



# HOUSE OF LORDS

Unrevised transcript of evidence taken before

## **The Select Committee on Economic Affairs**

Inquiry on

### **AUDITORS: MARKET CONCENTRATION AND THEIR ROLE**

*Evidence Session No.6. Heard in Public.*

*Questions 235 - 290*

TUESDAY 23 NOVEMBER 2010

3.40 pm

Witnesses: Mr Scott Halliday, Mr Ian Powell, Mr John Griffith-Jones and Mr John Connolly

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### Members present

Lord MacGregor of Pulham Market (Chairman)  
Lord Best  
Lord Forsyth of Drumlean  
Lord Hollick  
Lord Lawson of Blaby  
Lord Levene of Portsoken  
Lord Lipsey  
Lord Smith of Clifton  
Lord Tugendhat

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### Examination of Witnesses

*Witnesses:* **Mr Scott Halliday**, [Ernst & Young], **Mr Ian Powell**, [PwC], **Mr John Griffith-Jones**, [KPMG], and **Mr John Connolly**, [Deloitte].

**Q235** The Chairman: Good afternoon, gentlemen. Sorry we've started a little bit late but we had one or two matters to discuss. This is the sixth evidence session of our inquiry into auditors: market concentration and their role. I should say at the outset that a number of us have declared relevant interests in relation to this inquiry and these are available in the register of members' interests and also in the room and I don't propose to ask members today to repeat all of that. Thank you, gentlemen, very much for coming. We would be grateful if you could speak fairly loudly and clearly for the benefit of the webcast and the shorthand writer. In order to save time, because we have a lot to get through, I would imagine that sometimes in the first answer to the question, the response will have given a lot of the material that all of you wanted to say, so don't feel it necessary to repeat. Simply, if you want to add, please do, but don't feel it necessary to repeat what's been said by the first respondent. Would any of you like to make an opening statement or can we go straight into questions? Mr Connolly.

**Mr Connolly:** Thank you and thank you for providing my firm the opportunity to contribute towards your deliberations on auditor market concentration and allowing me a few

moments to make some remarks. Just a few things I would like to say. First of all, competition and choice in the market is vital but this must not be at the expense of quality, which really is so essential to the proper workings of the global capital markets and financial stability. I do think the degree of concentration in the audit market has arisen as a direct result of market forces and, in particular, the demand from investors for audit quality as well as appropriate capability to undertake complex audits across the world. That said, we would welcome, in my firm, even more competition but, again, not at the expense of quality. I think the solution is to encourage additional competition—and here liability reform is very relevant in terms of how that would influence increased competition—and importantly, to protect against the risk of four becoming three. Here the focus should be on contingency planning such as the living wills approach that has been discussed with banks.

I think the role of investors is important. They are extremely keen on improving competition. I was a member of the Market Participants Review Committee for the FRC and it was clear that there is a keenness to increase the level of competition but, again, not at the risk of quality. I think the role of the Audit Committee could be further enhanced in this respect with clear disclosure required of the reasons for auditor appointment and reappointment including consultation by the Audit Committee Chair with major investors.

Turning to the financial crisis, a topic you've been addressing, I do believe that auditors performed well in the highly complex circumstances of the financial crisis. We did draw the attention of regulators and Government to going-concern issues on high impact clients but there are important learnings and we particularly support the positive steps being taken by the Bank of England in respect of banks and other financial institutions in going back to what is described as the 1990s approach of trilateral meetings between supervisors, clients and auditors. All of our firms are actively involved in trying to deliver that change.

We do support the current relook at accounting standards relating to the timing of loss recognition.

A final point; I do think the focus on non-audit services is somewhat misguided. I believe there are very tough safeguards in place already. This is evidenced by the most recent consultation paper put out by the Audit Practices Board, which discloses that, in the last year, there were no consultancy fees paid to the Big Four by FTSE 100 companies. Where non-audit fees are paid, typically these are for audit-related pieces of work such as half-year reviews and independent opinions on financial information, again particularly in investment circulars. Thank you.

**Q236** The Chairman: Thank you very much. We'll be covering all of these issues and I should say, of course, that we've all read the written evidence that you've given to us for which we thank you very much indeed. That's been very helpful. Can I start with the first question. It's been clear from a lot of the evidence that we've received that there is a great deal of concern about the present audit concentration in the Big Four and particularly, of course, if you look at the FTSE 100 or the FTSE 250, nearly almost all the audits in the FTSE 100 are now carried out by the Big Four and most of them in the FTSE 250. There is also the concern that you've just mentioned, Mr Connolly, of four moves to three. So we've had a lot of evidence of concern about this. Are you happy about the present degree of concentration in the Big Four?

**Mr Griffith-Jones:** I'm not sure "happy" is quite the right word. It is the way it is. I know you've had a lot of evidence that it was eight, then it was six and then it became four. I think it's fair to say that concentration is the natural order of events in our industry. It's a very technical industry. There are many other industries in the world where you get maybe not four but a limited number of players who play at the top of the league and then quite a

diaspora underneath them. I think the natural tendencies to globalisation, the skill set required and the amount of investment required to keep the audit process up to date and a sort of magnet like approach to getting the best people to come and work for us naturally reinforces the arrangements, which is why we need a regulator to prevent it getting any more concentrated than it is at the moment. I wouldn't say it was a good thing and if you ask us whether we would prefer that there were six and we didn't have to sit here answering this question, I think we'd all be very happy to be in that position.

**Mr Powell:** It's worth adding to that as well that the concentration that's there is the result of market choice. I think that it is a very complex product and I think the market does look at the scale and reach of the services that it needs, so as our clients have become more global, as they become more multi-national, they look for that sort of degree of coverage from the audit firms that service them. I think when you start to look at the level of investment that's required across the world, I guess it is understandable that it has come down to a relatively few firms that can afford that level of investment. Just to give you an example, at PwC, our new audit approach has cost something like \$400 million to roll out across the world. The UK share of that is about £40 million. So to be able to service clients that are very complex, that cover so many different territories, with real quality—and that is the ultimate focus of everything that we do, the quality of the audit—then I think you do need this sort of scale of operation to be able to make that investment.

**Mr Halliday:** If I could just add from a competition standpoint, there's a great deal of competition. I think the question is, is there enough choice in the market. I would argue that the profession would improve itself by having increased choice in the market and I think there are some things that this Committee is considering that could help that. For example, removing the only Big Four clause from any banking agreements would be a positive step. I think also encouraging audit committees to really step back and take a look at the

complexity of the audit that they need to have executed by the firm and challenge themselves whether a second tier firm could really be well positioned to execute that audit versus one of the Big Four firms. Part of the solution also has to be for the second tier firms to really rise up and continue to invest to build the global network that the four of us are privileged to be a part of. With the Big Four firms, they need to continue to invest and scale up their business globally. 80% of the FTSE 100's revenues are earned outside of the UK and, therefore, their desire is to really have a firm that can serve them around the world.

**Mr Connolly:** If I can add one small point to the obvious question of whether another firm could emerge as a competitor, there's no doubt that it won't happen quickly but in the case of my own firm, if I go back just 15 years, my own firm had 4% of the FTSE 100 audits and now we have over 20%.

**Q237 The Chairman:** I was going to ask you about that. I think it is 22%, from what you said in your evidence. How were you able to bring that about?

**Mr Connolly:** First of all, a small amount, but only a small amount, of it that does relate to the action we took when Arthur Andersen imploded around the world and we did hire in this country, and in a number of other countries, but in this country, we didn't buy the business but we hired all of the partners and all of the staff. That did facilitate some of the clients, not all of the clients, that they'd had previously, joining us. That added four or five FTSE 100 clients to the roster we had. Mostly, it has been about significant investment every time an opportunity has arisen to compete for a new client and having some success in doing that.

**Q238 The Chairman:** So would it be fair to say, if content is not the right word, you do share the general unease about the fact that it could be four coming down to three?

**Mr Connolly:** No, I don't share that. I would be uneasy about it going down to three; I don't see that is on the horizon at all.

**Q239 Lord Tugendhat:** Perhaps I may ask a supplementary before the main question. You are only four, as we've just been saying, and you are fulfilling an absolutely vital function. I just wondered whether you would regard your relationship with your clients as being much the same as any other commercial relationship between a buyer and a seller or whether you would feel that because of the nature of the service you're providing and the very small number of people providing it at your level, that this is something in the nature of a public good from which benefits and dis-benefits flow to all citizens; not just your clients but the whole investment community; anybody who buys stocks and shares however small. Would you regard your service as a public good that should be judged on that basis?

