

Written evidence submitted by

**Periculum Associates Limited (company number 11407647)**

## 1. Introduction

- 1.1. Periculum Associates Limited (Periculum) is a global risk management company providing tailored forward-thinking solutions to clients across industries. Periculum helps transform risk management into competitive advantage by assisting its clients in innovating and growing, affecting change, putting data to better use, and managing risk more effectively to harden their businesses. Amongst Periculum's focus Risk Advisory capabilities are Organisational Design and Strategy; Framework, Policy and Governance; Event Management; Analytics; Regulatory Support; and Quantitative Analysis.
- 1.2. Periculum's clients include global and regional banks, insurance companies, and other financial services providers, credit bureaus, and oil and gas companies.
- 1.3. On several occasions over the past 16 months Periculum has weighed in on UK audit reform, primarily via published commentary<sup>1</sup>, or via separate chains of correspondence including letters to: the Prime Minister, the Labour leader, the CEOs of the FTSE 250, and to Mr. Darren Jones, your chair. Each letter advocated that the Government take up audit reform<sup>2</sup> as an urgent and priority matter in light of the conclusions set forth in each of the audit reform<sup>3</sup> reports.

## 2. Summary

- 2.1. Periculum **fully supports** the overwhelming majority of recommendations put forth in each of the Kingman Review, the CMA Study, and the Brydon Report. Periculum's only caveats, observations and recommendations are those we set forth in our responses to the Select Committee's first question, in Section 3 below, and its last question, in Section 8 below.
- 2.2. We urge the Select Committee to prioritize achieving its goal of improving audit quality by focusing on the four areas of reform we set forth in Section 2.3 below by:
  - Enacting, as soon as possible, the relevant recommendations for these reform areas which are contained in the three reviews; and
  - Pending the formation of the proposed Audit, Reporting and Governance Authority (ARGA), publicly signalling the Select Committee's approval of, and intent to ratify after-the-fact, appropriate action which may be taken in the interim by the Financial Reporting Council (FRC) or other independent bodies which might have jurisdiction over matters impacted by the proposed reforms (including the FRC's direction to the Big Four<sup>4</sup> to report by 23 October 2020 on their plans to operationally separate their respective audit and non-audit functions by 2024) or

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<sup>1</sup> See, e.g., <https://www.periculum-associates.com/reforming-the-audit-sector/>.

<sup>2</sup> Periculum's audit reform correspondence to all these recipients can be reviewed at <https://www.periculum-associates.com/championing-uk-audit-reform/>.

<sup>3</sup> See Sir John Kingman KCB, "Independent review of the Financial Reporting Council", December 2018 ("Kingman Review"); Competition & Markets Authority (CMA), "Statutory audit services market study", update paper 18 December 2018 ("CMA Study"); Sir Donald Brydon CBE, "Assess, Assure and Inform - Improving Audit Quality and Effectiveness: Report of the Independent Review into the Quality and Effectiveness of Audit", December 2019 ("Brydon Report")

<sup>4</sup> The "Big Four" refers to Deloitte, PricewaterhouseCoopers (PwC), Ernst & Young (EY), and KPMG.

to encourage the formation of other non-Government working groups tasked to progress aspects of the three reviews' recommendations (see Section 4 below).

2.3. The four areas of reform on which we urge the Select Committee to prioritize focus are:

- Updating auditing standards to address the ever-increasing complexity of financial risks, fraud, and corruption;
- Establishing a profession of "corporate auditor", with appropriate ethical obligations and behavioural standards and certifications;
- True legal separation of the Big Four audit firm's audit and consulting arms to ensure greater innovation and competition in a sector that is controlled by the "too few to fail"<sup>5</sup>; and
- Setting new standards of corporate governance with greater accountability placed on Board Audit Committee members, Chief Financial Officers, and audit professionals in positions of influence.

2.4. We will set out in the remaining sections below our responses to the questions being considered by the Select Committee.

