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# **REFORMING THE AUDITING INDUSTRY**

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## **\*REFORMING THE AUDITING INDUSTRY**

This review was commissioned by the Shadow Chancellor of the Exchequer, John McDonnell MP, and conducted independently by Professor Prem Sikka and others.

The contents of this document form a submission to Labour's policy making process; they do not constitute Labour Party policy nor should the inclusion of conclusions and recommendations be taken to signify Labour Party endorsement for them.

This report is promoted by John McDonnell MP, Shadow Chancellor of the Exchequer at House of Commons, Westminster, London SW1A 0AA.

\*We are grateful to partners and staff of the big four accounting firms, mid-tier accounting firms, Group A firms, small firms, regulators, individual investors, institutional investors, corporate executives, pension scheme trustees, pension scheme members and ordinary citizens for sharing their thoughts with us.

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## LIST OF ACRONYMS

Accounting Standards Board (ASB)  
Association of Chartered Certified Accountants (ACCA)  
Association of International Accountants (AIA)  
Audit Inspection Unit (AIU)  
Bank of Credit and Commerce International (BCCI)  
Bank of England (BoE)  
Chartered Accountants Ireland (CAI)  
Chartered Institute of Management Accountants (CIMA)  
Chartered Institute of Public Finance and Accountancy (CIPFA)  
Consultative Committee of Accountancy Bodies (CCAB)  
Competition Commission (CC)  
Competition and Markets Authority (CMA)  
Department for Business, Energy & Industrial Strategy (BEIS)  
Department for Trade and Industry (DTI)  
Federal Deposit Insurance Corporation (FDIC)  
Financial Conduct Authority (FCA)  
Financial Reporting Council (FRC)  
Generally accepted accounting principles (GAAP)  
Institute of Chartered Accountants in England and Wales (ICAEW)  
Institute of Chartered Accountants of Scotland (ICAS)  
International Accounting Standards Board (IASB)  
International Auditing and Assurance Standards Board (IAASB)  
International Federation of Accountants (IFAC)  
International Financial Reporting Standards (IFRS)  
Limited Liability Partnerships (LLPs)  
National Audit Office (NAO)  
PricewaterhouseCoopers (PwC)  
Public Interest Entities (PIEs)  
Public Sector Audit Appointments Limited (PSAA)  
Prudential Regulation Authority (PRA)  
Recognised Professional Bodies (RPBs)  
Recognised Qualifying Bodies (RQB)  
Recognised Supervisory Bodies (RSBs)  
Republic of Ireland (ROI)  
Securities Exchange Commission (SEC)  
Statement of Recommended Practice (SORP)

## EXECUTIVE SUMMARY

Accountants belonging to select few accountancy trade associations enjoy the state guaranteed market of external auditing. Yet audits have been used as a stall for selling other services. Auditors have been unable to deliver independent and robust audits and the auditing industry is in disarray, dysfunctional and stumbles from one crisis to another. Auditing firms are mired in conflict of interests and have shown willingness to bend the rules at almost any cost to increase their profits. A steady parade of scandals has followed and auditors' silence has been a major factor in loss of people's pensions, jobs, savings and investments. Supply chain creditors and tax authorities have been forced to write-off billions of pounds at Carillion, BHS and elsewhere. The 2007-08 banking crash showed that banks crashed within days of receiving a clean bill of health from auditors. It did not encourage the industry to examine its practices and reforms were organised off the agenda. The regulators are captured by the auditing industry and poor quality of audit work is the inevitable outcome. They have failed to check predatory practices, improve audit quality, mount speedy and thorough investigations of audit failures, apply effective sanctions against auditors delivering poor audits, or develop any schema for public accountability of the auditing firms.