**Mr Connolly:** Certainly the relationship is different for the reasons you've outlined. The stakeholder community is very wide. Conventionally, if you have a customer and supplier relationship, then there's a narrowness about who the customer is and who you're acting for, whereas in the case of audit, we have to recognise that, first of all, the primary client is not the management who might hire you but is the investor, the owners of the company. But we also have to recognise that the relevantly interested parties are very wide indeed. Speaking for my firm, and I've no doubt this would apply to each of my colleagues here, we believe that our responsibilities go well beyond serving just the team of people who might hire us when we talk about the client.

**Q240 Lord Tugendhat:** Thank you. Then to come to my own question; the ABI wrote, and I do emphasise it was the ABI in 2006, "We are not comfortable with a position where large firms could determine the shape of regulation by threatening to withdraw from the

audit market”. Obviously they feel that you do threaten, or you did threaten, to withdraw from the audit market. Do you regard that, first of all, as a reasonable assessment and secondly, would you agree that since you are only four, any threat to withdraw could be said to be an abuse of a statutorily privileged position?

**Mr Powell:** Certainly from PwC’s perspective, we see audit absolutely at the heart of our brand. We see it as fundamental to what we do. We have no intention of withdrawing from the audit market. We see the investment we make and the people that we recruit, the development of the procedures and systems that we have, are all really designed to get better and better quality of our audit into the future. So we don’t see it as a threat from PwC perspective.

**Mr Griffith-Jones:** It would be highly irresponsible to threaten it if we didn’t mean to go; of that there is no doubt in my mind. Ultimately, if the job became impossible to do and we really were going, I suppose we have a duty to tell people we’re going, but we have no such duty and while I don’t know what the ABI reference was to, certainly my firm, as far as I am aware, has never played chicken with the ABI, or indeed for that matter, anybody else about leaving the audit.

**Q241 Lord Tugendhat:** Can I just come back to Mr Powell’s answer? You said audit is absolutely central to what you do. I wonder if you could just give me your descriptor, as it were. I notice in *The Financial Times* on 15 November, they were reporting some of your activities and they describe PwC as the “professional services firm”. Is that the way in which you would describe yourselves?

**Mr Powell:** We would, yes. We offer a wide range of services to our clients, but right at the heart of the brand—and really the brand has been built off a high quality audit practice for

the last 160 years effectively— as an organisation, while we believe it is important to invest in other areas of the business, we also see audit as absolutely fundamental to what we do.

**Mr Halliday:** Can I just add from Ernst & Young's standpoint, we are deeply committed to the audit market share. We would have no intention to exit it and it defines our brand around the world. It is what we are at our core.

Following up on your question about the relationship, it is very different. One of the cornerstones of our profession is that we maintain an independence from our clients both in fact and in perception and also that we ensure we maintain a healthy degree of professional scepticism as we go about executing our audit work. I do think the relationship is very different from a typical vendor/customer relationship.

**Mr Connolly:** : Can I just confirm for the record that Deloitte has never threatened to withdraw from the audit market, so I don't know what is being referred to in the remarks that were made.

**The Chairman:** Please don't feel that you need to reply to every question. Lord Smith.

**Q242 Lord Smith of Clifton:** How competitive can the large company audit market really be when it is so highly concentrated and tendering and switching rates are so very low?

**Mr Powell:** Just to kick off on that one; fiercely competitive. Every audit that comes up for tender, I think my competitors would also agree, is ferociously fought. I think that the costs of a major audit tender are significant for all of us and I think that the evidence of this is that although there's only four of us in this marketplace, any marketplace that you are in a bidding situation, a bidding environment, so the audit is a tender. So where you have at least two people starting to bid against each other, I think you are going to get a ferociously competitive situation. Certainly if you look at the pricing of audits over recent years, if you

look at the competition that there is between certainly the Big Four firms on every audit tender, it is significant.

The only other thing I would add on this as well is that really the appointment of auditors is undertaken on an annual basis and so, at the end of every year when the audit is reviewed, it is the role of the audit committee to look at the efficiency, the way that the audit is being done, the quality of the audit and that is a tough discussion. It's not as though there is an automatic rollover of audit appointments at the end of every year. There is a responsibility on the audit committee to review the audit and there is an extensive debate on the quality of the audit at that point before the re-appointment.

**Lord Smith of Clifton:** Presumably audit committees vary in the assiduity with which they carry out their duties.

**Mr Powell:** I think the guidance that's been given to audit committees by the FRC is pretty stringent. The way that the audit committees have to report as well in terms of their report to the AGM, their report in the annual report as well, is well laid out and so I think there's quite a lot of focus on the audit committee. So overall, audit committee quality is good. I'm sure it would be the case that different audit committees operate at different levels but broadly, the quality of audit committee debate is intense.

**Q243 The Chairman:** I declare an interest as a member of audit committees in the past. Is there really that ferocious a debate in most of them? It is the one item in the AGM that passes without any comment ever I think. I noticed from Oxera's Consulting Report in 2006 that more than 70% of the FTSE 100 has not held a competitive tender in the last 15 years. That doesn't sound like a very lively competitive tendering market.

**Mr Powell:** Certainly speaking to our audit partners and the discussions that are undertaken with audit committee chairs each year end, these are professional, businesslike discussions and debates.

As regards the rotation of auditors or the changes in auditors, I guess that also reflects the fact that there is a cost to a company of making that kind of change. Also, there is the discussion that's ongoing about the overall quality of the audit as they perceive it. So if a client is happy with the quality of the audit and is happy with the provision of the services, then that is the depth of the discussion in reaching the decision whether they want to go out for an audit tender or not. It is important that the audit choice is the choice of the client as to whether or not they want to go out for tender.

**Q244 Lord Forsyth of Drumlean:** I don't want to press you on this but just on the Chairman's point about Oxera. I must say I find it very difficult to take this argument that it's really competitive when, according to their figures, which I see you're not really disputing, the switching rates for a FTSE 100 company are every 48 years; for a FTSE 250, every 36 years and for all listed companies, every 25 years. How can you possibly argue with a 4% churn every year that that's a competitive market?

**Mr Griffith-Jones:** I think it's important to understand what happens before it actually gets as far as a tender. Let us assume that there is unhappiness or relative underperformance, which is the most common cause of potential tender. We as a firm obviously would take such circumstances very seriously and basically offer to either change the team or improve the procedures or essentially to be given another year to sort ourselves out. If you look at it from the audit committee's perspective, it seems like a logical decision to say, "Okay, let's see: either yes or no". Very frequently, they decide pragmatically and they decide, I hasten to add, not us. It doesn't happen all that often, but it does, of course, happen, that they decide

whether to go for a tender or for rotation. Now, you also have to bear in mind that audit partners since, I think, 2005 or 2006, have had to rotate every five years and the team under them, by natural affluxion, rotates as well. So it's not as though the same people are doing the audit year after year.

**Lord Forsyth of Drumlean:** In 48 years, they'd all be dead; long since retired.

**Mr Griffith-Jones:** But seriously, you have a new team. From the public good angle, you have a new team looking at the audit on a rotation basis every five years without changing firm and given the loss of corporate knowledge by changing, and you weigh up the respective advantage and disadvantage of that, I can only tell you that is my perception of why it is the clients that decide to keep us because it's certainly not us who have the right, as it were, to stay there indefinitely.

**Q245 Lord Hollick:** I want to take up Mr Powell's point about the cost of moving from one auditor to another. It would be interesting for the Committee to know, as a percentage of the annual audit fee, what is that cost and would it not be the case that in a truly competitive marketplace, the incoming auditor, the winning auditor, if you like, would ease the path and sharpen their pencil to remove this problem?

**Mr Powell:** I would guess that it would be the cost of disruption to a company as well in terms of the need to be involved with a new team. That loss of corporate knowledge that has just been referred to would also be an additional cost. We did some work on this as a firm to try to just evaluate what the potential cost of a move could be to a company and the estimate was between £500,000 and £1 million in terms of the disruptive cost, if you like, to the company itself. I think it's fair to say that might not be substantial in the overall context but I think in terms of a cost that might not need to be incurred because people are satisfied with the quality of the work that is being done, that is something people take into account.

