pursue these, where public accountants are involved.

12. With regard to reports from the Audit Committee to the shareholders, the suggestion by the CC is not legally feasible. The Audit Committee comprises non executives, and should include the Chief Financial Officer (the FD), or else they would have no executive input to inform themselves. If they were to assume reporting obligations, the terms would need to be carefully defined, and an announcement would need to be made, as that reporting obligation is prima facie an executive function, and this would be a notifiable change.

13. It would be surprising were members of the Audit Committee to agree to such a move, and, arguably, unless they re-performed the work of the FRC team they would be in no position to assess whether it was worth their time putting the points to the external auditor and paying them to respond. If any points were significant the auditor should have included them in the "letter to management". If they were not significant, or were but not included, that is a matter between the FRC and the auditor, and ought not to take up management time.

14. The FRC has no statutory part to play in statutory audits. If it were to acquire any, the proposals would have to come from it, be permitted under its constitution, be sponsored by BIS, be subject to public consultation and laid before Parliament.

15. The additional burden would require financing. The FRC would need to attend AGMs and explain why it could not resolve its points with the auditor directly, if it were not satisfied with the quality of their work.

ASSURANCE ON DEBT RECOVERY

A prohibition of 'Big-4-only' clauses in loan documentation (ie clauses that limit a company's choice of auditor to a pre-selected list).

16. The objective of the CC in this provisional remedy is to ensure that there is competitiveness in the audit market. However competitiveness (ie commercial and other aspects of independence) in the audit market will not be achieved by interference in other markets, being the money markets and insurance markets.

How such came about

17. The reasons that there are such restrictions in loan agreements, are simple. Some years ago the Limited Liability Partnership Act 2000 came into force, and did so as a result of lobbying. Lobbying, by definition, is anti trust, and causes distortions in a market place by seeking to achieve an outcome that would not be achieved by perfect information, market clearance conditions and rational self interested conduct.

18. This development facilitated and included (but has not been limited to):

18.1. restricted secret members agreements;

18.2. the ability to incorporate without at least a three year trading record, made public based on audited accounts;

18.3. the ability to supply services to listed companies, without their auditors themselves having been through similar vetting, as for a flotation;

18.4. auditors not notifying who their own auditor was, their insurer and full details of all other risk shift arrangements (until months after the event);

18.5. not publicly providing the operating guidelines deployed by the audit teams, nor the risk management and risk register templates that they relied on to give their assurance certification;

18.6. not publicly providing full CV's of those deployed in the audit services, nor personal address for acceptance of service of documents, as directors;

18.7. the adoption of accounting policies that guaranteed that the accounts could never be independently audited, including the exclusion of contingent

liabilities, including those which were fatal;

18.8. no audit of the pre incorporation balance sheet, to assess solvency and whether the tax rolled over basis of incorporation was valid;

18.9. the development of secret internal legal departments, highly incentivized, which:

18.9.1. interfered in the reporting process,

18.9.2. blocked communications with Boards and directors,

18.9.3. entered into arrangements to transfer evidence of defaults to banks, with capital depth and to lawyers with access to underwriting markets that a public accountant cannot achieve;

18.9.4. issued false reports and manufactured false statutory and accounting records;

18.9.5. stole statutorily confidential data and used the courts to secure personal data to asset strip witnesses to their financial crimes;

18.9.6. used witnesses' lawyers to mount organized deceptions of the regulators;

18.9.7. turned financial crimes into professional negligence claims by using the courts, and obtained insurance funding on embargo'ed decisions that never became public;

18.9.8. interfered in the integrity of the judicial process by toxic contamination of court records and evidence, fraudulently mis-representing the witnesses ("identity theft"), and replacing the court records with forged evidence on stolen layered personal data;

18.9.9. sought to brain-wash judiciary and the FRC that their reputation was effectively "sacrosanct", such that judges jumped into the arena to stop witnesses self incriminating, despite being deemed to know that in the court there is a dis-application from the privilege from self incrimination. Similarly BIS ministers that there are dishonest people in a fundamentally solid system of integrity, not that the conclusions of the

Parliamentary Commission for Banking Standards for the conduct of the bankers must logically apply to those who certified their financial statements viz ***the extent of collusion and corruption beggars belief.*** BIS has been told that the courts are only relevant for professional negligence claims, not for civil relief and damage mitigation for financial crimes by the auditor and other LLPs;

18.9.10. sought to create an industry out of crime, and make money by supplying to law enforcers, to use up tax payer funding that would otherwise be available to prosecute them and to protect the public from their rapacious greed and self interested conduct, devoid of those elements of conduct generally recognizable as humanity.

18.10. This process, referred to as *"dehumanization",* is fundamental to an understanding that the LLPs are little more than litigation and risk vehicles trading in the courts on "*litigation weapons".* This is an ideal forum where they can operate as it is wholly unregulated, has no proceeds of crime gate keeping, has no processes and procedures in place to protect the integrity of the records, allows judgments to disappear and purported orders are secretly secured, used unlawfully outside the courts and cross courts, where there is no procedures for crime reporting, and paralysed by heavily layered remote management structures, edifices of internal departments creating work for each other, no line management responsibilities, escalation procedures, operating guidelines for staff, management info or links to police, SOCA, SFO.