### **3. Do the proposals from the three reviews of audit fit together as a coherent package that can deliver meaningful reform?**

3.1. **Yes.** Periculum fully supports the collective recommendations set forth in the three reviews, and does, in fact, view these three documents, subject to the exceptions noted below, as coherently integrating three major elements of audit reform, namely:

- (a) formation of ARGA as a new effective regulator to replace the FRC<sup>6</sup>;
- (b) structural reforms via true operational separation of the audit functions of the Big Four firms from their non-audit practises<sup>7</sup>; and
- (c) establishment of enhanced standards and structures to the conduct of audit practise, in the form of
  - (i) enhancements to the standards of how audits are conducted<sup>8</sup>, and
  - (ii) the creation of a new profession of corporate audit separate from the existing profession of accounting<sup>9</sup>,

into meaningful, measurable and eventually testable reforms addressing the most critical of the current failings of audit in the UK; *provided, however*, that these three areas are accompanied by corporate governance reforms, as discussed in Section 8 below.

3.2. We note that each of the three reviews were careful to identify areas in which the reviewers deferred judgment and recommendations to another of the reviews, or, conversely, specifically expressed a position contrary to one or more of the other reports. We applaud the level of coordination exhibited in the final work products, with

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<sup>5</sup> See, e.g., <https://www.nytimes.com/2005/06/25/business/auditors-too-few-to-fail.html>.

<sup>6</sup> Kingman Review, Recommendations 1-5

<sup>7</sup> CMA Study, Remedy 5.

<sup>8</sup> Brydon Report, at Chapter 5.

<sup>9</sup> Brydon report, at Chapter 6.

our only concern being the resulting delay in commencement of Government action in enacting any of these reforms.

#### *Scope of ARGA's coverage*

- 3.3. As a matter of scope, we endorse Sir Donald's and Sir John's recommendations<sup>10</sup> that the definition of Public Interest Entity (PIE) be revisited to redefine the scope of what entities are to be included in the coverage of the new audit regime. In particular, Periculum recommends that the PIE definition be expanded to also include entities (not otherwise included in the existing definition<sup>11</sup>), the failure of (or adverse impact to) which entities would pose an operational risk to the wider UK economy. These would include firms such as material outsourcing service providers; data, media and communications network infrastructure providers; construction firms; and other critical sector players with material market presence.
- 3.4. We endorse the Kingman Review's suggestion that ARGA establish a market intelligence function which would serve as a baseline clearinghouse for emerging risks in particular business sectors and/or to the wider UK economy.<sup>12</sup> Such a function would be able to draw upon information sources which would not be filtered by senior management, and would, in fact, ultimately empower auditors to challenge management in how they are addressing known risks. Care should be taken, though, that this new intelligence function be as inclusive of proffered risk information as reasonably possible, and we recommend that qualitative assessments by ARGA analysts of these risks, including divergent opinions with ARGA, also be made available to auditors and investors.

#### *Updating auditing standards*

- 3.5. Periculum endorses the proposed changes in auditing standards set forth in the Brydon Report to require and incentivise more meaningful challenge by auditors of management's positions, as well as more empowerment of the audit firm to conduct independent fact-based inquiry into the veracity and context of those statements, noting in particular the Report's recommendations at Sections 5.3.2<sup>13</sup> and 8.4.3<sup>14</sup> of the Report. This shift in focus from an accounting exercise of validation to a professional exercise of diligent inquiry will go a long way to putting companies' financial statements and other business communications on a sound footing, objectively assessable by investors. We are confident these actions will be emulated by other nations' governing bodies to ensure that their markets operate in the same environment of transparency in favour of investors. This will have the benefit of the UK setting the terms for a global audit reform effort.
- 3.6. The Brydon Report addresses the question of whether audit reports should remain binary statements and discusses the recommendation of the Kingman Review that

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<sup>10</sup> Brydon Report at 2.0.3; Kingman Review, Recommendation 18.

<sup>11</sup> As stated in the Brydon Report, "PIEs for existing UK regulatory purposes currently includes UK companies with equities or debt admitted to trading on a regulated market (including the London Main Market but not the Alternative Investment Market) and credit and insurance firms." Brydon, at 2.0.3, note 7.

<sup>12</sup> Kingman Review, Recommendation 44.