**Mr Halliday:** I would offer to the Committee a couple of thoughts on this because I think it's an important area around audit committees. I apologise for my voice; I'm fighting off a cold. One of the things that we see in some countries around the world is that there's a statutory reporting relationship between the external auditor and the audit committee. So it is by law clear that the audit committee is hiring the firm. I would offer that as something to think about as well as requiring that all fees paid to the external auditor are approved by the audit committee. Together with that you might consider a report that was externally issued by the audit committee that talked about the duties that are carried out in performing this important governance function. So I would offer those things for the Committee to reflect on.

**Mr Connolly:** Can I just add a point that I think is relevant. Increasing the rate of change in auditors, at the end of the day, is up to the companies. That, in itself, doesn't necessarily deal with this concentration issue. There are a small number of countries in the world, not many, where there is mandatory rotation but it doesn't lead to a change in concentration. In Italy, for example, there is mandatory rotation and the Big Four still dominate the audit market. So that, in itself, doesn't lead to change. I think requiring audit committees formally, making it a legal requirement, for them to record and report in some detail how they arrived at the decision to appoint, reappoint or not reappoint the auditor would be helpful because that would cause the audit committee to focus explicitly and that might lead to consideration, particularly in the light of the sort of statistics you referred to.

**The Chairman:** We must move on because we have a lot to cover. Lord Hollick.

**Q246 Lord Hollick:** We've received a number of suggestions about how to address the concerns about the dominance of the Big Four including breakup, prohibition on consulting for audit clients, joint audits, abolition or relaxation of the statutory requirement for audits,

and the appointment of advisers to board risk committees, independent of the auditor. It would be interesting to know your views on the feasibility of these measures. Do you think they would be desirable?

**Mr Connolly:** First of all, I think the concept of independent advisers advising risk committees is a good one. If that was adopted, I think that is a good change. I really don't see that some of the other options that are referred to would be feasible. I'll just pick on one of them and perhaps colleagues would pick on others. When we talk about the concept of breaking up the Big Four, firstly it's a fairly artificial thing to seek to achieve but clearly, if the law said in this country that we had to divide ourselves in some way, then we would have to do that. We do have to remember that doesn't solve the situation globally because we have big global networks and if we divided, my firm illustratively, into two, then one of the firms perhaps would have a global network and the other one wouldn't. Now, if in fact we said, "Well, what we'll do is you can both use the same global network", then you ask the question, "Well, has that really achieved anything if the same firm outside of the UK is continuing to do all of the work for each of these two firms that have been broken up?" particularly recognising the comment made earlier that 80% of the business of FTSE 100 companies anyway is outside of the UK. So I really don't see the feasibility of that.

**Mr Powell:** Just to add on the breakup point as well, to break up the firms would restrict the amount of investment monies that would be available in order to continuously improve the quality of the audit service and to serve increasingly complex and multi-national organisations.

**Q247 The Chairman:** What about the prohibition on consulting? What impact would that have; what effect?

**Mr Powell:** From PwC's perspective, less than 10% of our consultancy business is spent on audit clients, so it's a relatively small amount. Interestingly as well, this is a highly regulated and reviewed area. The AIU review this as part of their annual procedures in looking at the audit services that we've offered. Also there's been quite a lot of consultation on this. I think APB have been consulted; have had consultation papers out twice in 2009 and again in 2010. There was a lot of response to those consultation papers with overwhelming views that the way that things are organised at the moment is working and that the discretion that's left with audit committees, and is left with clients and with the audit firms as well to review our relative independence in terms of the provision of those services, seems to be working.

**Mr Halliday:** One of the things our firm is very focused on is globalising our network. If you look at the activities that we've undertaken across the Americas and also across the Asia-Pacific region really to accelerate the globalisation of our firm they really had two main drivers. One is what the market was asking for, to be able to serve them on a seamless, consistent and cross-border basis, but also at the heart of it was to improve the quality of the audits that we would execute. When you think about a company that has far flung operations somewhere on the other side of the world but they're headquartered right here in the UK, we will undertake, in this effort to globalise the firm, strengthen our processes to be able to best serve those clients around the world. That's why the scale in size, coming back to your breakup point, is so important for the firms to be able to continue to execute high quality audits for companies that have far flung operations around the world.

**Mr Griffith-Jones:** Shall I deal with joint audit? I think you've had evidence from Mazars, but the only country really that has a major interest in joint audit is France. I think it's important to realise that part of the reason the French had joint audit was to protect the French national auditing profession from what they regard as the Anglo Saxons and by having joint audits, they had one of the big firms and one French firm. Over time, this has condensed

down. Now, if you take the CAC 40, which is the top 40 companies in France, there are five, not four. In fact, Mazars' market share is pretty much identical to KPMG's in France but it hasn't led to any broadening. There was a sixth, which was called Salustro, which merged with KPMG three years ago. So joint audits, per se, don't enhance competition. What they do question is whether they improve quality. I know the French argue that the system works, as far as they're concerned, perfectly satisfactorily, but we have had various examples in the UK, while not necessarily joint audits in the sense of being joint at the top, but having more than one audit firm involved where fraud, and particularly fraud, has deliberately got through the cracks by playing the two firms off against each other in different jurisdictions or different year ends. I refer particularly to BCCI which was probably the most famous example, and without prejudicing my colleagues around the table, Parmalat is another example. While there is no strong evidence either way that two firms are better than one, there is some evidence that two firms can lead to a weakening of the audit relationship where someone is deliberately trying to commit fraud; not, I may say, where there's an accidental error.

**Q248 Lord Lawson of Blaby:** May I follow on from what Mr Powell said? I think I heard you say that it's only 10% of cases where you do internal audit or other consultancy type stuff for clients for whom you are the external auditor.

**Mr Powell:** Yes. Not internal audit but in terms of our consultancy fee, only 10%.

**Q249 Lord Lawson of Blaby:** How about internal audit? What is the percentage for internal audit for external audit clients?

**Mr Powell:** As a firm, we don't outsource internal audit services at all.

**Q250 Lord Lawson of Blaby:** So, in fact, since this is so small for you, all this stuff, it wouldn't be of any great concern for you if that were prohibited.

**Mr Powell:** I think there's a wider discussion about this as well, which is around the capacity, if you like, of firms to recruit the very best people and to develop those people as well. For example, if you are recruiting great graduates, they come to our firm because they want to gain great business experience across the whole gamut of the business. So they want to work in audit, they want to work in consultancy and over the years, as they develop their experience, because we're a firm that can offer those of kinds of experiences, as they move back into audit practice, they are much better auditors because of the quality of the training and the experience that they've had. I'd argue that we are better auditors because of the other services that we offer as well.

**Q251 Lord Lawson of Blaby:** But you don't need to offer them to the same client; that's the point. Of course you can offer these services. The question is whether you should offer them to the same client. As I understand it, it's pretty small beer, the extent to which you do this and, therefore, you wouldn't be greatly exercised if that was prohibited.

**Mr Powell:** But it would be an artificial restriction if we couldn't offer those services to all of our clients. Ultimately, it's the client's choice as to whether they buy those services from us or not and it is heavily regulated. It is reviewed. We review our own independence. We take this very, very seriously in terms of whether any of the work we undertake for our audit clients could ever accuse us of being prejudicial to our independence. I think it is highly regulated. If our clients buy services from us, and I'm sure that you've seen the trends as well, generally non-audit services to audit clients over the last few years have reduced and I think that generally, our clients look to buy from their audit firms when they feel as though they can get the very, very best from their audit firms. I think if we said, "Look, we won't sell

any services to our audit firms”, that would be a restriction on the choice of clients. Also, it would prevent them from making a decision as to whether they’re buying the best services or not.

**Mr Halliday:** I think one of the areas on this subject that’s being looked at is the disclosure of the non-audit services. The Auditing Practices Board is looking at improving that and adding more transparency to the nature of non-audit services.

**Q252 Lord Hollick:** Is there not a conflict of interest though at the heart of this because you’re providing advisory services, let us say, on taxation and tax planning, which is a major part of the professional services you supply, and then another group from your firm come along and audit the same thing? Doesn’t that present you with a real conflict of interest?

**Mr Powell:** No because the independence rules are very strict on this. They’re reviewed by the audit committees; they’re reviewed by ourselves in terms of the provision of those services. We would not put ourselves into a situation where we had to audit a work that was undertaken by the firm in a different way. So the independence rules are very strict on this. As I say, we apply them and so we are very careful not to put ourselves into a conflict situation.