18.11. Unless this context can be properly understood, the relationship between the auditors and the banks cannot be understood. Indeed the lobbying by the banks to keep their pet auditor fills the press, when lobbying by definition, is an indicator of lack of independence. Little is heard of investigation of PwC's audit of Barclays and how the latter averted requiring bail-out, yet much is heard of Barclays seeking to keep PwC by lobbying. Why? How much money has been made and by whom, in the years in question and what has that to do with an independent audit, if anything?

18.12. In any relationship that operates under corrupt conditions of conspiracy, there must be a mutuality: in this case the banks absorb the

evidence of the defaults of the auditor, transferring this onto the victims and witnesses, and allowing the auditor to exit, in exchange for the auditor not looking, except at what is put under their nose, ultimately relying, but not saying so, on bail outs and the leverage from apparent terror of loss to the exchequor of £63b revenues a year from the City. This chronic lack of self confidence on the part of those charged with policing what is not inherently capable of policing, honesty, can never be evaluated until the question is posed, why is it £63b and not £630 billion and why is the City so chronically underperforming its potential?

18.13. ICAEW publishes literature on an expensive glossy about “restoring trust”. Trust cannot be “restored”. Trust must be earned. Trust can only be earned if law enforcement works and financial criminals identified and indicted quickly. The CC has not identified the barriers to this, and therefore the anti competition elements, including in the relationships that allow a defaulter to move from one firm to another, in exchange for a deal which says their integrity is sold to the “centre” or legal department; relationships with lawyers and banks exploited, risks shifted, and profit stream and power enhanced, all “regulatory” constraints warded off, for fear of “reputational damage”.

18.14. This is a model of self-destruct, where the market clearing price of the product sold labeled “audit” is zero, and where the audit certificate is merely another financial instrument of risk shift that is traded.

18.15. Restrictions in loan agreements are part of these arrangements: it merely records that the loan vendor wants capital depth from the auditor in terms of the insurance cover. It is exactly the same as the merger and creation of G4S in 2004, when Baker Tilly was not regarded as sufficiently covered to cope with the audit of the merger or reporting accountant. PwC became joint auditor, over the balance sheet date, 31 December 2004, and then resigned, leaving Baker Tilly to report in May 2005 on 31 December 2004, when the two had been joint auditor. The liability remains for ever with both, but the buyer has the comfort of the stronger balance sheet of PwC and insurance cover, that Baker Tilly could not hope to achieve alone.

18.16. The CC has no remit in regard the behaviour of the loan purveyor and

their pricing which includes terms. If someone is lending money, they can ask for whatever they like, and the appropriate forum to object was the Parliamentary Commission on Banking Standards.

18.17. However what is relevant to the CC is the audit of those banks who have benefited from the government loan guarantee scheme for growing businesses. This is a peculiarity. The government wishes to give benefit to the businesses, but, bizarrely has given it to the banks instead.

18.18. Not a single auditor has reported adversely on what the banks have done, even though there are now criminal proceedings on the subject. Why not? Any why is it that the FRC is employing barristers and conducting "tribunals" so that those guilty of reckless and knowing conduct in mixing of client monies by the banks, who have not been through a trial, can be let off as having made an "honest mistake"? What hope is there for "restoring trust"?

18.19. Post LLP Act the auditors reports changed to exclude responsibility to the banks. The exclusion is meaningless but shows the extent to which the legal industry has taken control over the auditor, the effect of which is that no auditor, in particular the larger and mid tier, can properly say they are "independent". The product delivered is not that in the Companies Act and the market clearing price accordingly is zero.

18.20. The incorporation of these restrictions in loan agreements is merely a "tit for tat" in regard the exclusion of liability to banks. The banks are always able to bring action against the auditor for theft, procurement of pecuniary advantage by deception. An auditor who shifts the evidence of their default onto a bank on the grounds "banks are big boys" are only going to get away with it, if they tow the line.

18.21. For these reasons, any attempt by the CC to interfere in loan agreements is bound to fail. The CC is obliged to confront and report on these matters and not leave the witnesses, victims and consumers to have to confront what must fill any simple person with feelings of revulsion. These obligations are those of the state and must be tackled by those empowered.

Shareholders vote on Audit Committee reports

A shareholders' vote on whether Audit Committee Reports in company annual reports contain sufficient information.

Capital adequacy verification

19. This is a FSMA 2000 matter. In the event the market is not fully informed, including on a timely basis, there is the risk of a false market and/or a split market if the sponsor/broker is informing their clients differently to what is in the market.

20. The part which is most relevant to the auditors and in which they, without exception default, is the FSMA 2000 obligation to review that the directors have reviewed capital adequacy. This is an equivalent to the Companies Act obligations. Any auditor who has reported on a bank and omitted to report that they have only been able to report in reliance on government bail-outs, has defaulted and is liable to Crown prosecution under FSMA 2000 by the FSA/ Prudential Authority/FCA and/or DPP instructed by BIS.

