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David Andrews
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By email to d.andrews@frc.org.uk

Dear Mr. Andrews

Proposals to reform the Financial Reporting Council

I would like to make some general comments on the proposals to reform the FRC relating to the regulation and supervision of the accounting profession.

My background

To introduce myself, I am the person who was referred to by the media in February 2009 as "The HBOS Whistleblower" after I gave detailed evidence to The Treasury Select Committee about being dismissed from my role as Head of Group Regulatory Risk at HBOS by Sir James Crosby after raising regulatory and risk management concerns to the HBOS Board about its aggressive strategy for sales growth. You may recall that my evidence was made public on the day that the Committee interviewed the ex CEOs and Chairmen of HBOS and RBS leading to intense media interest and the resignation of Sir James Crosby the next day from his post as Deputy Chairman of the FSA.

I attach as Appendix 1 a summary description of my professional experience. From this, you can see that I have been involved as a practitioner and professional adviser in risk management, regulatory compliance and corporate governance in the financial sector since before regulation in the UK began in 1986. I have over 25 years of experience in financial services both in-house and as one of KPMG London's top performing Partners where I worked for over seven years before I joined HBOS. I worked closely with all the service areas at KPMG but especially Audit. I have also worked with with accountants, auditors and actuaries while is senior executive positions in industry itself (including as Head of Group Regulatory Risk at HBOS). I think it is fair to say that I have real, in depth, "coal-face" experience of the way the accounting profession operates and, therefore, a useful "insider's perspective".

I am happy to share my knowledge, experience and views with any of the team working on the FRC review.

General comments

It goes without saying that the accounting profession is absolutely crucial to the proper workings of society and we need to be extremely careful as to how we re-organise its regulation to ensure that we do not give the message that the current status quo is satisfactory.

Of course, we all want less regulation and, to that extent the intention behind the proposals to reform the FRC is both right and good. Of course, we do not want over-lap between what the FRC does and what the other "institutes" do e.g. ICAEW.

But the trouble is that there really is a very great deal that needs to be done to reform the way the accounting profession works – including its regulation and supervision – before we "tinker" at the edges with structures, scope and focus of what the FRC does. To repeat the well-known clichés – the proposals to reform the FRC, feel a bit like re-arranging the deck chairs on the Titanic or fiddling while Rome burns. In fact, in my opinion, I would say that the current proposals increase the risks to society associated with the accounting profession by giving a distinctly wrong message of "lightening up" regulation and supervision when, in fact the opposite is actually required.

The heart of the problem here is about culture, responsibility and ethics – just like economics generally and probably society as a whole.

It seems to me that, in any civilised and developed society, if we cannot be satisfied **so that we are sure** that we can trust and rely on the competence, integrity and independence of our professionals – the very people who are supposed to be the best educated, brightest and most honest people in society - we are in real trouble.

If I combine all my professional experiences with the personal experience I suffered as a result of the so called "independent KPMG investigation" following my dismissal from HBOS (to which I will return later), I have developed a very strong concern, over a considerable period of time, about whether fees come before independence, objectivity (or, sometimes, even competence) in important parts of the accounting profession. I also think that the evidence, from a range of sources, seems more and more to support this conclusion. One very important source of evidence, anecdotal though it is, is that it is not difficult to find very senior accounting professionals (and other professionals outside of the accounting world e.g. lawyers, journalists) who are very concerned about this "focus on fees".

As a truly extraordinary example of what I am saying, Andrew Hilton, the highly respected financial editor of The Evening Standard, told me that he was personally present at a private conference when John Griffiths-Jones, the senior partner of KPMG, admitted that Auditors were never going to challenge the Directors of clients outside the specific scope of the audit because it might jeopardise their commercial relationship with the client – presumably both in relation to the audit as well as other "advisory" work. I have asked John Griffiths-Jones

about this comment and, as you might very well expect, he denies it but there really is no reason to doubt Andrew Hilton's word on this it says it all; it is an admission "straight from the horse's mouth", so to speak! In any event, I can testify to the fact that the sentiment expressed by John Griffiths-Jones is common "corridor talk" amongst senior accountants that I know.

