

Rt Hon Nicky Morgan MP
Chair, Treasury Select Committee
House of Commons,
London,
SW1A 0AA

29 November 2017

Dear Ms Morgan,

HBOS Report

We undertook to provide the Committee with a full report on the FRC's Investigation and Supervisory Inquiry into KPMG's 2007 and 2008 audits of HBOS. The report sets out what the FRC has done and why, and the lessons we have learnt for the future. We will be publishing the report, along with this letter, tomorrow at 07:00.

Last month I spoke about the lessons we drew from the financial crisis more generally, the steps we have taken since then, our analysis of the strength of audit today, and the further measures we are proposing. Both the report and my speech are attached.

As we announced in September, the FRC Executive Counsel concluded that there was no realistic prospect that an independent tribunal would make a finding of misconduct in respect of KPMG's audit of going concern; misconduct being the applicable test that tribunals have to apply. The misconduct test is a high hurdle to pass in order to bring a successful prosecution. As the report explains, a tribunal would need to find that no reasonable auditor or audit firm would have acted in the way that KPMG did, and this was not the case in relation to HBOS.

We have addressed this problem with the test in relation to audit cases. On being designated the competent authority for statutory audit in the UK in 2016, the FRC implemented an audit enforcement procedure which enables investigations and enforcement action to be undertaken in relation to "*breaches of a relevant requirement*": a test aimed at breaches which may not have amounted to misconduct but which nonetheless should be pursued.

The old test remains in being in relation to cases involving accountant members of the professional accountancy bodies. We are reviewing this with the bodies as they need to agree to participate in any new arrangements. It is our view that accountants in public interest roles should be subject to a similar threshold of accountability as auditors now are to protect the public interest. We would appreciate your support for this and, if necessary, legislation.

A learning point for the FRC is that we should have adopted a more proactive approach to our early enquiries in relation to HBOS rather than a heavy reliance on other regulators. We were concerned that the limitations in our powers to secure information from companies meant it was sensible to await the conclusions of the financial services regulators which had full access to information and whose conclusions would enable us to focus our own work better. However, these other investigations took much longer than initially expected and, therefore, a substantial gap in inquiries in relation to audit opened up whilst the FSA and FCA/PRA work was underway.

FRC investigations should be undertaken in parallel so that there is no unnecessary delay in reaching conclusions, and so our evidence can be fed into other inquiries if appropriate. We have since adopted this approach. As the competent authority, we now have additional powers to obtain information and we have invested in a significant increase in the size of our Enforcement team.

We also recognise that we should say more about the reasons for decisions to close an investigation. In the future, where there is a public interest to do so and no legal constraints, we will publish a summary of our reasons.

Concerns have been raised about the FRC's own governance, in particular that we have too many people with a background in the major accounting firms we regulate. In 2016, the EU Audit Regulation came into effect and provides that nobody who has practised as an auditor within the previous three years should be involved in audit regulatory decisions. The FRC already had arrangements in place which were consistent with this provision, and when the Government reviewed this and other aspects of FRC governance it concluded that the FRC was fit to be appointed as the UK competent authority for audit. A similar review was conducted and conclusion reached in 2012 prior to legislation on our powers being put forward to Parliament and the associated changes to our structure. We are now conducting a further review of aspects of our governance and will in consequence be expanding the diversity, range of skills and experience on our Board and Committees.

I hope this letter and attached report help to illustrate the FRC's commitment to learning lessons and developing as an organisation to meet public expectations.

Yours sincerely,

Stephen

Stephen Haddrill
Chief Executive

Enc:

- i) *The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS*
- ii) "Developments in Audit" - Stephen Haddrill, 25 Oct 2017