21. This obligation is re enforced by the public admission by the Prudential Authority that they have no authority over internal compliance officers, and the public is unprotected. In other words there is finally explicit confirmation that self regulation is dead, not dying, and nobody knows what to do, who must do it, and who is prepared to risk the perception of risk to the revenues from the City to the Exchequor.

22. The obligation of the auditor is to report if they are unable to agree the underlying true position with the estimates and disclosures in the draft financial statements. Implicitly they must look. The FRC does not carry out live inspections to see whether they look or not. BIS has not recommended to Parliament that, since neither the banks (and insurers) nor auditors are trusted, there is now no choice but to require positive reporting, certifying by named person that the auditor has looked.

23. Secondly in a world where it is all about "whose risk", risk shift, risk arbitrage, and exploiting mismatches like the mismatch between implicit and explicit law (each of which has the same legal standing); asymmetric knowledge;

separation of those with the knowledge of the true position from the person requiring it; the auditors have adopted the approach of sitting in the room where the directors have a piece of paper in front of them headed "cash flow forecast; capital adequacy review". Their litigation risk based approach says they witnessed the event that the directors reviewed capital adequacy. The box is ticked and the exceptions based risk register, provided to the person signing off, has no entry.

24. The auditor reports "there is nothing that has come to their attention…..". Plainly this will be the case, if they have not looked, adopting the litigation principle of "*not being on notice".* In other words the techniques and devices of the legal industry which do not apply to independent assurance reporting, have metamorphosed into it, have had the effect of fatal toxic contamination, depriving the market of independent assurance reporting, direct (audit) or otherwise.

25. What is the price of this exercise? Whose definition of an audit is this if it is not that of the Companies Act or FSMA 2000? How is Trading Standards in the City (three full-time one part-time) supposed to act when a consumer complains of licensing breaches and "audit" mis-selling and price rigging? Would it not be simpler, cheaper and more honourable to photograph the directors holding the piece of paper headed "Capital Adequacy Review" and inform that this is the evidence relied on that the enterprise will not topple in the next 12 months (two years preferred)?

26. Contemplating the shareholders voting on whether the non executives on the audit committee with the CFO have done a proper job in reporting, is in essence an attempt to replace the rigours of market notification and the independence of the auditor in deciding what evidence he relies on in reporting, in the first instance to the directors.

27. The CC needs to be mindful that shareholder meetings are private meetings. The CC's suggestion relies on the shareholders knowing what they do not know (impossible) and becoming insiders. The suggestion needs reworking. The auditor must be obliged to reveal the evidence that they have received from those outside the enterprise (introduced explicitly under Companies Act 1985 s389B), and which the auditors with the lawyers who shelter them have attempted to restrict in statutory interpretation to evidence from directors and senior employees (Herbert Smith and PwC, joint paper October 2006) (offence to knowingly or recklessly omit to provide intelligence to the auditor).

Audit Committee remit

> *Measures to strengthen the accountability of the external auditor to the Audit Committee and reduce the influence of management, including a stipulation that only the Audit Committee is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes, make recommendations for appointment of auditors and authorize the external audit firm to carry out non-audit services.*

28. The Audit Committee comprises non executives and ought to include the CFO, in order to inform the AC. The Audit Committee per se has no executive function and its terms are subject to vetting by the Listing Authority on flotation, and require shareholder approval to change.

29. The external auditor is accountable to each office holder severally (meaning of "the auditor shall report"), with a direct cause of action in any default. An auditor who defaults will not in practice provide the evidence of their default to the director/office holder. Nevertheless that individual is personally liable for the defaults of the auditor, and may be indicted for knowing or reckless conduct if they do not secure access to the true evidence the auditor has relied on or manufactured, alone or with others (bank, lawyer, broker).

30. The director has no chance of achieving this access. The DTI (now BIS), refer witnesses and victims to the SFO for the exercise of their powers under s2 of the Criminal Justice Act to require delivery up of the evidence and records, which in fact are the property of the director and/or office holder. Neither the DTI nor the police have such powers.

31. If the auditor can REFUSE to deliver up the evidence, which forms part of the books of prime record, and which belongs to others; can REFUSE to meet a listed company chairman; it is plain, the auditor is saying "*we are accountable to no-one*" and, implicitly, it is the directors who face indictment for the conduct of the auditor for which they are personally liable, and can do nothing to enforce without ready access to the tools of the Criminal Justice system.

32. The CC cannot impose restrictive statutory interpretation on the implicit and explicit obligations of the auditor (narrowing them to those to the AC).

33. The "reduction of the influence of management" would be unlawful, since it

is the directors severally who are personally liable for the creation of proper records, maintaining them, reporting, notifying, and these must be sufficient to enable the enterprise to ascertain its financial trading position at all times.

34. The directors therefore must have access at all times and the obstruction of such access, including by the auditor, is a prima facie offence. The manufacture of false records by the auditor, including their reports, is an offence under the Thefts Act, the Fraud Act, the Senior Court Act and the Land Registry Act (for those assurance vendors who seek to asset strip the directors to whom they must report, including on their own defaults, with or without others, in lieu of reporting properly) and the privilege from self incrimination is disapplied: ie the auditor/assurance vendor must, of their own volition, deliver up evidence/intelligence of their own defaults, even though this may result in their indictment.