**Q253 Lord Hollick:** Who would audit that work then?

**Mr Powell:** The question is whether that work, as it’s done, needs to be subject to audit. It really works the other way. If we are the auditors of an organisation, if we review, let’s say, a piece of tax planning and say, “We can’t do that piece of work because we would bring ourselves into a conflict situation”, that piece of tax work would be done by someone else. That piece of work wouldn’t be let by the company; it wouldn’t be let by the audit committee and we wouldn’t take it anyway.

**Mr Connolly:** I think this is the point because there are explicit rules already in existence that fundamentally say that you cannot audit your own work and there's then a whole range of very specific exclusions. To the point that Lord Lawson made, as a matter of fact, the APB's recent paper, as I referred to earlier, did conclude that in the last 12 months, no FTSE 100 company paid anything to their auditors for management consulting services. Where you get into some difficulty from the perspective of the companies, if you just have a blanket elimination of doing anything other than the audit, is those areas of work where the client concludes that because of the special knowledge and experience that the auditor has, there are certain things that they would have a preference for the auditor to undertake and it might be because of security, confidentiality and speed; but they can still only select things that would not cause there to be an independence issue for the auditor.

**Q254 Lord Levene of Portsoken:** In effect, the audits that you are doing are reports to the owners of the businesses, which are the shareholders. To what extent do you have a dialogue with large shareholders of the principal companies in the FTSE rather than just talking to the companies themselves?

**Mr Griffith-Jones:** At the moment, very rarely, if at all and that's through convention and the way it is. The audit committee is taken to represent and act in the interests of the shareholders. The shareholders are not very active in coming to general meetings with our firms. We offer to meet them on a general basis. The issue of meeting on a specific client is clearly confidentiality because what they want to know is something of market advantage to themselves and clearly, unless you had all the shareholders in the room at the same time, to talk to one group of shareholders in advance of another and to give qualitative views on one's clients would not fit comfortably into the rules in the way they are operated at the moment.

**Mr Powell:** It is going to be interesting under the new audit firm governance code as well because one of the requirements of the code is to facilitate the dialogue between investors and between the auditors. There's not much guidance in the code as to the best way to do that. We've put together our public interest group, which is five senior people. We are working with them to decide what is the best way to try to meet that requirement of the audit firm governance code. I think there will need to be some dialogue between investors. We just need to design what the best way to do it is. This is a brand new code. It's only just at the point of being rolled out during the current year ending 30 June 2011. As we're working through that, that is going to be an interesting area as to how we stimulate that level of discussion between the auditors and between the investors.

**Q255 Lord Levene of Portsoken:** Would you welcome the opportunity to have that dialogue?

**Mr Powell:** Yes, we do; very much.

**Q256 The Chairman:** Are there any other comments that any of you want to raise on all the different alternatives and suggestions that have been put to us and that Lord Hollick referred to?

**Mr Griffith-Jones:** Can I just come back, very briefly, to this question of risk committees? I think it possibly goes into the banking agenda which I suspect we may get to later. I personally believe that the auditors have an important potential role to play around the risk area and to mandate the auditors out of the loop that risk advisers have to be, as it were, not the auditor; we need to be careful with the definitions that we use. I quite accept that they shouldn't be advising but if the consequence of having a separate set of risk advisers is that the auditors do not get involved in risk, I think that would be to miss a major learning

from the financial crisis and that we must be careful how we structure those rules. I also think that the chances of a risk adviser being another audit firm are by no means 100% and it's certainly not a way of increasing competition. It may be a better way of auditing banks but put forward as a solution to competition, I do not think it's a particularly valid argument.

**Mr Halliday:** I was just going to offer that this is a really important area for the Committee to reflect on because I think trying to better identify systemic risks that exist in different sectors is one of the learnings from this. If you look at the banking crisis, all four of us had meetings with the Bank of England around trying to improve the dialogue between the Bank of England and the firms. I think there's more that can be done in that area including the use of—I think they are referred to as 166 reports in this country—and more of a dialogue going both ways with auditor and the regulators. One of the things FRC has done is that next week, or the next two weeks, we're going to be visiting with them on what are the systemic risks going into this year end reporting season. I think those are healthy discussions because all of us are going to come at from a little different place but I think if we sit down and create a dialogue to occur, we'll have a better opportunity to identify the systemic risks that are in those sectors.

**The Chairman:** This is an important area and we will be coming back to that later. Lord Tugendhat.

**Q257 Lord Tugendhat:** Just coming back to the French situation, I understood you to say, and others have said, that the joint audits haven't led to an improvement in the quality of audit and I can imagine that is so. What they surely do provide the French with is some element of insurance if anything happens to one of you. One of the systemic risks, which we have at the moment, is that there are only four of you; there were five and Arthur Andersen came unstuck. We live in a world in which some of the largest banks in the world have

suddenly had to go into government ownership virtually. We don't know what's going to happen. The substitutes bench argument for developing a reserve capability in the event of a crisis in one or other of your firms; surely the insurance argument has some strength.

**Mr Griffith-Jones:** The only answer I can give is that it hasn't created a substitutes bench in France. There's one more but they were always there and they were there because of the way it was structured originally. So the other mid-sized firm is not on their substitutes bench any more than it is on the UK substitutes bench; at least at the top end of the market.

**Mr Halliday:** I think you have to keep at the heart of it that it is good for the quality of executing the audit. If you just think about two vendors or two firms having to have two dialogues with management, two dialogues with the board, there's an opportunity for gaps to exist. To turn the argument around, you could argue there's more systemic risk because if something went wrong with that company and there was damage to the brand of the two firms that audited that company, the result could be the collapse of two firms. Our firm strongly believes that having a single auditor will resolve in the best communication with the board, the best communication with management and resolve in the highest quality audit.

**Mr Powell:** It's worth noting as well that there is nothing that prevents a joint audit. It's the fact that the market, over a period of time, has decided that these are not as efficient and maybe from a quality perspective as well. I can't remember when the last joint audit fell away but it was probably in about the last five or six years. The choice is there if people want to have a joint audit but it's the market that has chosen that joint audits are not something they would want to buy.

**The Chairman:** We have spent quite a bit of time on this question because it is very much at the heart of one part of our inquiry. I think on the next questions, if we could move a little swifter, it would be helpful. Lord Lipsey.

**Q258 Lord Lipsey:** Thank you. You were just referring on risk committees to the evidence given by Baroness Hogg and it led me to reflect that a few years ago, the FRC put forward a number of proposals which it said would be a market-based solution to the problems of concentration. When she appeared before us, Baroness Hogg--and I don't like to summarise her too briefly--said that these had not worked and came up with the suggestion, for example, which you just made with regard to risk committees. My question is this. The new publication from the FRC jointly with the ICAEW, the audit firm governance code to which you also referred a minute ago, Mr Griffith-Jones, that came in in January 2010 possibly with similar sets of objectives. I wondered if there was any chance that would be any more effective than the last FRC market based solution.

**Mr Griffith-Jones:** I sat on the body that generated the code, so I declare an interest in it as well. I think it's an excellent idea. Mr Powell said they've just announced their public interest group; we're on the cusp of announcing ours. Benefits will be felt and I would hope it would promote confidence in all the firms that adopt it. It includes the next four down the list. I do have to say that then you will have eight firms all complying with the code. So whether it will be a point of major differentiation, I can be less certain, but I think it will lead to an absolute improvement in overall quality.

**Mr Halliday:** The UK should take great credit for the production of the UK governance code. It's being adopted and looked at across the globe right now. As a result of it, our global board has decided to implement the UK audit firm governance code at a global level and we are in the process of putting independent, non-executive directors on to our global governance code. Obviously one will also be domiciled here in Britain but one will be from the Americas, one from the continent of Europe and one from the Far East. It will really be consistent with the global nature of the firm in which we operate to have those independent

directors up at the global level evaluating and overseeing what we're doing. This is a huge step forward for the profession and I think the UK should take credit in driving this.

**Mr Powell:** One big advantage of this, having had the benefit, if you like, of the very first meeting of our public interest body, is the quality of people that are prepared to act on these bodies. They're not the sort of people who would put their names to something that wasn't likely to have real teeth and to work. The real big advantage of this is transparency because one of the big reasons for having independent directors, independent non-executives, on the audit firms is also to look after the public interest as well. So as we analyse the code and as we decide the best way to apply that, working with our public interest board, one of the key areas, as we referred to earlier in terms of the discussions with investors, is going to be around transparency. That will be one of the big benefits.