<sup>13</sup> "I recommend that auditors should be free to include original information, materially useful to a wide range of users, in their audit report and at the AGM, and not be confined to commenting on that which has already been stated by directors." Brydon, at 5.3.2.

<sup>14</sup> "I recommend that the audit report should include a new section in which the auditor states whether the company's section 172 statement is based on observed reality, on the basis of the auditor's knowledge of the company and its processes." Brydon, at 8.4.3.

graduated audit reports be considered<sup>15</sup>. The Brydon Report nevertheless recommends retaining binary audit report statements. We disagree in part with Sir Donald's conclusion. Although we ultimately agree with him on retaining a binary up-or-down ultimate determination, we do recommend that, rather than leaving graduated findings to the market<sup>16</sup>, there be a standardized set of qualifications to those binary determinations, each based on the information provided (or not provided) in the audit, which would disclose caveats, dependencies or conditions (or, alternatively, any exemplars of disclosure found by the auditor) to the determination, thus better informing investors of the context of the determination.

- 3.7. We also fully endorse the Brydon Report's concept<sup>17</sup> of promoting the use of external information obtained from non-senior management employees, suppliers, NGOs or other stakeholders of the company, whether through the auditor's heightened independent sceptical inquiry under the proposed new audit standards, or via whistleblowing or other ombuds reporting – particularly in cases where there is suspicion of fraud at the audited company or at one of its business partners (such as a supplier). If audit quality is to be improved, it must have the ability to draw on information from sources external to company management – provided the veracity and applicability of the information can be credibly assessed by the audit firm.

#### *Establishing a profession of "corporate auditor"*

- 3.8. Key to this shift in audit focus is the Brydon Report's proposed establishment of a new profession of corporate audit. As Sir Donald noted in his Report<sup>18</sup>, the skill set required for diligent and sceptical inquiry, forensic investigation and particularly for detection of sophisticated frauds are not typically developed via the accounting profession's educational requirements. We believe that such a profession could, like the legal profession, engender the requisite sense of duty and healthy scepticism in leaders which could, in turn, be leverageable eventually as skill sets in other roles impacted by corporate audit, such as internal auditor, CFO, CEO and other senior management and board positions. Moreover, the profession, like law or medicine, should be established with the capability of certification in specialty areas of practise, such as data security, fraud detection, operational resilience, etc.
- 3.9. Periculum's one caveat regarding establishment of the new corporate audit profession is that it not be established in a way that the new profession's requirements harden the existing bias towards Big Four firms. In other words, the "credence good" of *status quo* Big Four audit practice should not merely be reinforced by having the Big Four's existing auditors' obtain a new certification of audit professional status. Rather, we recommend (as above) the use of specialty capability designations to further promote the prominence and use of non-Big Four firms – first, in speciality areas, and later with the prospect of these other firms enlarging their footprint as they gain more capability.

#### *Separation of the Big Four's audit and consulting arms (and other competition-related recommendations)*

- 3.10. Also key are the CMA Study's recommendations of true operational separation of the audit functions of the Big Four firms from their non-audit practices. We fully agree with the CMA that separation is a necessary step to improve the independence of the audit function from the influence of the non-audit revenue and sales streams.

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<sup>15</sup> Brydon Report, at section 17.5; Kingman Review, Recommendation 53.

<sup>16</sup> Brydon Report, at 17.5.9.

<sup>17</sup> Brydon Report at 22.9

<sup>18</sup> Brydon Report, at 6.0.2.

3.11. However, although we understand that operational separation is a critical first step, we ultimately believe that eventually it will be demonstrated that complete legal separation of audit and non-audit will be necessary to achieving the goal of improved audit quality. Although the influences of the Big Four's non-audit functions on the audit practises would, under operational separation, be more indirect, the money and influence asserted by the non-audit practise would remain pervasive and dominant, and would, even in an operational separation, set the agenda for:

- (a) operational coordination of utilization of shared services for back-office or outsourced functions;
- (b) which function serves as the primary basis for each of the Big Four's brand goodwill; and
- (c) the complexities of profit sharing within the global firm, while attempting to maintain objective audit independence and audit quality.