35. The market clearing price for an auditor who does not do this, is properly zero, since there is no market for an audit which is not independent, if competitive conditions apply. They do not, but the oligopolistic, price rigging, collusion ridden features place the audit as part of assurance, non assurance, the legal market, the insurance market and the banking market.

36. Since the market does not separate these, the CC cannot. However what it can do, it to “mimic” what a competitive independent market might look like and identify what is required to achieve it (protection of supply side; changed flexible delivery models; stand alone practices, delivering audit and directly related tax compliance; live inspections; and publicized paths to fast track separation of prosecution from civil reliefs).

37. The authorities are loaded with the personal responsibility of the director/office holder. The Companies Act is all about that personal responsibility. The CC cannot change this without throwing out the Companies Act and making nobody responsible for the accounts.

38. The approach adopted unfortunately has sinister whiffs, “as though” the directors are the villains and seek to “cosy up” to the auditor who is pure in their independence, in order to influence him. This is a blatant denial of the evidence of the market, that those profiting from this industry lobby to change the law to favour themselves; “buy” the enforcers into lucrative jobs defeating the enforcers; when

they do not like the law (CA 85 s389B), they rewrite it, and import statutory interpretations which are restrictive that would not pass a judge; and, if all else fails, collude to asset strip the witnesses and victims, jailing them if at all possible and walking off with a mere fine from a Tribunal.

39. The CC must have some way to go to restore credibility with executive directors and to restore the power of the work of the House of Lords, which told Ian Powell of PwC "***you are not believed"*** and of the courts, who did the same to the Royal Bank of Scotland, and are well geared up to a confrontation with the auditors who have abused the courts and caused them to contravene their obligations under the Victims Code.

The audit fee

40. This is a matter for the procurement department. The audit is a commodity, undistinguishable from any other. A non zero price for any audit which is not independent is inflated. The AC are not paid to work in procurement.

The scope of the audit work

41. This is unlimited and must be determined by the auditor who, in fact, does not need to reveal what they do, since these are their own working papers (the evidence itself however belongs to the directors).

42. The Companies Act requires anyone with information relevant to the work of the auditor to provide it: the CC cannot dis-apply the Act or restrict it.

Changes of auditor

43. There is currently mandatory rotation of the audit team every seven years. There is not an iota of difference between rotation of a team inside an auditor and rotation of a team by moving firms. In both cases the prevalence of team members who do not understand the contracts of the enterprise (or do not look), is the same, and the time wasted by management on teaching the auditor is the same burden.

44. The suggestion of the CC that the AC should get involved in this process is unlikely to receive a polite reply.

Non audit services

45. A competitive market price can never be attained unless the auditor is doing nothing commercially but audit. However there are directly related functions that can only be carried out by the auditor: eg reporting accountant and tax compliance. In the event that the supplier is organized as a firm using its own model (see challenge to delivery model in these notes), it is necessary to "unbundled" how business in each part is obtained. The outcome can be predicted not to mimic an audit only business (including ancilliary).

Observation

46. In a "healthy" relationship with an independent auditor, it would be common to consult and inform on major events, as new contracts, a draft announcement, a recruitment possibility. However the true position on the relationship does not get tested until the auditor is in default. In this case the defaulting auditor, who does not resign citing loss of independence, but ought to do so, can be predicted to act in self interest, as they are bound by the members agreements and the internal lawyers of the auditor, to whom they have ceded control.

47. This means that by definition the relationship was never "independent" never compliant with the Companies Act, and never could be. Therefore it could not be worth more than a zero price (this is predictable in an oligopoly with collusion across sectors and between those audited and the auditor).

48. There is no case for the AC to be a purchasing authority for a business area for which they have no executive function.

The letter to management is to each director, compliant with the obligations "an auditor shall report". The AC is not distinguishable, and those responsible for the relevant area in the enterprise being audited are included.

The letter of representation is from each director/office holder to the auditor, confirming compliance with the law, including those aspects emanating from the auditor. An auditor acts unlawfully if he reports without clearance on his own work from each individual officer of the enterprise audited. Such an event is a conclusive indicator of the absence of independent reporting.

Competition in delivery of a statutory function

The FRC should amend its articles of association to include a secondary objective to have due regard to competition.

49. This is already included in the published standards on integrity and independence in the context of assurance reporting. However the FRC does not realize this because they have allowed themselves to be led by lawyers and not executive directors, finance directors and audit partners who know what an assurance report is. The FRC refers to BIS for prosecution of crime and to the police for witness and victim protection. They do not realize that neither provide the service. They refer to the FSA for crimes affecting quoted securities, not realizing they will not do anything.

50. In regard competition generally, especially in delivery of a statutory function, these points are matters primarily for BIS (ex DTI), which ultimately, through the various bodies licenses people/bodies for enforcement of the Companies Act, Insolvency Act, FSMA 2000, Thefts Act, POCA etc in all matters to do with public accounts, registers (Companies House, Land Registry, Bankruptcy), and the operations of the labour market.