From a personal perspective, I can testify to having been in meetings while at KPMG, in which I have raised statutory duties to report, when it has been extremely difficult, even though the evidence has been very strong, to persuade the Audit Partner concerned to fulfil their duty because of the risks to the "client relationship" (i.e. fees).

On one occasion, I was actually asked by the lawyers of a client "what it would take" for me to agree not to write a report required under our terms of engagement containing evidence of serious regulatory breaches in a client. When I refused to agree to this, I was asked by KPMG to give up my role as the engagement Partner of the project.

Another very important example of the same problem is the supposedly independent forensic investigation by KPMG of my allegations that I was dismissed by James Crosby for raising legitimate challenges to the Board of HBOS about its inadequate risk management systems. I have given detailed evidence about this which is the public domain to the Treasury Select Committee when I "blew the whistle" in February 2009. It was obvious that KPMG were conflicted form carrying out this work as they were HBOS's auditors but they nevertheless proceeded to do it. I publicly challenged the independence of their report to the media alleging either gross incompetence or even dishonesty. Since doing so neither Sir James Crosby, nor the FSA nor KPMG itself have made any rebuttal to my allegations. But what is even more extraordinary is that neither the ICAEW nor the FRC/AADB have considered it appropriate to investigate or ask me about the allegations I made even though they were clearly a matter of great public interest and even though the Prime Minister Gordon Brown MP himself said in Parliament that my allegations were serious and should be investigated.

At the same time as raising these important points, I do want to make it clear that I think that, as individuals, the vast majority of the accounting profession are people of integrity who want to do the right thing but are often so caught up in the "commercial pressures" for fees that they cannot find a way out of the vicious circle that they do not support either.

The general point that I am making here is that the proposals to reform the FRC, although well-intentioned, are to a large extent irrelevant without looking much more deeply into the reform of the accounting professional generally.

Below I set out the specific areas that I believe should be looked at more thoroughly.

The root and branch reform of statutory audit

We must conduct a root and branch review and reform of the statutory audit. What it is for? How should it be done and by whom? How does it fit into the other "checks and balances" and governance systems?

I am sure that many ordinary people, as well as "right-thinking" professionals, must think that statutory audit is practically pointless (if not worthless) if it was not able to red flag any part of the risk of the banking crisis in advance. It must be literally incredible to most ordinary people that unqualified audits or certificates were given to the large banks shortly before (and in some case literally weeks before) they would have failed had it not been for the massive injection of public funds and liquidity.

On this point, I entirely agree with the latter part of paragraph 221 of the House of Commons Treasury Select Committee report on the Banking Crisis published on the 15 May 2009 which stated:-

"*We have received very little evidence that auditors failed to fulfil their duties as currently stipulated. The fact that some banks failed soon after received unqualified audits does not necessarily mean that these audits were deficient. But the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit really is. We are perturbed that the process results in "tunnel vision" where the Big Picture that shareholders want to see is lost in a sea of detail and regulatory disclosures."*

It was, of course, very unlikely that any of the big firms of accountants were going to volunteer any proper evidence to the TSC in 2009 in support of the first part of that paragraph 221, on auditor failure in their Going Concern duties and responsibilities. Nor have the FRC/AADB carried out any investigations of the accountants in the audits at RBS (Deloitte) or Lloyds (PwC) or HBOS (KPMG) or Northern Rock (PwC). That is wrong.

In addition, the evidence revealed during the House of Lords Economic Affairs Committee cross-examination of the Big 4 audit leaders on 23 November 2010 and captured in the media the following day with headlines such as "Lords accuse auditors of deceiving investors" and "Lawmakers attack auditors over bank statements", also fully supports the point I am making.

Reform of accounting standards and the approach to setting them

We also need to reform accounting standards. Who sets them? Is there too much of an assumption of the independence of the professional bodies which set them? Is there enough scrutiny and oversight by the regulator?