**Q259 Lord Lipsey:** So just to be clear, it will deliver quality, you hope. It will deliver transparency. It is not particularly about widening choice and dealing with the widening choice issues.

**Mr Powell:** Only to the extent that, as the audit firms are more transparent, people can look at the way that the firms are run and make a decision as to whether they want to move to a wider choice.

**Mr Halliday:** If there was an Andersen moment involving one of the Big Four firms, having independent non-executive directors who could step in and assist in that situation would be very helpful.

**Q260 Lord Best:** It has been suggested that audit is implicitly a form of insurance, even though obviously it isn't formally that, and we have heard the views of Professor Joshua

Ronen of New York's Stern School of Business. Do you think there is any merit in Joshua Ronen's financial statements insurance approach? Is there anything in this?

**Mr Connolly:** I have to say I'm not an expert in the detail of what he has proposed but I did, in the light of this prospective question, spend some time looking at it. I am aware that this has been around for seven or eight years as an idea and that it has explicitly been examined in the US by the SEC and rejected as something that is practical. When you look at the detail of the proposals I think one of the key features is the assertion that audit quality would be improved if the auditor was doing the work for somebody or is hired by somebody other than the company.

Again, even when you read the detail, there is a suggestion that the intensity of the auditors' work would change. I find it very difficult to appreciate why that is a platform for the new idea. But it also is extremely costly. It introduces, again as far as I can see, a new layer of activity. It talks about each company having underwriting reviewers who would examine the entity and their control environment and the probability that there could be an accounting error. So another raft of activity would take place which would have to be paid for.

The audit still has to be done, so the audit cost doesn't change, and you then get right down to the heart of it and that is: is the insurance going to be available? Now, when we look at the insurance that is available for firms like our own in respect of audit failure, it is very, very limited indeed. There is not enough insurance in the insurance market to cover the market capitalisation of a single FTSE 100 company, let alone the whole market, so I do not know why there is the view that this insurance would exist.

A final point that I would just make, which I did find fairly odd, was that companies would pay their insurance premium as well as all of these other costs and if the auditor qualified the financial statements and then there was a failure, the insurance doesn't pay out because the accounts were qualified. They only pay out if a mistake is made when the accounts weren't

qualified. So it just seemed to contain a lot of very impractical features to me and it does seem that experts, much more expert than me, have examined it in some detail and rejected it as being practical.

**Mr Powell:** I would also disagree with the statement that an audit is an insurance. I think there is quite a distinct difference between insurance and assurance and I think that audits add a lot more value to the development of businesses, and to giving assurance as regards trust in capital markets, than just underwriting a loss.

**The Chairman:** That is a fairly comprehensive demolition, so we can move on.

**Q261 Lord Levene of Portsoken:** Would you agree that by about the middle of 2007—and I am talking about the banks now—the writing was sufficiently on the wall about the global financial crisis for auditors to have sounded serious notes of caution well before their report on the 2008 year-end statements? Was this a failure of the audit and, if there are lessons learned from that, what changes are going to be made to try to avoid it in the future?

**Mr Powell:** Can I pick up on the last point first, which is that I think there are lessons to be learned from this. I think everybody has lessons to learn, including us as auditors. One of the key elements for me is, when you look back at the Banking Act 1987, there was a real encouragement at the time for a dialogue between regulators and auditors. That seems to have slipped away with the FSMA Act and we referred to it a little bit earlier in terms of the discussion that is ongoing with the Bank of England and the regulators at the moment as to how we can rebuild that communication between auditors and regulators to try to make sure that there is a sharing of information as we come into more difficult times.

**Q262 Lord Lawson of Blaby:** If I may come in on that particular point that you raised—I was the author, as you know, of the 1987 Banking Act and the provision for there to be a

regular dialogue between auditors and regulators was something that I attached enormous importance to. To begin with, that happened. But, as you say, it slipped away; it stopped happening. Can you explain why?

**Mr Powell:** It didn't transfer across as a compulsory into FSMA.

**Lord Lawson of Blaby:** No, it stopped happening.

**Mr Powell:** I think you would be reassured by the discussion that we had with the Bank of England, with the other regulators. There is a working party on this between the big audit firms or six big audit firms and the regulators at the moment to see how we can develop that and get that back into being an automatic part of the relationship between regulators and auditors.

**Q263 Lord Lawson of Blaby:** May I pursue this further, Chairman? I was slightly surprised. In his opening statement, presumably on behalf of all of you, Mr Connolly explicitly said—and I think I took this down right; if I didn't I'm sure he'll correct me—that, so far as the question of auditing the banks is concerned, the auditors performed well. That seems to me to be extraordinarily self-satisfied in the light of what we now know to be the case. How do you justify that statement?

**Mr Connolly:** First of all, let me say I wasn't representing my colleagues when I made that statement.

**Lord Lawson of Blaby:** All right. On behalf of yourself then.

**Mr Connolly:** So on behalf of myself—

**Lord Lawson of Blaby:** You would know about it because you were the auditor of the Royal Bank of Scotland Group, weren't you?

**Mr Connolly:** That's right.

**Lord Lawson of Blaby:** Which went belly-up within a few months of your giving it a clean bill of health.

**Mr Connolly:** Yes. Well, of course, it didn't go belly-up. It was supported and that's—

**Lord Lawson of Blaby:** No, it went belly-up. That's why it was supported.

**Mr Connolly:** There is a difference. No, there is a very important difference. But, first of all, in terms, the question that Lord Levene asked and which you are pushing back on now is, "Was there a failure of audit?", and I don't think there was. I think that the environment was such that the complexity of the financial environment at that time caused there to be a hugely intensive effort from auditors, recognising the onerous nature of their role. As a consequence of that, we dealt with very significant complex audits and had very important decisions to make around our audits.

I think that it's relevant to note that the independent inspectors who look at the work of auditors have generally found, from their reviews of all of the firms, that the bank audits were of a high quality. That is what they reported. In no case has there been a requirement to restate the financial statements, which would have been required if the financial statements had been incorrect. On the point you're making about "Did it go belly-up?", one of the vitally important issues we all faced was how we dealt with the going concern question.

All four of the people here had detailed discussions, instigated by the Big Four, with Lord Myners because of the circumstances we were in. It was recognised that the banks would only be going concerns if there was support forthcoming. The management of the banks, first of all, who make the initial decision as to whether they conclude they are still a going concern, had to take into account all circumstances, including the likely availability of support, in concluding that they were a going concern. We had to take into account all the available evidence in reaching that conclusion. I think it was a proper and appropriate act

from the four firms to seek to understand the likelihood of support being forthcoming and I can only say that had we concluded—and I assume had management of the banks concluded—that there was not going to be support, then a different audit opinion would have been given.

**Q264 Lord Lawson of Blaby:** I find that absolutely astonishing.

**The Chairman:** So do I.

**Lord Lawson of Blaby:** Absolutely astonishing. It seems to me that you're saying that you noticed that they were on very thin ice but you were completely relaxed about it because you knew that there would be support; in other words the taxpayer would support them, so there was no problem. That's what it seems to me you just said.

**Mr Connolly:** No, not at all. What we were aware of, very aware of, was that the consequences of reaching a conclusion—had that been the proper conclusion to reach—that a bank was going to go—

**Lord Lawson of Blaby:** Belly-up.

**Mr Connolly:** Belly-up, to use your term. The impact that that could have had was huge. The requirement of the auditor is to satisfy itself—the requirement first of all starts with management—that that will not occur; however it might not occur, that that will not occur.

**Q265 The Chairman:** But I think you said at one point, “likelihood of support”, and then at another point, “viability of support”. What conversations did you have with Government to enable you to come to that conclusion; that it was likely to happen?

**Mr Connolly:** We had conversations that sought to understand the likelihood of support being forthcoming.

**Lord Lawson of Blaby:** At what point?

**Mr Connolly:** I believe the initial meetings we had were—was it December?

**Mr Griffith-Jones:** December 2008.

**Mr Connolly:** December 2008 and later again in January.

**Q266 Lord Forsyth of Drumlean:** Are you saying that, looking at the position, you thought that the bank was likely to be in trouble but you couldn't possibly say that because that might precipitate the crisis and, therefore, by giving assurance you took the view that the accounts were okay?