51. The fundamental issues which affect/restrict competition and achieving the market clearing price in a notional competitive market, with no supply side constraints or barriers to entry, are currently that:

51.1. There is no **published recommended price list** for unit labour cost, stating licensing credentials and relevant experience. There ought to be;

51.2. The supply by an auditor is of a “commodity” with no inherent value add, beyond statutory compliance and assurance. This is not to undervalue these items. However the “value” (or “price”) ought properly to reflect the market value, ie the amount that a civil servant is paid for carrying out similar tasks. Immediately the remuneration of those carrying out such a statutory compliance function overtakes the package of the equivalent civil servants, the market is distorted, and the outcome can be predicted to be neither independent nor reliable. **Remuneration and package of all team members** must be disclosed in the same way as that of directors’ is disclosed by law;

51.3. The activities which are carried out by the audit team, the frequency, and documented disposal of exceptions, are not published deliverables (to management) which a Board can confirm have been delivered. They ought to be. Whereas an auditor's working papers are his own, delivering the result of pre agreed testing, is simply a contract deliverable, that is part of **reporting to management** (those charged with the governance of the enterprise);

51.4. There are currently no alternative models for supply put forward, eg Firm X assembles a **mixed team** including those who are not its own employees. This means that those interviewing for small firms, or working in them, are explicitly excluded. The CC has not, as yet, carried out any quantative analysis on empirical data, on this hidden labour pool, and the impact over three, five or ten years of exclusion from this supply market. It can be shown, by modeling, that this can only result in increased concentration, polarization, and an upward pressure on price. No measures have been proposed for easing the compliance and regulatory costs for smaller firms. Simply, if they are wanted in the market, the **access price** (including opportunity cost) **must be set at zero**;

51.5. The CC has not quantified "hidden costs" such as the training costs of those in an audit team "learning on the job", who would not be included, if the labour were assembled from the open market, based on experience, or as part of a team that has worked together previously, with the requisite industry experience.

52. Competition is well within scope of the FRC's constitution under the provisions relating to **INDEPENDENCE** and **INTEGRITY** in regard assurance reporting (direct ie audit, and the rest). No amendments are therefore required.

53. The FRC is currently held back in effectiveness in regard the following:

53.1. building up in-house competence and experience, so work does not have to be outsourced, and experience is retained and reused;

53.2. retaining a **backlog of referrals** to it, and is vulnerable to cases being abandoned when its staff change. Consequently trends are missed and what the public, the market, the enforcers expect of the FRC is not aligned with what

the FRC delivers, or believes it ought to be delivering. ;

53.3. it has not focused on **one single "customer",** but is spread over "stakeholders": it is only the director who is responsible for the maintenance and publication of proper records. Therefore without a sharp focus by the FRC on a "raison d''etre" of making that director's job more "doable", energy and resource is dissipated;

53.4. it does not carry out **live audits**, and ought to. Its business model in this aspect ought to be the same as inspecting an MOT garage carrying out testing, in accordance with certain published rules; a driving instructor at work; a teacher at work; a pilot at work. An inspection after the event can have no conceivable value and trends which it repeatedly spots (eg promotion on the back of sales ability), which are contrary to independence, go nowhere beyond in a report which UK Plc does not read;

54. The FRC has undergone a public consultation of its reform, which it ran with BIS. This point did not come out from that consultation. However it is important to be sure. The CC requires access to all the FRC evidence collected. The FRC has this. It is currently off the (revamped) website but should go back up shortly, IT permitting. The FRC ought to be able to confirm to CC that all previously closed consultations remain publicly available, and, as in this case, that of BIS.

55. Independence and integrity are practically the same as competitive behaviour. Certain market conditions must apply for the outcome to be predicted to produce the efficient market clearing price. Those conditions do not apply; cannot apply in the delivery of a statutory function; with the result that the outcome can be predicted to not reveal the true underlying position on the audited draft accounts.

56. "**Self regulation**" has compounded the problem, with "tribunals" permitting fines for indictable statutory offences, and the audit report reduced to another financial product for value and risk shift purposes. Neither the courts nor the enforcers have caught up.

Mandatory rotation and other mandatory activities

The CC has decided against bringing in measures requiring mandatory switching of auditors, further constraints on audit firms providing non-audit services; joint audits; shareholder or FRC responsibility for auditor reappointment or independently resourced risk and Audit Committees.

57. CC must report on the empirical evidence that has caused it to stop short of mandatory "switching" and in particular the **marginal cost** in going from the rotation that must happen every seven years inside an auditor, to moving firm. On the surface the marginal cost must logically be zero, since the incoming team replacing that retiring by rotation, is the equivalent, ie it is the same as an incoming team from the auditor across the road. All management time in interviewing the newcomers is the same, depending on how many reach that stage.

58. CC must obtain evidence and report on the extent of interdependencies in auditors' pipeline. This includes the extent to which non audit services come out of either referrals from audit; non audit assurance work and/or the fact that the business is credible and wins work because it is an auditor.

The distinction is between this and lines of business which are totally independent of audit/assurance, that the business can show it would achieve had it not been an assurance vendor at all (or referred by the assurance business). Business which in one form or another, emanates from assurance business, is the relevant figure, and is never revealed, instead "*audit is only 25% of our business"* is the sort of remark that is made, whilst proper segmental reporting of how the business was generated, is not disclosed and would be in a prospectus.