I suspect that many people would find this even more worrying if they knew that it seemed to be common knowledge amongst accountants before the crisis that some of the international accounting standards were not really giving a "true and fair view" of the numbers. On this point, I can personally testify that a CFO of a large UK bank told me explicitly that "one of the major causes of the banking crisis was accounting standards designed for a different purpose" which means that he / she knew very well that they were inappropriate in accurately reporting P&L and Balance Sheet results before the crisis and agreed with the problems being discussed in the Economic Affairs Committee of the House of Lords recently. Having noted that, it is helpful that the FRC has again reiterated in 2008 and 2011 the primacy of the "True and Fair" view to remind Directors and Auditors that this is not about tick box accounting. Worryingly I still know practising accountants who are not even aware of that re-stated supremacy position on True and Fair from the FRC since 2008.

Institutional conflicts of interest

I think it just obvious that trying to combine all sorts of advisory work with statutory audit and setting accounting standards obviously causes very serious problems with conflicts of interest.

We must not allow the conflicts of interest which beset / bedevil the major firms of accountants (in particular, the Big 4) to continue unchecked. Indeed, many people would contend that the "Big 4" are so big, subject to so little competition in working for large quoted companies, have so many alumni and other "incestuous" / "nepotistic" relationships (including such close relationships with regulators) and seek to do so many disparate types of "advisory" work at the same time as conducting statutory audits for the same large clients that they cannot avoid running into "institutional" conflicts of interest. I also think that it is fair to say that the business models of the Big 4 could simply not survive if they only carried out audit work for audit clients. Does this not make it necessary for conflicts of interest to exist?

In this regard, I also refer you to what Andrew Hilton said to me as explained earlier.

As well as the problem of conflicts of interest, there are also important questions of competence (both of the firms themselves as well as their professional regulatory bodies) when accountants develop their advisory practices (to take advantage of commercial advisory opportunities) outside of what most people would regard as their natural areas of expertise i.e. in matters relating to accounting.

For example, it is one thing for a firm of accountants to carry out forensic investigations into accounting frauds where they have an obvious expertise and experience but carrying out broad and deep enquiries (forensic investigations) into, for example, whistleblowing allegations or generally into the compliance of a firm with company law, financial services law and regulation etc is much more within the competence of those experienced in the

judicial or quasi-judicial procedures where the laws of evidence and fair judgement are much more in issue.

It was these conflicts and competence issues that affected me (and others such as Brian Little) so personally when KPMG conducted its "forensic investigation" into my allegations about what happened at HBOS. The work KPMG did in my case also raised serious questions of competence in contravention of the Code of Conduct of The Institute of Chartered Accountants of England and Wales.

The debacle over the "forensic investigation" commissioned by the FSA to be carried out by PwC into RBS post banking crisis is yet a further example of the problems with which we are dealing. It is almost impossible to see how PwC could have been (and seen to have been) completely independent in carrying out such an investigation when it would not be in their interest to find against either RBS or the FSA because it might jeopardise the possibility of future lucrative professional assignments at those organisations. I understand that PwC is one of the largest providers of consultancy services to the FSA.

Reforming corporate governance to ensure a proper separation and balance of power in large financial sector organisations

The FRC need to ensure a truly adequate separation and balance of power in the corporate governance of large publicly quoted, regulated and societally important companies. These very large companies have balance sheets larger than many sovereign governments and the current FRC paradigm of corporate governance is simply insufficient.

Proper corporate governance must include ensuring appropriate reporting lines and formal protections for people who work in the key "control functions" inside such large organisations i.e. risk management, regulatory compliance and internal audit. People who do these jobs have a duty (and in financial services regulation a personal obligation to the regulator) to raise "protected disclosures" (i.e. actual or potential breaches of law or regulation) on a regular day to day basis. They are not the standard type of "whistleblower" and yet are obliged to "blow the whistle" without truly adequate protections. If control functions report to the executive they will never raise all the issues that they should.