The UK auditing industry is dominated by the big four firms who are routinely implicated in scandals and seem incapable of delivering high quality audits. The auditing industry lacks basic market pressure points. There is lack of competition and choice, especially at the top-end of the market. In competitive markets those producing shoddy goods/services and deriding customers for expecting higher quality are pushed out of business. They can face mega lawsuits. But despite monumental failures, auditing firms stay in business because the audit market is guaranteed by the state and regulators do nothing. Auditors enjoy too many liability concessions. Anyone selling automobiles, food or medicines has to ensure that the product is fit for purpose and will not injure current or future consumers, but such considerations are absent from the audit industry. People have few, if any, rights against negligent auditors.

The industry sets its own auditing standards or benchmarks which are often the lowest common denominator. A mechanical checklist mentality dominates within the firms to the detriment of audit quality. A culture of profit maximisation has resulted in inadequate time budgets, irregular auditing practices, offshoring (or outsourcing) of audit work and reliance upon work performed by staff not under the direct control of the firms. Firms have a history of non-cooperation with regulators.

The reforms of the auditing industry have been grudging, minimalist and ineffective and often on the terms specified by the big four accounting firms. Reforms are needed to give backbone to auditors by ensuring that they concentrate on audits only. The distraction of non-auditing services needs to be removed and auditors must act exclusively as auditors. Auditors of large companies need to be freed from fee dependency on company directors and therefore need to be appointed and remunerated by an independent body. In order to reduce market domination and reduce turbulence resulting from the demise of a large supplier, joint audits for large companies need to be mandatory. For the last fifty years, the audit firms have been unable to deliver effective audits of financial enterprises. Society has paid dearly for

such failures and cannot afford any further banking crashes. Therefore, an independent statutory body needs to perform audits of banks, building societies and insurance companies. For far too long, the setting of accounting standards has been left to organisations under the control of big firms and corporations, and the end result has been a poverty of accounting practices as shown by banks, Carillion and other cases. Accounting standards affect the distribution of income, wealth, wages, dividends and risks only parliament has the democratic mandate to oversee such matters. All accounting standards/principles need to be set by parliament. The same applies to auditor duties and auditing standards. Parliament shall legislate on the principles and the Companies Commission, a newly created independent regulator, can then fill-in the details. There shall be no statutory regulatory powers for the Financial Reporting Council or any of the accountancy trade associations.

The following is an overview of the reforms proposed by this report. Details are in the text that follows:

### **Auditors Must Act Exclusively as Auditors**

- 1 Statutory Auditors of large companies and other entities must act exclusively as auditors.
- 2 The audit business of accounting firms must be legally separate from everything else, with no cross holdings.
- 3 Auditors and their associates cannot sell any non-auditing services, with the exception of delivering statutory returns, to audit clients.
- 4 It will be a criminal offence for statutory auditors of large companies and any entities related to them to offer or perform non-auditing services for audit clients.
- 5 Members of the audit team cannot join the staff of the audit client for five years after ceasing to be a member of the audit team.

### **A Statutory Auditor for the Financial Sector**

- 6 The state can become the fifth largest supplier of audit services.
- 7 A statutory state-backed body must be created to conduct real time audits of banks, building societies, credit unions, insurers and major investment firms.
- 8 The statutory auditor will work closely with the financial sector regulators.
- 9 The financial sector regulators shall have unhindered access to the files of the statutory auditor.

## **Expand Supply of Auditing Services**

- 10 Remove all restrictions on the ownership of auditing firms in order to attract new entrants, capital, competition and choice and create pressures for improvement in audit quality.
- 11 Joint audits must be made mandatory for large companies, as defined by the Companies Act 2006.

## **Independent Body for Appointment and Remuneration of Auditors**

- 12 An independent body to be created to appoint and remunerate auditors for all non-financial sector large companies, as defined by the Companies Act 2006.
- 13 Big four firm share of the audits of FTSE 350 companies must be capped at 50% of that market.