59. These issues are as fundamental as the break up of the banks and the work of the Parliamentary Commission on Banking Standards. CC must be informed by this work, and draw the necessary parallels.

60. Second, the issue of **multidisciplinary businesses** must be addressed, in particular in the context of modern financial instruments, all of which are factors which create and enforce oligopolistic behaviour, as:

60.1. **Trading an audit certificate**, for a risk shift;

60.2. Exiting, but **withholding notification of exit** until over a balance sheet date, to de-risk for a successor, and thereby facilitate a "de-risked" exit;

60.3. Accessing **underwriting markets** through third parties, which an assurance vendor cannot properly access on a stand-alone basis;

60.4. Managing reporting on the basis of whether **"on notice"** or not, rather than by looking and reporting, including documenting the disposal of the risks and/or defaults identified;

60.5. The irregular and unlawful **use of the courts** to deflect risk and similarly, the **use of Tribunals** as, effectively, a secondary market to enable fines instead of more serious sanctions and penalties (seeking to convert "*reckless conduct*", attracting a penalty, to an "*honest mistake*", a nothing);

60.6. Exploiting **mismatches**, as the difference between **implicit and explicit law** and other forms of **arbitrage**;

60.7. Prioritizing commercial interests over independent reporting, such as the adverse impact of each of **lobbying** and **revolving doors** which distort the market;

60.8. The impact of audit partners moving on to becoming plc non executive directors with no previous experience as a public company executive director or to work in law enforcers, with no pedigree in crime investigation and prosecution.

61. The references to FRC or shareholder re-appointment of the auditor or "independently resourced" risk and Audit Committees, are essentially all the same, being techniques to separate the "checkers" from the "doers". All are based on a common but widespread misconception of what an audit is, and the relationship between the auditor, the director and the enterprise.

62. The model they espouse suggests that commissioning an audit is analogous to having an ongoing contract for the servicing of a gas boiler, with an annual check, and other periodic activities as agreed/required. However this is an ill-conceived approach and the following is the case:

62.1. The Audit Committee, the Risk Committee or any other committee are simply directors, and each one is as severally personally liable as the other. These personally must ensure that proper records are maintained. How they get to that point is ultimately down to them: the law provides each shall have access and must maintain those records that sufficiently enable the financial trading position of the enterprise to be ascertained "*at all times*". A director can never be independent of the enterprise, when his responsibility and liability is so fundamental to its existence.

62.2. The auditor is a holder of an office, and is therefore a part of the Company: the shareholders ratify their appointment. In the event of default by the auditor, the directors severally are liable. The FRC is not on the Board, and could not get involved in such a way without assuming legal liability, as the director carries.

62.3. The fact that the auditor shall report, if he cannot agree the underlying records to the estimates in the accounts, but does not have to certify that he has looked, is the single biggest problem. It means that the auditor has no incentive but to act rationally and predictably in their own commercial self interest.

63. The question of how a statutory compliance function can be delivered through a commercial market, where price and supply side constraints are not state regulated, is not addressed by the CC but ought to have been.

64. Empirical evidence is thin in the output of the CC so far as is:

64.1. evidence from executive directors;

64.2. evidence collated by the licensing bodies from members and provided in raw form to the CC;

64.3. evidence of those who have worked in BIS, Insolvency Service, CIB;

64.4. evidence from those jailed over accounting and notification issues or who have lost their jobs in circumstances relevant to the evidence gathering of the CC;

64.5. evidence from those working in firms with under fifty employees and the output of other investigations and consultations (as Parliamentary Commission on Banking Standards).

The response of the industry to the banks' collapse was that the interdependence between the banks did not matter because the government would bail them out.

Since that is what they relied on, according to them, the auditors' reports should have said so: they did not. The reports were therefore not independent, not the result of a competitive market operating in a regulated statutory function. This is therefore prima facie evidence that the audit fee was not properly earned and the report was knowingly misleading, in other words, the price was, and is, rigged.

65. This will never change unless and until the supply side from the smaller firms is nurtured, the price is quoted by the unit labour cost, the reports are positive reports of what has been done and who by, audits are inspected while live and auditors who are defaulters are held to account in the same way as an executive director is, and operate with the same transparency, filed at Companies House, including their address for service of documents, date of retirement/departure notified at the time the decision is taken and all other details publicly available, as befits a person carrying out a function on behalf of the state, and remunerated accordingly.

Feedback on terms of reference

In its investigation, the CC is required to decide whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom'. If so, then there is an adverse effect on competition and the CC will also consider whether this is resulting in a detrimental effect on customers such as higher prices, lower quality or less choice of goods or services. The CC will then decide whether the CC should introduce remedies to tackle the adverse effects on competition or detrimental effects on customers or whether the CC should recommend action be taken by other bodies to remedy the adverse effects on competition, and if so, what actions or remedies should be taken. If the CC finds that there is no adverse effect on competition, the question of remedies will not arise.