**Mr Connolly:** I think it would be wrong to say we couldn't possibly say it if it had to be said.

**Mr Powell:** I think, just in general terms on this—personally I wasn't at that meeting although my firm was represented—the reason that banks got into real difficulty was the closure of the wholesale markets, and the closure of the wholesale markets in the second half of 2007 created real difficulty for many banks. As the auditors, one of the things that we have to do is look forward—and it's the same whether it's a bank or whether it's any other type of firm—at the liquidity that is available. One of the key questions around the banks in signing off the audit opinions at the year-end 31 December 2007 was, “Is there adequate liquidity available to this bank to enable us to form the view that the bank is a going concern and we can sign off a going-concern audit opinion?”

The discussions that have been referred to were around, “Is there adequate liquidity or is there likely to be liquidity provided to these banks to survive?” That was the depth of the discussion, as I understand it, in December 2007 and in 2008. Based on the assessment that we took as the four large audit firms, and based on the assessment of the availability of that liquidity, we then had to go away and form a view and our auditor partners had to form a view as to whether or not we could sign off a clean going-concern opinion on those facts. That is the process that we went through to enable us to form that opinion.

**Q267 Lord Lawson of Blaby:** But the question of liquidity in the wholesale market and so on was only one of the elements. It wasn't the only element. There was also extremely risky business being undertaken which was a threat to solvency. They were not insolvent at that time but there was a threat to solvency there and that is clear. So I am still astonished. I am still not clear, first of all, whether you thought that, as Mr Connolly says, it was perfectly all right because there would be a bail-out or whether you didn't notice there was anything wrong or whether you did notice something wrong but you thought you shouldn't say anything to the regulators. As far as I can make out you didn't say anything to the regulators at that time.

**Mr Powell:** No. Can I just talk you through the Northern Rock situation?

**Lord Lawson of Blaby:** Yes.

**Mr Powell:** Just a little bit of history on Northern Rock: we signed off the audit opinion on Northern Rock, which was for the year ended 31 December 2006 on 25 February. At that point the wholesale markets were open. Commercial paper in Northern Rock was heavily oversubscribed. As the year went on, I think one of the early signs in this was when BNP Paribas, I think it was, issued a statement that there were liquidity issues. That was on about 9 August.

Now, in the early part of September we spent time with Northern Rock and we formed the view that there was something that we needed to report to the FSA. So our contact with the FSA was on 11 September when we called the FSA to say that we had concerns about the going concern of Northern Rock. That was followed up by a letter and then quickly followed up by meetings with the FSA. So I think it is wrong to say that we didn't. I know that is just the Northern Rock example. I can't speak for what—

**Q268 Lord Lawson of Blaby:** You say you did that with Northern Rock. What did the FSA do when you did that?

**Mr Powell:** Well, we reported it to the FSA. I think the Bank of England were involved as well at that point and so Northern Rock asked for emergency support from the Bank of England on 13 September and were granted that.

**Q269 Lord Lawson of Blaby:** So it was at the last minute. Since we're talking about specific banks, may I ask a question? It's very dangerous to ask a question to which you don't already know the answer, so I am laying myself wide open, but did any of your four great companies audit either Allied Irish Banks or the Bank of Ireland?

**Mr Powell:** I'm not sure. I'd have to get back to you on that one. We didn't audit Allied Irish but I don't know whether we audited Bank of Ireland.

**Lord Lawson of Blaby:** So you don't know?

**Mr Powell:** Well, it would have been audited—

**Lord Lawson of Blaby:** Your colleagues don't know whether they did?

**Mr Connolly:** I know we didn't.

**Mr Halliday:** I know they're not us.

**Mr Powell:** Which would tend to imply it was probably us.

**Q270 Lord Lawson of Blaby:** Yes. That sounds circumstantial, yes. So did you notice anything wrong?

**Mr Powell:** I can't speak on Bank of Ireland, to be perfectly honest. I mean, whether that was one of our audits or it was audited by our Irish firm as well, as opposed to the UK firm—

**Q271 Lord Lawson of Blaby:** Your Irish firm is wholly owned, isn't it?

**Mr Powell:** No, it's not wholly owned.

**Lord Lawson of Blaby:** It's wholly separate, is it?

**Mr Powell:** Well, the structure of an organisation like PwC is a series of network firms—local partnerships. But I can look into the Bank of Ireland situation if you would like a written response on that to give you more detail on it.

**Lord Lawson of Blaby:** I think it would be of some interest, yes.

**Mr Powell:** Okay.

**Q272 Lord Tugendhat:** I was going to ask the Irish question but that's been asked, so I shall ask a different question. The situations that arose at the Royal Bank of Scotland and HBOS, for that matter, and Northern Rock were all, at the time that they arose, unprecedented. Nothing like it had been seen in the professional lives of the people concerned. If I might ask you this: do you feel that at the top of your own firms you were sufficiently abreast of the potential dangers at RBS, at HBOS and at Northern Rock or was this information of a very unusual nature kept too close within the audit teams responsible for those banks?

**Mr Connolly:** Speaking in my case, I have a reasonable degree of confidence that knowledge that was possessed by those undertaking the audits would not have been retained with those partners who were undertaking the audit, primarily because there was an awareness of the significance of the complexity of the market—in our case, particularly recognising that the lead partner responsible for the Royal Bank was one of our most senior partners in the top leadership team.

**Q273 Lord Tugendhat:** In the case of HBOS and Northern Rock?

**Mr Griffith-Jones:** Certainly in our firm—and I am aware of this—there were very intensive and weekly telephone calls between the senior bank auditors over the 2007 year-end. So I think we were completely aware of what was going on in the world but, like most other people in the world, didn't appreciate what was going to happen, especially to Lehman Brothers, in September 2008.

**Q274 Lord Forsyth of Drumlean:** Just on that point, can I ask a question? I have asked it a number of times during the course of this inquiry. I don't understand; seeing balance sheets being so extended, seeing the kind of growth that there was at Northern Rock, seeing the multiples that were being lent—why would that not sound alarm bells among the auditors at an earlier stage and some questions about “Is it really sensible to be lending 39 or 40 times?” or whatever the number was? Why did that not happen?

**Mr Griffith-Jones:** With hindsight, it is, of course, a pretty good question and I'm sure people have struggled to answer it.

**Lord Forsyth of Drumlean:** But when we discovered the extent to which the balance sheets were extended we were all shocked.

**Mr Griffith-Jones:** The first point is that the auditor's primary role is to count the score at the end of the accounting period and that they do. It is a look-back exercise. Sure, it has this obligation to look forward on a going-concern basis but not a look-forward other than that. So we are not trying to forecast next year's profits.

Secondly, it is not responsible—and this is interesting learning from the whole thing—for making an assessment of the risk of the business. So, for example, if you have a company that has leverage of 100 times and a company that has no leverage at all, the audit report is the same, or up to now has been the same. It is not the role of the auditors to say to the company, “Your business model is different from your competitor's business model”.

Whether it should be, going forward, is an open question but it is not a statutory obligation and it is not a generally understood one. It is the role of the auditors to point out weaknesses in controls. But weaknesses in controls as opposed to a different business strategy, I would suggest, are rather different things.

With respect to Mr Powell, who should probably speak to Northern Rock rather than me, everybody knew what Northern Rock's business model was. Everyone was buying shares and indeed rating Northern Rock extremely highly because of their rather clever business model, which with hindsight, of course, was not the case. But I don't think it was the auditors primarily or particularly—

**Q275 The Chairman:** Maybe I am getting the wrong impression but I got the feeling that you were suggesting that there was sufficient concern at the top levels of your firms and also in relation to the possible viability of support from the Government that you were raising these issues before you signed off, which suggests that you were having concerns about it being a going concern.

**Mr Powell:** I think that was—

**Mr Griffith-Jones:** That was 2008—it is rather important, that—not 2007.

**Mr Powell:** It was the year 31/12/2007, wasn't it? So as we moved into 2008 we were looking at the audit opinions on the banks that were at 31 December 2007. Clearly the market had moved at that point. Everybody was aware of it. At the tops of our organisations, we didn't have perfect hindsight either. But we were heavily involved as soon as we realised just the scale of the issues and what the issues were. Sorry, just to complete the point as well on Northern Rock—when you're undertaking an audit you do look at the market conditions that were extant at the time of signing off of the audit. As I said earlier, the wholesale markets were open. Northern Rock was able to finance itself at that point in

time. It was only the closure of the wholesale markets later in the year that really brought Northern Rock into the difficulties that it had.