## **Audit Market and Competition**

- 14 Large companies must be required to change audit firms, partners and entire audit staff at least once every five years.
- 15 Audit firm rotation must be accompanied by a ten year cooling-off period i.e. the outgoing firm cannot return for another ten years.
- 16 Audit tenders should be publicly available
- 17 The winning audit tender, in its original form, shall be filed at Companies House.
- 18 Collusion in any part of the audit tendering process in order to secure competitive advantage shall be a criminal offence.
- 19 The Competition and Markets Authority must examine the auditing industry at five yearly intervals, until such time that its structure and practices change to secure high degree of competition and choice to deliver value for money and high quality audits to protect stakeholders.

## **Exposure to Organisational Culture**

- 20 Auditor files should be available for stakeholder scrutiny
- 21 Each resolution to appoint or reappoint an auditor, and each audit report must be accompanied by the following:
  - A copy of the audit contract.
  - A list containing composition of the audit team, the time spent by each member on the job, their qualifications and the hourly rate charged for each grade of staff.

- Details of the audit work performed by staff not under the control and direct supervision of the entity signing the audit report, together with the names of the entities where the work is performed.
- Percentage and significance of the audit work carried out by staff not under the control and direct supervision of the entity signing the audit report.
- A statement that the auditor accepts full responsibility and liability for the quality of work carried out by staff not under the control and direct supervision of the entity signing the audit report.
- A statement that the audit firm has arrangements in place to ensure that all files and staff related to the audit work, whether at the firm or at third party location, shall be made available to regulators.
- A list of materially significant questions asked by auditors and directors' replies.
- A list of regulatory action taken against the firm during the five previous years and the firm's response to each action.
- A list of the shortcomings in the firm's audit procedures identified by the regulator during the previous five years and the firm's response and commitment for dealing with each of them.

22 The provision of false or misleading information would be a criminal offence.

### **Reforming Auditor Liability**

23 Auditors must owe a 'duty of care' to individual stakeholders who have a reasonable justification for placing reliance upon auditors.

24 The incidence of liability must act as a pressure point for improvement of audit quality. Individuals and society must be empowered to seek redress from negligent auditors

25 There must be personal liability for audit failures upon partners responsible for audits.

26 Where a partner of the audit firm acts negligently, fraudulently or has colluded in the perpetration of fraud and material irregularities, civil and criminal liability must fall upon the partner or partners concerned and upon the firm jointly and severally.

27 Class lawsuits must be permitted to empower stakeholders as many stakeholders are not always in a position to seek redress from negligent auditors.

28 In the event of negligent and fraudulent practices, audit fees for the relevant years shall be returned to the audited entity.

### **Accounting for Accounting Firms**

29 Auditing firms must not be permitted to write their own accounting, auditing and financial reporting rules.

- 30 Auditors and auditees must not collude and fix financial reporting and auditing rules for LLPs.
- 31 Accounting trade associations must not be permitted to write accounting rules for businesses controlled by their members.
- 32 Auditing firms must provide socially useful information about their operations, including information about their offshore links, captive insurance companies, political links, audit failures, cooperation with regulators, regulatory action, lawsuits and profits from predatory practices.
- 33 The contents of financial and transparency reports must form part of a revised Companies Act, or equivalent legislation, so that the requirements can be enforced to secure consistency and empowerment of stakeholders.

### **Regulatory Structures**

- 34 No statutory regulatory powers for accountancy trade associations acting as the Recognised Supervisory Bodies.
- 35 No statutory regulatory powers for the Financial Reporting Council.
- 36 All aspects of the UK company law, including accounting and auditing, to be overseen by the Companies Commission. It will licence auditors and monitor audit quality.
- 37 Societal stakeholders to have presence on the Companies Commission.
- 38 The entire regulatory structure to be the subject of freedom of information laws.
- 39 Accounting standards must be set by Parliament and emphasise prudent accounting practices.
- 40 Accounting standards must meet the needs of stakeholders.
- 41 The Companies Commission shall provide guidance on the accounting principles set by Parliament.
- 42 All accounting standards must be stress tested to ascertain their effects.
- 43 Auditor duties to be clarified by a revised Companies Act.
- 44 Auditing standards must be formulated by the newly established Companies Commission.
- 45 Auditors shall approach each audit with an inquiring mind and design audit tests to determine whether financial statements are free from fraud and material irregularities, and report the matter to regulators.