As I wrote in my evidence to the Committee in February 2009:-

"In simple terms this crisis was caused, not because many bright people did not see it coming, but because there has been a completely inadequate "separation" and "balance of powers" between the executive and all those accountable for overseeing their actions and "reining them in" i.e. internal control functions such as finance, risk, compliance and internal audit, non-executive Chairmen and Directors, external auditors, The FSA, shareholders and politicians..... The real problem and cause of this crisis was that people were just too afraid to speak up and the balance and separation of powers was just far too weighted in favour of the CEO and their executive."

In relation to banks and other large financial institutions, I do not think the Walker Review spent nearly enough time taking evidence or went far enough to ensure a proper separation and balance of power in the Board rooms and elsewhere of these huge financial institutions. I have written detailed papers about my views in this area which I can share with you if you are interested.

Specific points about cases which the FRC should already have investigated

Before concluding, I feel that I must specifically return to the narrower subject of forensic investigations conducted by large firms of accountants into allegations of misconduct by whistleblowers.

What is abundantly clear to me is that things must change.

Certainly, in relation to the sorts of issues which were raised by Brian Little at Magellan Aerospace and me at HBOS, it must be self-evident to any fair-minded person that the system of relying on supposedly independent forensic investigations by firms of accountants whose independence / objectivity (and even competence) to carry out such investigations is highly questionable.

I raise the question of independence because of the self evident truth that any of these big firms have too much interest in finding in favour of the big client simply because they have the budgets to engage them in future high-paying assignments. The age old truism applies perfectly here “he who pays the piper calls the tune”. It is for this reason that the big firms of lawyers will not represent high profile whistleblowers against big clients because they might lose out on other lucrative assignments – but, at least, they acknowledge their conflict of interest.

I raise the question of competence because the competence required to do this sort of work is actually a competence in the administration of justice not in accountancy i.e. the laws of evidence, disclosure, cross-examination, rights of reply and fair judgment etc.

In any event, it seems to me that if any firm of accountants (or lawyers for that matter) are going to do this sort of work then the engagement must follow commonly accepted principles and procedure of fairness and justice e.g. terms of reference should be jointly agreed, the sources of documentary and witness evidence should be agreed, the investigatory process should be jointly supervised, rights of reply should be given throughout, drafts should be provided to both parties, final submissions should be kept on record and the report should deal very closely with what evidence is accepted and why and what evidence is disregarded and why. In other words, the process should follow a judicial type process with pleadings, disclosure, examination-in-chief, cross-examination and re-examination, final submissions and judgement.

In relation to my own case, apart from the obvious unfairness' which were self evident from the report itself and our legal response to it, how could KPMG ever have thought that they were independent (let alone competent) to carry out such a forensic investigation of my allegations when they were also the auditors of HBOS?

Key questions / issues about the competence of KPMG's investigation into my allegations at HBOS included failing to agree appropriate terms of reference, adopting an unfair investigatory process, failing to interview key witnesses, arriving at conclusions before all the evidence was received (or treating it as if it bore no weight), failing to investigate or corroborate crucial evidence or failing to take account of the evidence that was gathered in a balanced way and failing to provide or allow responses to draft reports.

I can tell you that ex partners of mine at KPMG (who cannot be named for obvious reasons) have agreed with me that the firm should not have accepted the engagement because they were conflicted but also did a very bad job as well.

The overall regulation (rules, standards, supervision, investigation and enforcement) of the accounting profession

It goes without saying that if my view is that a "root and branch" review and reform needs to be carried out into the areas set out above, that "a root and branch" review and reform of the regulation of the accounting profession is also needed.

It may have been the case some decades ago that all professionals were pretty much self-regulating in relation to matters of competence, integrity and independence but, repeating what I said earlier:-

"It seems to me that, in any civilised and developed society, if we cannot be satisfied **so that we are sure** that we can trust and rely on the competence, integrity and independence of our professionals – the very people who are supposed to be the best educated, brightest and most honest people in society - we are in real trouble."