We believe that mere operational separation will prove to be ineffective in creating a truly independent professional class. What ultimately will be needed to effect a truly independent professional class is true legal and financial separation, including brand / firm names, which will need to be applied to non-Big Four firms to achieve true audit independence.

3.12. Periculum is sceptical of the efficacy of the CMA's proposal to require joint audits<sup>19</sup>, particularly in achieving the desired increased market penetration of non-Big Four firms into the FTSE 350. We do not see evidence that such an annual exercise would provide meaningful shifts in engagements for full audits to non-Big Four firms, and in turn result in improved audit quality, versus being an exercise that establishes a second-tier of firms primarily engaged in "shadow audits." Regardless of what is encompassed by a joint audit – is it either a divided sharing of audit duties between two firms, or two full audits run in parallel? – we agree with prior commentary<sup>20</sup> that for companies that have relatively simple structures, the cost burden would not be commensurate with the benefits received.

3.13. Rather, we recommend the Select Committee consider two alternative remedies:

- (a) If joint audits are to be required, mandating that joint (shadow) audits be conducted only in the third (last) year of the relevant audit committee disclosed three-year audit policy period, or even less frequently in the last year prior to mandatory switching of auditors. This would eliminate unnecessary redundant expense, promote the shadow audit as a check on abuses by the primary audit firm, reinforce the focus on consistency in management's statements (particularly those that look forward), promote the operational importance of the three-year audit policy look-forward period, and better position the shadow firm as a suitable challenger for the main engagement when the audited company is required to rotate.
- (b) Rather than have shareholders ratify the choice of one auditor at the general meeting, require that the shareholders elect one of two final candidate firms as auditor – one of which candidates must be a firm with a market share in the FTSE 350 below 15% (or a similar small market share percentage). Holding a

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<sup>19</sup> CMA Study, Remedy 2.

<sup>20</sup> See, e.g., Written evidence submitted by the Association of Investment Companies (FOA0034), submitted February 2019.

true election rather than a plebiscite would finally empower investors and shareholders with the ability to force candidate audit firms to focus on investor-oriented issues, and the procurement process would be rendered transparent in ways not obtainable via an up-or-down vote. It would also give each firm the opportunity to present at the AGM their capabilities and approach to those shareholders.

#### *Setting new standards of corporate governance*

3.14. We discuss corporate governance reform in more detail in Section 8 below.

### **4. Which reforms can be delivered without legislation and what progress has the FRC made in implementing such reforms ahead of future legislation?**

- 4.1. Without the ARGA in place, the opportunity to pursue reforms prior to legislation is limited, but not non-existent. We believe that the FRC's request of the Big Four for operational separation plans<sup>21</sup> is a critical first step to maintain the momentum of reform, which step could be both ratified by the ARGA and modified if the operational separation proves ineffective, as we expect (as discussed above).
- 4.2. In a similar vein, a working group of stakeholder representatives drawn from accounting and other professions, as well as academics and other experts in the field, could be formed today by the Select Committee to begin the preparatory process of scoping the parameters of the new corporate audit profession recommended in the Brydon Report, the resulting work product of which could be ratified and modified once ARGA is established. It does not necessarily take legislation by the ARGA to begin the process of gaming ideas on how this new profession should look, and even for the working group to propose further suggestions to the Select Committee on draft legislation.

### **5. Will the reforms proposed by the audit industry itself address the failings that were identified by the reviews and the BEIS Committee's Future of Audit Report?**

- 5.1. As evident in this submission, Periculum truly does not believe that such proposed reforms will adequately address such failings.

### **6. When will the Government bring forward its proposals and the necessary legislation where required?**

- 6.1. As evident in this submission, our recommendation is that the Government, as a priority matter should bring forth its proposals as soon as possible.

### **7. Will audit reform help track progress made by companies in meeting the UK's Sustainable Development Goal commitments and in particular Net Zero?**

- 7.1. Provided that, consistent with the recommendations of the Brydon Report<sup>22</sup>, auditors

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<sup>21</sup> See <https://www.complianceweek.com/accounting-and-auditing/frc-sends-letter-to-big-four-outlining-operational-separation/28505.article>.