- 46 Auditors shall to have a statutory duty to design audit tests to determine whether the auditee is a going concern at the date of the balance sheet.
- 47 Legislation shall be enacted to give regulators powers to implement a greater range of sanctions against auditors delivering persistent low quality audits. These can include banning firms for a specified period from securing new clients and the possibility of closure.
- 48 No further jurisdictions shall be awarded to auditing firms until they have addressed the quality gap and shown ability to deliver high quality financial audit.
- 49 The provision of false information to regulators and stakeholders shall be a criminal offence.

## **CHAPTER 1**

### **THERE'S NO BUSINESS LIKE ACCOUNTING BUSINESS**

The 2007-08 banking crash caused one of the biggest economic crises of modern times. Banks were bailed out by taxpayers at enormous cost. This ushered in austerity, cuts in public spending, rise in government borrowing, economic stagnation, wage freezes, erosion of people's purchasing power and the resulting destruction of well-known high street names which has turned city centres into economic deserts. Amidst this economic turmoil, one group has increased its revenues and profits. That is the big four accounting firms – PricewaterhouseCoopers (PwC), Deloitte, Ernst & Young and KPMG. They audit almost all of the UK and the world's major banks and leading corporations. They are paid millions to hold companies and their directors to account, but have delivered little.

#### **TAKING AUDITS FOR A RIDE**

Audit has been the making of the accounting firms. There are no state guaranteed markets for engineers, mathematicians, scientists, designers, biotechnology or telecommunications experts, but there is a state guaranteed market of external auditing reserved for accountants belonging to a select few trade associations. The sick are not required to consult a doctor and the injured are not compelled to hire a lawyer, but corporations, trade unions, schools, hospitals, local authorities, public bodies, housing associations and others are required by law to submit to an audit regardless of whether auditors deliver a worthwhile audit or not. Audit has given accounting firms easy access to senior management and has been used as a stall to sell many other services, including internal audit, risk management, executive remuneration, corporate governance, internal controls, regulatory compliance, mergers and acquisitions, legal work, pensions, restructuring, business turnaround, pre-share issue due diligence, interpreting accounting standards, tax avoidance and even laying golf courses, printing T-shirts and badges.

The big firm's fingerprints are all over the Panama Papers<sup>1</sup>, Luxembourg leaks<sup>2</sup>, Swiss leaks<sup>3</sup> and the Paradise Papers<sup>4</sup> as they devise ingenious tax avoidance schemes on an "industrial scale"<sup>5</sup>. The sole purpose is to deplete the UK public purse with the consequences that the elected government cannot deliver the social investment mandated through the ballot-box. They exercise the ultimate veto on democratic choices. On many occasions courts have declared the tax avoidance schemes crafted by the firms to be unlawful, but no big firm has been investigated, fined or disciplined<sup>6</sup>. Despite scandals, failures and conflict of interests, the firms

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<sup>1</sup> <https://www.icij.org/investigations/panama-papers/>

<sup>2</sup> <https://www.icij.org/investigations/luxembourg-leaks/>

<sup>3</sup> <https://www.icij.org/investigations/swiss-leaks/>

<sup>4</sup> <https://www.icij.org/investigations/paradise-papers/>

<sup>5</sup> House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms (follow-up), 28 January 2015;

<https://publications.parliament.uk/pa/cm201415/cmselect/cmpublicacc/1057/1057.pdf>

<sup>6</sup> Austin Mitchell and Prem Sikka, "The Pin-Stripe Mafia: How Accountancy Firms Destroy Societies", Basildon: Association for Accountancy & Business Affairs, 2011.