66. The CC is its provisional findings is a long way off from being in a position to conclude on its remit as described above and has been hampered by the amount of time that has passed from the House of Lords investigations (2010) into the responsibility of the auditors in the failure of the banks and the resultant massive shift of private wealth, savings and public money to those responsible for the financial instability and their auditors. As at August 2013, the CC has not fully assimilated the vital evidence, findings and conclusions of the Parliamentary Commission on Banking Standards, which has come and gone during the time of the work of the CC. The evidence collected by the OFT and passed to the CC has neither been acknowledged nor fully taken into account.

67. The remit of the CC as stated above has not been refreshed to accommodate vital trends and evidence that have emerged publicly from 2011, when the CC started on this project to date, with the consequent real risk that the conclusions and recommendations, by the time they come, are out of date, and therefore not resilient to challenge. The CC has not operated on a heavily evidence based approach, publishing the evidence simultaneously with the analysis and conclusions drawn from it, and citing both empirical data and source. Licensing bodies have not been asked to mobilize evidence from members, supplied in raw form directly to the CC nor has the listing authority been asked to request same from listed company directors. Reimbursement of expenses has not been offered

to small firms, to elicit their contributions, when in fact, they are the key to the current supply side constraints, and unblocking the manifest paralysis in the market. An "independent" auditor cannot be found in the ranks of the large and middle size firms, those who audit banks, insurers, global traders, and those who have gone through mergers and conversions to limited liability partnerships. This stark fact ought properly to be finding number one. It is not.

The supply side and labour pipeline

68. The polarization of the labour market, the burden of compliance, regulatory, and training costs, the dilution of the Companies Act and the refusal by enforcers to prosecute under FSMA 2000, POCA etc, have predictably led to de-skilling, lack of confidence and no proper mechanism for school leavers and graduates to enter the market, unless they are prepared to subject themselves to the large corporate machines that prioritize their own profits and risk management over the independent statutory function, which the buyers thought they were getting, some twenty years ago but which no longer exists. This group, together with careers services of the local authorities and colleges are voiceless in the evidence elicited by the CC. The impact of the heavy debt that students must assume to get through training has not been assessed as a barrier to the future supply chain, and the polarization resulting from the differential between those whose parents can fund entry to education and the industry and those who must do it themselves.

69. These are the classic ingredients of the creation of self serving edifices that have characterized the legal industry, the banking/insurance industry and now the large and mid size public accountants and which have created the oligopolies (co-operating across industry), emboldened by the effectiveness of lobbying which no single law enforcer is prepared to tackle. This includes police; Trading Standards; OFT; BIS (ex DTI); FSA (now in two parts); SFO; SOCA; or HMRC. HMRC, so long as it gets the tax it seeks, does not prosecute those responsible for the manufacture and trading in the toxic arbitrage and risk shift products that are deployed to ward off risk, by burying the evidence and disabling the witnesses, including those inside the public accountant/auditor, who are controlled by the sinister secret members agreements, that ought to be publicly available on inspection but are not.

70. The position is considerably worsened by the acceptance of the auditors as non executives directives those who have come from the auditing world, with zero experience in being an executive director, occupying position of influence, that they plainly do not have the experience to fulfill or members of an audit or remuneration committee who are not licensed accountants who are prepared to stay up all night to reconcile cash, or understand the implicit risks in the changing business model of the external auditor, that the auditor has omitted to declare. The practice has turned what ought to be a serious legal office into a sinecure for retiring auditors. This is an appalling "letting down" of those whose pensions and savings are tied into the outcome of proper stewardship.

Final demise of self regulation: unstated but plain to Joe Public

71. The CC has not carried out any investigation into the silence around the predictable and predicted (by the DTI) collapse of self-regulation, and the related fact that the "regulators" themselves are paralysed in their operations by their own in-house lawyers, whose sole raison d'etre appears to be to separate the investigators from the prosecutors. These are obliged on sight of evidence and knowledge of the identity of suspects to prosecute (unless a compelling public interest reason not to proceed), under the prosecutors code; and otherwise bury, lose or deny the existence of the evidence.

72. The CC has not probed either the silence or the collapse, depriving itself of the opportunity to consider how the vacuum is to be remedied. This itself requires investigation of the impact of privatization, and outsourcing by government departments, the predictable difficulty in retaining in-house experience and expertise, and the flush of early retirements and moves from the civil service, in order to using the acquired knowledge and experience in the private sector, but this time applied to defeat the law enforcers.

73. Without such probe, the CC will not get near a quantative, empirically backed report on the extent to which foreign and domestic investment is frightened off, or pulls out, citing lack of resilience in corporate balance sheets and lack of proper regulation and enforcement.

Final demise of self regulation: effectively admitted by the new Prudential authority

74. The new authority (the part of the old FSA dealing with capital adequacy etc), in its pronouncements in recent months, has laid great stress on internal audit, risk and compliance functions and more importantly, that it has no powers to do anything when these fail. The internal audit and compliance functions are the very people who can never be relied upon to be independent in conduct. They are the ones who are subject to top down corporate bullying, and to detrimental treatment and harassment, leaving them with a stark choice of shutting up or getting out.

75. An auditor who is independent, in their testing of the resilience of the internal controls of an enterprise, will high light this as a key risk. They do not. Instead they adopt the same culture, and rebrand internal controls compliance testing, as *"risk management and governance"*, and outside scope. That is not an independent audit by an independent auditor.