**Q276 Lord Levene of Portsoken:** I think I may have missed something here. You said that your job primarily is to look back and report on what has happened and not look forward. But how can you give an opinion on whether it is a going concern if you're not looking forward?

**Mr Powell:** Well, I think Mr Griffith-Jones did add as well that while you look at a snapshot of a balance sheet and a business at that point in time, you do have to do the look forward. We look forward at liquidity as a minimum of 12 months but if a company, for example, produces forecasts that go forward 18 months or two years, we look as far as we can into the future.

**Q277 Lord Lawson of Blaby:** But following on from Lord Levene's point, Mr Connolly said that the likelihood of there being official support was a factor in his thinking. The likelihood of official support implies that, without it, it wouldn't be a going concern. So I don't see how you can answer Lord Levene's point when that is a factor.

**Mr Connolly:** It certainly was a factor and I think the key thing to recognise is that the judgement, first of all, that the management and the directors have to make is that their organisation is going to continue for a period of at least 12 months and the auditors have to reach a similar conclusion or modify their audit opinion. The mechanisms that are going to be adopted in order to provide that confidence can be varied and, in the environment we were in, there was absolutely no doubt at all that one of the key features of giving assurance that the banks were going to continue was the likelihood of Government support.

**Q278 Lord Hollick:** Speaking on the going concern point, if we go back to the end of 2006, I think you said, when you did the audit for Northern Rock, in order to form a judgement about a going concern—not just the scorekeeping element of your job—you would have to form a judgement about the business model. As Lord Lawson said, Northern Rock was financed on one side by hot money and on the other side was making some fairly adventurous loans or high-risk loans. At the time did it occur to the audit team—was there any discussion within your firm or other firms—that there was a danger in this model? It goes to the heart of the going-concern judgement; frankly, as an investor that is what we hang a great deal of faith on. That is the assurance that we are looking for.

**Mr Powell:** It's not the job of the auditor presently to look at the business model of a business. That is the job of management. It's not the auditor's job to give a view as regards the actual model that is put together.

**Q279 Lord Hollick:** How do you form a judgement about the going concern?

**Mr Powell:** I wasn't a member of the audit team on Northern Rock but I think that the way that the audit was undertaken at the year-end was: you would look at the business model; you would look at the liquidity effect of that business model; and you would make an assessment as to whether or not the markets would support that liquidity into the business in forming your view. Our audit team did extensive work in auditing the year ending 31 December 2006 to make sure, assuming that the markets would continue as they did—and there was no evidence at that point that we were going to go into a wholesale global meltdown of the financial services sector—that that model would be sustained for the next 12-month period by the markets and by the continued rolling of the commercial paper. Then, of course, it comes down to the disclosure that goes into the accounts of Northern Rock. So we formed the view that there was adequate disclosure of the financial position of

Northern Rock for the users of the accounts on Northern Rock to take a view, whether they be investors or whether they be other users of the accounts.

**Q280 Lord Lipsey:** I have an increasing Alice in Wonderland feeling about this discussion, quite frankly. I'm a naïve amateur in this field but I expect "going concern" to mean that a business can pay its debts as they fall due, but you meant something quite different. You meant the Government will dip into its pockets and give the company the money and then it can pay its debts as they fall due and you gave an unqualified audit report on that basis. If you had said, "We are satisfied that support will be available from Government that will enable it to continue as a going concern", of course you wouldn't be subject to this criticism. But instead, where your duty is to report to investors the true state of the company, you were giving a statement that was deliberately designed to mislead markets and investors as to the true state of those banks. That seems to me to be a very strange thing for an auditor to do.

**Mr Powell:** No. The reason that I disagree with that statement is that I think when you look at the audits at the two-year end—so let's look at 31 December 2006—nobody could perceive the crisis that was coming. So on the assessment that was made at that point on the availability of liquidity, you have to assume that when you're trying to form a view as regards the going-concern nature of an organisation, it's not just going to run completely into a brick wall at some point during the next 12 months. You make an assumption, a realistic and educated assumption, as regards the market conditions—the way the market is likely to go. So that is the year-end 31 December 2006, before the financial crisis.

Post the financial crisis the assessment that the auditors then need to make at that point in time is whether or not there is going to be adequate liquidity going forward, wherever that liquidity might come from. In the audit considerations at the year-end 31 December 2007, the view that we formed as auditors was that there would be adequate liquidity available to

enable us to sign off the financial institutions that we were auditing at that year-end. Those were not misleading statements. They were statements that gave full disclosure and were based on an assessment of the liquidity at that point in time.

**Q281 Lord Lipsey:** How is that full disclosure?

**Mr Powell:** I think you have now gotten on to an interesting point, which is about how do we get more transparent in terms of the audit work that we undertake; in terms of the debate and the discussion that goes on behind the doors, if you like, in forming a view as regards the going-concern nature of a set of accounts, and not just publishing a binary audit report. It was pretty clear that, as we came through that year-end, the amount of time that was spent in looking at whether or not going-concern, clean-audit reports could be signed as regards those financial institutions was absolutely intense. So the real question was—as a reader of a set of accounts at that point you would look at the audit report. You would see a binary audit report and you would not know the level and degree of challenge that had gone on behind the scenes or how the auditors had gained comfort. Maybe that is another one of the key learning lessons going forward: how do we improve the transparency of the debate that the auditors have undertaken in forming their going-concern view as well?

**Q282 The Chairman:** Can I just raise a point here because you know that it's been put to us, and we're very interested in this, that going forward auditors should have more dialogue with the Bank of England in its regulatory role. In fact we had a discussion with the Governor about this particular point last week. If this does go forward—and one can see very much the advantages from the bank's point of view and from the global knowledge and so on and impending problems—what problems does that create for you as an auditor, because you will sometimes be talking to the bank about issues, issues that we have already

**Mr Halliday:** That's why the Bank of England has formed this committee—to look at the competition laws and make sure we're not afoul of any of the competition laws and also to begin to think through some protocols because I think we need to have an open, transparent discussion with our bank clients around how this will operate and get those things on the table and get some protocols laid out up front.

**Mr Powell:** So the working group on this is ongoing at the moment to try and help us work through the thought process as to what conversations we can have; how do we satisfy client confidentiality, for example. That is the remit of the working group at the moment.

**Q283 The Chairman:** But it includes issues about worries about going concern.

**Mr Powell:** It does.

**Mr Griffith-Jones:** I think there is no getting away from this dilemma that the banking industry is, to an extent, built on confidence. It borrows short and lends long and it always has done. Full disclosure is absolutely fine in a stable environment and everyone asks for transparency and, come a crisis, the Government of the day and the Bank of England of the day may prefer for the public not to know. With respect, it's not our role or we're not powerful enough, put it whichever way you want to put it, to control events in those circumstances, which is why the working party has this somewhat sensitive issue to think about before we can put into effect a useful dialogue. But would a dialogue have been useful, with hindsight? It most certainly would have.

**Mr Halliday:** I think it's important that it's two-way as well. It's not just the firms coming to the Bank of England but it's also the Bank of England sharing with the firms their concerns of risks as well.

**The Chairman:** We've obviously not been able, this afternoon, to spend as much time as we would like on this issue but you can see how critical it is to our thinking in relation to our report. So if you would like, on reflection, to submit another note to us about this—because I realise that there are some remarks you may have made which you would prefer to work through more carefully—that would be very helpful. Lord Forsyth, do you want to raise one more issue on this before we move on?

**Q284 Lord Forsyth of Drumlean:** It's related. We've heard evidence from Professor Fearnley, Timothy Bush and others who suggested that the introduction of less prudent IFRS standards was a key factor in the banking crisis. The question really is: do you think IFRS accounting standards led bank auditors to a tick-box approach instead of scepticism and prudent judgement on client banks as going concerns? The argument is that under the old UK GAAP system there was a degree of prudential judgement required and that the effect of IFRS has been to mean that you could say, "Well, we've done the audit but we haven't looked beyond it"; exactly the discussion we've had. How much has the change in accounting standards contributed to this problem?