<sup>22</sup> Brydon Report, at 6.8.5 and

ultimately be required to subject to the new audit standards the veracity and consistency of compliance with a company's statements such as its Public Interest Statement in its Director's Report, and its Sustainability Report, audit reforms will certainly help to track progress in meeting these goals.

## **8. How will audit reform fit with wider corporate governance reform?**

- 8.1. Periculum endorses the Brydon Report's proposal<sup>23</sup> that PIE audit committees be required to issue a three-year rolling Audit and Assurance Policy, as a necessary way to promote auditors' ability to assess consistency in management's statements of financial condition as well as other statements such as those relative to a company's use of Alternative Performance Measures, its Public Interest Statement, or its Sustainability Report. However, establishing such a policy statement requirement should not be done in a way where the issuance of such a statement becomes a disclosure vehicle by which a company's board or senior management is thereby insulated from liability by the mere issuance of the policy statement. As implied in the discussion of auditor and management liability in the Brydon Report<sup>24</sup>, care should be taken to optimise the circumscribing of the ability of both management and audit firms to insulate themselves from liability for failings in this area. We do not believe that such restrictions on the ability of companies to limit the liability of its audit firms and its directors and senior management will adversely affect the lucrative incentives which are otherwise available to companies in recruiting competent and experienced persons to serve in these roles.
- 8.2. Rather, we endorse steps at reform aimed at improving both accountability of companies' senior management and boards of directors – including audit committees – by imposing liability and, in some cases, penalties, for their failure to adequately disclose risks and relevant contextual information to their corporate auditors. Even though a new profession of corporate auditor would impose a significant professional obligation of sceptical independent inquiry upon auditors, it must be made clear that those auditors cannot be hamstrung by obfuscatory or, worse, fraudulent actions of senior management. This penalty and liability structure would be independent of, but coordinate with and buttress, our recommendation that certain senior management roles and non-executive directors (NEDs) be encouraged to also seek professional qualification as corporate auditors.
- 8.3. We recognise that NEDs already have legal duties to act in the best interest of shareholders and that audit committees are structured to have a majority of members who are independent, as well as have at least one member who has competence in accounting or auditing, or both, and have members who have competence relevant to the sector in which the entity is operating. We would recommend that, in addition to such independence and audit/accounting competence, PIE boards, and their audit committees, also be required to recruit experts in risk management and risk identification as NEDs, and to coordinate audit committee activities regarding development of the three-year audit and assurance policy. We also endorse the Brydon Report's recommendation that companies publish their statement of principal risks and uncertainties before determining the scope of each year's audit and actively seek shareholder and other views on the appropriate emphases.<sup>25</sup> This could involve a greater specialisation of the roles of individual expert NEDs in the day-to-day management of the company.

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<sup>23</sup> Brydon Report at 2.4.1

<sup>24</sup> Brydon Report at 25.1.3.

<sup>25</sup> Brydon Report at 2.4.3

- 8.4. Periculum acknowledges that some companies outsource specific aspects of the finance function, if not its entirety, to external service providers. Legislation should be crafted to ensure that not only are any such service providers engaging in such audit functions subject to the same standards as internal finance function employees to ensure their work is transparent, accurate and reliable, but that the company maintain robust, competent, and qualified capabilities of financial and risk oversight of these service providers, which oversight would be subject to similar penalties and liabilities for failure to adequately exercise such oversight.
- 8.5. Finally, although we believe that implementation of a “Sarbanes-Oxley-like” regimen of certification of internal financial reporting controls may ultimately devolve into a routine “check-box” exercise as it has for many US companies, the fact is that such devolution has been made possible through the robust implementation of automated and resilient controls on financial data and statement production which ultimately will produce in the UK similar resilient and credible financial data so as to promote the end goal of significant improvement in audit quality. Consequently, we endorse the recommendation in the Brydon Report that legislation establishing such a regimen be enacted.<sup>26</sup>

*27 August 2020*

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<sup>26</sup> Brydon Report at 2.8.3.