76. The FCA has not to-date given any assurance on the investigation and prosecution of its backlog, inherited from the FSA. It has asserted it is on a journey to a vision of what the FCA ought to be. Auditors typically assert market notification is outside scope although the Listing rules make explicit provision for the auditor reviewing capital adequacy vetting ("going concern"). Auditors in the big 4 consider they have discharged this obligation by the existence of a record that such exists and has been looked at by the directors; they do not "tick" the numbers to see that they agree to the underlying records, and report to directors ("*an auditor shall report")* if they do not.

77. The chasm that is left is plain, predictable and predicted. The CC has not addressed it.

Conditions under which a statutory function can be "left" to private interests to deliver

78. The key feature of the assurance market (direct reporting) is that the office of a statutory auditor is a statutory function that can only, by definition, be licensed and policed by state enforcers. It does not prima facie lend itself to either a competitive model of the market or competitive delivery of the function.

79. In practice it has not been delivered in this way. The CC has not identified parallels, eg the MOT garage, or the border guards checking papers and goods on entry. As a result, the audit certification has been reduced to the same status as a notary who witnesses the signature on a witness statement of a corrupt lawyer, who is using the statement to achieve an illegal and irregular outcome.

Audit certificate: form of insurance

80. The market knows this. The CC however has not investigated WHY buyers assert that a big 4 auditor must be the auditor in business contracts; the answer is simple, it is that they can best withstand large claims, and in averting them, they effectively provide off balance sheet "insurance". The buyer is therefore getting a form of insurance contract, and whether or not the auditors have looked at the underlying records or understood the end-to-end contracts, is irrelevant.

81. Imposing restrictions on the buyer, rather that compelling the supplier to make full disclosure on a par with a plc, and subject to the full vetting to make them on a par, is the wrong instrument, imposed on the wrong person.

Attributes of competitiveness

82. The attribute of the delivery of a regulated state function, that is open to competitive behaviour, is the labour. This is because the delivery of a statutory audit depends on people with certain attributes carrying out tasks in what is essentially a commodity supply. It is different to, for example, the provision of energy that requires a power station, with heavy barriers to entry.

83. There is currently no alternative delivery model mooted for supply of this function that puts together the plentiful supply with the demand, nor a published price list for unit labour cost subject to license and experience. This is a fundamental oversight.

Extracts from: CC outlines measures to promote a more competitive audit market 22 Jul 2013

The Competition Commission (CC) has today published a provisional decision regarding the remedies it is considering introducing when it publishes its final report on the supply of statutory audit services to large companies in the UK this autumn.

In a summary of its provisional decision on remedies, the CC has put forward a package of measures to promote competition and to ensure that competition is directed towards satisfying the demands of shareholders. The remedy package includes measures to improve the bargaining power of companies and encourage rivalry between audit firms; measures to enhance the influence of the Audit Committee; and measures to promote shareholder engagement in the audit process.

In its provisional findings report published in February, the CC said that competition was restricted in the audit market due to factors which inhibit companies from switching auditors and by the incentives that auditors have to focus on satisfying management rather than shareholder needs.

The main measures the CC has proposed are as follows:

- *FTSE 350 companies should put their statutory audit engagement out to tender at least every five years. Companies may defer this obligation to go out to tender by up to two years in exceptional circumstances. There will be a transitional period of five years before the measure comes into full effect.*
- *The Financial Reporting Council's (FRC's) Audit Quality Review (AQR) team should review every audit engagement in the FTSE 350 on average every five years. The Audit Committee should report to shareholders on the findings of any AQR report concluded on the company's audit engagement during the reporting period.*
- *A prohibition of 'Big-4-only' clauses in loan documentation (ie clauses that limit a company's choice of auditor to a preselected list).*
- *A shareholders' vote on whether Audit Committee Reports in company annual reports contain sufficient information.*
- *Measures to strengthen the accountability of the external auditor to the Audit Committee and reduce the influence of management, including a stipulation that only the Audit Committee is permitted to negotiate and agree audit fees and the scope of audit work, initiate tender processes, make recommendations for appointment of auditors and authorize the external audit firm to carry out non-audit services.*
- *The FRC should amend its articles of association to include a secondary objective to have due regard to competition.*

The CC has decided against bringing in measures requiring mandatory switching of auditors, further constraints on audit firms providing non-audit services; joint audits; shareholder or FRC responsibility for auditor reappointment or independently resourced risk and Audit Committees..

4. The OFT referred the market to the CC for investigation in October 2011.

5. In its investigation, the CC is required to decide whether 'any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of any goods or services in the United Kingdom or a part of the United Kingdom'. If so, then there is an adverse effect on competition and the CC will also consider whether this is resulting in a detrimental effect on customers such as higher prices, lower quality or less choice of goods or services. The CC will then decide whether the CC should introduce remedies to tackle the adverse effects on competition or detrimental effects on customers or whether the CC should recommend action be taken by other bodies to remedy the adverse effects on competition, and if so, what actions or remedies should be taken. If the CC finds that there is no adverse effect on competition, the question of remedies will not arise.