Many professionals and particularly the general public are no longer "satisfied so that they are sure" that this is, in fact, the case. Many believe (and the evidence supports this) that the "fees focus" has taken over. This means, unfortunately, that a more rigorous regulatory system is required for the accounting profession in which more proactive supervision, investigation, enforcement and sanctions are required as a clear deterrent to wrong-doing.

The BIS / FRC proposal at this time on the Reform of the FRC at question 6 to withdraw the FRC's role in relation to individual member or individual member firms professional conduct and leave it to the ICAEW and other RSB's creates additional risk in the system and should **not** be implemented. There are already real questions as to the "cosiness" of the relationship between the profession and the ICAEW.

On a specific point, I am not at all sure that the record "sanction" of £1.4m against PwC for their audit work at JP Morgan as reported last week was anything like a deterrent to change the behaviour and culture in the accounting profession.

Conclusions

In conclusion, the government needs to carry out a root and branch reform of the accounting profession in the UK and re-consider the report from the House of Lords Economic Affairs Committee in its report last March 2011 when it stated at para.110

"*The regulation of accounting and auditing is fragmented and unwieldy with manifold overlapping organisations and functions. This is neither productive nor necessary. Other professions have only one regulator—medicine for example under the General Medical Council. The wider powers sought by the Financial Reporting Council would go some way to simplifying and streamlining matters for audit. But further impetus needs to be given to rationalisation and reform. We hope and expect that the profession will provide that impetus. In the absence of rapid progress, we recommend that the Government stand ready to impose a remedy*."

At the very least, any reform of the FRC **must not** be limited to the change in structure but an overall fundamental review of its scope (to positively and proactively include all professional conduct matters for the accounting profession and be properly funded and staffed by competent people) and a new independent Board with at least 50% members who have never been members of the accounting institutes.

I do hope you find this input useful but please do not hesitate to contact me if you would like to discuss or obtain clarification on any of the matters raised.

Yours sincerely

Paul Moore

[Sent by email and, therefore, not signed]

Appendix 1 – A summary description of my professional experience

I have been a professional adviser and practitioner in the financial sector specialising in the fields of risk management, regulatory affairs / compliance and corporate governance for over twenty five years.

I am a Barrister by original profession. I moved into financial services in 1984 as an in-house legal and regulatory adviser before the first Financial Services Act 1986. I joined Allied Dunbar's (now Zurich) legal department in 1984 advising on product development and implementing the first round of regulatory requirements. I then joined a UK subsidiary of American Express in 1989 as General Counsel, Head of Compliance and Director.

I moved into professional services in 1995 when I joined KPMG to lead their regulatory advisory practice focusing on the retail financial services sector. I led engagements working for large banks, insurance companies and asset managers. More often than not the regulators were involved in our work, either directly or indirectly. I was appointed a Partner at KPMG in 1999. I was involved in helping clients to prepare firms for the new FSA "risk focused" regulatory regime. I worked closely with both Audit and Advisory Partners and gained a deep insight into both the practices and the "mind-set" of the Big 4.

I left KPMG to join HBOS in 2002 where I was first appointed to the Board of the Insurance and Investment Division of the bank as Head of Operational and Regulatory Risk. Having received positive feedback in that Division from both executive and non-executive alike, I was, then, promoted by James Crosby in 2003 to be Head of Group Regulatory Risk for the whole bank when it found itself in real difficulties with the FSA. My accountabilities included setting group wide standards and policies to meet FSA requirements for "systems and controls" including risk management and regulatory compliance, carrying out oversight and assurance work to ensure policies and standards were being met and reporting findings to the Divisional Risk Control Committees and the Group Audit Committee. I do not need to go through the history of what happened at HBOS as that has already been well documented.

After HBOS I worked for a short time between October 2005 and July 2006 as Head of Risk and Compliance EMEA at Marsh Ltd, the largest insurance broker in the world. This was after "The Spitzer Affair" when Marsh was alleged to have "rigged" large insurance bids and was forced to set up a compensation fund for clients of nearly $1bn and re-organise its compliance and governance systems. My time at Marsh was yet another interesting story of what can happen to heads of risk and compliance if they do their jobs properly.