**Mr Powell:** Okay. Just to kick off on this one as well, ultimately accounting reflects a business. It's not the other way round. So whichever accounting model that you go for, it's going to have to reflect exactly what happens. I think if you look back to UK GAAP say 10 years ago, obviously things needed to change. UK GAAP didn't, for example, have a standard on "How do you account for derivatives?" So there were new businesses and new business models that were starting to be introduced. Then IFRS came in and the new rules were applied. I think overall IFRS probably helped in the actual recognition of some of the problems probably earlier than maybe they would have recognised been under UK GAAP. But IFRS is not perfect and I think it is reassuring that the standard setters are now

reviewing IFRS, particularly as regards recognition of when loan impairment should be recognised.

**Q285 Lord Forsyth of Drumlean:** I'm sorry to interrupt you but I am interested in the specific point that IFRS introduced a box-ticking culture rather than the old requirement to take a prudential view and also, for example, it's been suggested that IFRS meant that the banks could delay recording actual losses while booking paper profits. There are specific criticisms of the rules but the broad philosophical attack is that we've moved to a box-ticking practice rather than a judgement and that is what most people would expect from an audit.

**Mr Powell:** I don't think that that is a fair reflection of the work that is done by auditors in that that is a set of standards that is IFRS. The application of it has a judgemental element to it as well.

**Q286 The Chairman:** So you say that they're wrong?

**Mr Powell:** Pardon?

**The Chairman:** You say that that evidence is just wrong?

**Mr Powell:** This is obviously a pretty complex area and I think that there are some areas about IFRS that are good and that I think have helped and I think there are other areas that need review, which is exactly what the standard setters are doing at the moment.

**Mr Connolly:** I think you are trying to get specifically to, "Is it box-ticking?" I think it would be quite a simplification to suggest that was the case. I think at the heart of the specific issue that is now under review—and I think we would all support that review taking place and it probably will result in a change—was that for many years there was a view held that the fact that judgement could be applied to decide what kind of provisions might be required against

the value of assets and you could look forward and contemplate what the ultimate value of those assets would be in doing that.

A view that was held that resulted in change was that that was too lax and, as a consequence of that, there were all sorts of suggestions, particularly in financial institutions but not just financial institutions around the world, that the inability to understand quite how that—whether that judgement was one that was very conservative or the opposite—led to failure to be able to make proper comparisons and understand the financial results more effectively. The change that came in was to say that a loss has either occurred or it has not occurred. It is not a question of “might it occur”. It is “has it occurred?” and only if the loss has occurred were you able, under IFRS, to recognise the loss.

Now, if we say, “Isn’t that box-ticking?”, if that is what you mean, then that was the case; the loss had either been incurred or it hadn’t been incurred. I think it was the G20 who recommended, and there is now a review that will perhaps lead to, a move back to need to recognise losses if you expect they will occur. That definitely will require much more judgement but will be open to more latitude in terms of the exactness.

The other feature of IFRS that is more often picked upon and used as a, “Wasn’t this”—or some have even said, “Didn’t this cause the crisis?”—which, I think, again, would be unfair—was those assets that had to be mark to market and there was criticism. I mean the clarity was that you had to value these assets at market value. Often the market was disrupted by the conditions and the view was held, “Well, it is the market—we accept that—but isn’t this a distorted market? So shouldn’t you be using something different?” I am advised, and I’m not an expert on banks or auditing banks, that that has been very significantly exaggerated as a feature because the relative proportion of assets that are dealt with in that way is very low.

**Q287 Lord Forsyth of Drumlean:** Chairman, I'm conscious that there isn't time to do this now. I don't know whether you've had a chance to look at the evidence that came to us, but there was one piece of evidence that went through each of the banks and explained how the change in the accounting rules made the system worse. It would be very helpful to have your written comments on that—perhaps the clerk could send it—because it does seem to be a very important factor. In talking to finance directors and people outside, there does seem to be some concern that the old prudential judgement has been undermined as a result of the move to IFRS and that is purely anecdotal. But you seem to be saying that that isn't an issue.

**Mr Halliday:** I think one of the keys here is to get one consistent global accounting policy globally, one standard, and we believe that is IFRS—that IFRS should be applied consistently around the world. I also think it's important to step back and challenge ourselves on the heels of this Committee and say there weren't a lot of restatements or errors noted in valuation through this crisis. What can be done maybe to increase the financial reporting and the disclosures of these things? What needs to change in the financial reporting model in addition to get one globally consistent set of accounting policies?

**Q288 Lord Forsyth of Drumlean:** Where my question is going, to the evidence we've had, is that people were too concerned to do that—to get a global system of accounting agreed—and not concerned enough about the effect that that would have on telling people what was going on in these banks. That's the accusation.

**Mr Powell:** We will set out our views in writing on this as well but it's pretty clear, given the depth of review that is ongoing by the standard setters at the moment as regards IFRS, that maybe things did go a bit too far and took out some of the judgement that should have been in there.

**The Chairman:** This is clearly another area of great interest to the Committee and, therefore, I would strongly support Lord Forsyth's suggestion that you send us a written note.

**Q289 Lord Lawson of Blaby:** I will ask one more if we've got time on a different matter, although I think this is the key issue—this whole question of auditing the banks. Indeed my question links up with that. It is about one of the things that I introduced in the 1987 Banking Act, as part of the requirement for there to be a regular dialogue between the regulator—at that time the Bank of England and it's now going to be the Bank of England again—and the auditor. As one of you said, it should be a two-way thing but a regular dialogue. I am still puzzled and dismayed by the fact that that went into disuse. It was never repealed. It just stopped happening, to all intents and purposes. But one of the things that buttressed that was that I provided in the Act that auditors would not be liable in any way for any adverse consequences that flowed from telling the regulator that there was something wrong with this particular bank's accounts. I know that at the time the auditing firms felt they needed that protection and the Act gave them that protection. Now, are there occasions when, today, you are inhibited from saying publicly, in any qualification to the accounts or whatever it is, that you have any reservations because of the fear of litigation—that, even though you think in your heart that there ought to be a qualification, the concern for litigation, which could be extremely expensive, inhibits you? Do you think, if that is so, that there might be a case for some kind of provision which would limit the damages to which you would be subject in the event of litigation going against you?

**Mr Connolly:** If I could offer a view first: first of all, I do agree with your observations about the circumstances that prevailed with the Bank of England and that did enable special pieces of work to be undertaken without risk. They were specific pieces of work and that was

valuable. I certainly believe that we live with the risk, in the risk environment we're in, and we develop our opinions in a way which is appropriate, recognising that that risk is there and not in any way interfered with by the level of risk we run. We recognise that we have unlimited liability but I'm very confident that at no point does the existence of that risk cause there to be an opinion other than the appropriate opinion. In most cases, of course, I would suggest that failure to give the right opinion is more likely to lead to litigation because litigation mostly arises where a company has failed and you really don't want to be in a position where you had not given the right audit opinion in those circumstances.

But to the general point—would we prefer there to be more protection?—yes, of course we would. I think also if there was more protection it would encourage, potentially, an extension of the market. For some of the medium-sized firms at the moment, the horror of dealing with clients of a scale that could wipe the business out at a stroke if they happened to have a problem must be a barrier to entry. But even more valuably perhaps, if there was more protection then it is more likely to create an opportunity to extend the role of the auditor to report on things that we don't have to report on now but might be valuable. I think a dialogue around what further things could we report on that we don't have to report on now would be very valuable. But you could only entertain those if there was a measure of protection.

**Q290 Lord Lawson of Blaby:** Could you let us have a note on what things you think it might be a good idea if you were able to report on that you don't report on at the present time?

**Mr Connolly:** Yes, absolutely.

**The Chairman:** Are there any other comments on the liability question?

**Mr Griffith-Jones:** Only the rather obvious one that, in the matter of protecting us from going from four to three, the litigation risk is, certainly in my firm and I'm sure in all the others, the biggest risk on our risk register. Without the protection and without the insurance market it's probably the single most likely cause of there only being three of us in front of you at another time.

**The Chairman:** Gentlemen, thank you very much. We've had a long session and we've already asked for three notes. We haven't been able to cover two other subjects we were intending to discuss with you but could I ask you, as you're very important witnesses to us in this inquiry, if you could also let us have a note on the breakdown of fees as between audit and non-audit and also a question in relation to providing internal audit services as well? I will make sure our clerk lets you know exactly what it was we were interested in but, in order not to prolong this, perhaps you could very kindly let us have a note on these matters. It's clear from the discussion we've had that it's been a very interesting and helpful session to us and we look forward to your further notes. Thank you very much indeed.