describe themselves as independent auditors. As a consequence of the closeness of the ties and the capaciousness of the revolving doors, successive governments have indulged the firms by giving them liability protections and shielding them from the consequences of their failures<sup>7</sup>. This has diluted incentives to deliver good audits. Their partners have colonised HMRC<sup>8</sup> and are permitted to write laws which ensure that they and their clients always win<sup>9</sup>. They advise government departments and promote accounting-think to promote more demand for their services<sup>10</sup>. They have colonised regulatory bodies. They hire legislators, former and potential ministers to advance their business interests<sup>11</sup>. Unsurprisingly, they have been highly influential in determining and preserving the rules of the game in which they are the most highly rewarded players. In 2007, the combined global revenues of the big four firms was \$89 billion and by 2017 it reached nearly \$142 billion<sup>12</sup>, a growth of almost 60%, making them the 56th largest economy<sup>13</sup> and dwarfing the gross domestic product of countries such as Hungary, Kuwait and Ukraine. The rents from the state guaranteed market and revenues from services sold on its back have swelled the coffers of the UK arms too. In 2007, the big four firms had combined revenues<sup>14</sup> of £6,354 million and by 2017 they reached<sup>15</sup> £11,864 million, an increase of nearly 87% at a time when the UK economy hardly grew and workers' share of GDP plummeted to all time low of 49.14%<sup>16</sup>. In 2017/18, the average profit per partner at Deloitte was around £832,000; £712,000 at PwC; £677,000 at Ernst & Young, and £519,000 at KPMG (rising to £601,000 in 2018). This represents a return of around 200% on their capital<sup>17</sup>.

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<sup>7</sup> Prem Sikka, "Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey", *Accounting, Auditing and Accountability Journal*. Vol. 21, No. 3, 2008, pp. 398-426.

<sup>8</sup> Prem Sikka, Michele Christensen, John Christensen, Christine Cooper, Tom Hadden, Deborah Hargreaves, Colin Haslam, Paddy Ireland, Glenn Morgan, Martin Parker, Gordon Pearson, Sol Picciotto, Jeroen Veldman and Hugh Willmott, *Reforming HMRC: Making It Fit For The Twenty-First Century*, A Policy Paper Published by the UK Labour Party, 8 September 2016.

<sup>9</sup> The Guardian, 'Big four' accountants 'use knowledge of Treasury to help rich avoid tax', 26 April 2013; <https://www.theguardian.com/business/2013/apr/26/accountancy-firms-knowledge-treasury-avoid-tax>

<sup>10</sup> Richard Brooks, *Bean Counter: The Triumph of the Accountants and How they Broke Capitalism*, London: Atlantic Books, 2018.

<sup>11</sup> Austin Mitchell and Prem Sikka, 2011, *op cit*.

<sup>12</sup> As per the firm's annual reports available at 30 September 2018– Deloitte, \$43.2 billion; PwC, PwC 41.3 billion; Ernst & Young, 31.4 billion; KPMG, 26.4 billion.

<sup>13</sup> <http://databank.worldbank.org/data/download/GDP.pdf>

<sup>14</sup> As per Accountancy Top 60 league table of UK accountancy firms: 2007; PwC, £1,980 million; Deloitte, £1,790 million, KPMG, £1,454 million; Ernst & Young, £1,130 million; <https://www.accountancydaily.co/sites/default/files/Top60Survey2007.pdf>

<sup>15</sup> As per the firm's annual reports available at 30 September 2018 - PwC, £3,764 million, Deloitte, £3,580 million; Ernst & Young, £2,348 million; KPMG, £2,172 million.

<sup>16</sup> Office for National statistics, *GDP quarterly national accounts, UK: January to March 2018*; <https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/quarterlynationalaccounts/januarytomarch2018>

<sup>17</sup> Richard Brooks, 2018, *op cit*.

## THE SILENCE OF THE AUDITORS

An audit makes people feel comfortable that a competent party from outside is checking a company's accounts and ensuring that the information is 'true and fair' and not misleading. Such hopes continue to be dashed by a regular parade of scandals, such as Carillion, BHS, Tesco, BT, Quindell, Autonomy, Rolls Royce, Cattles, Conviviality, Patisserie Valerie and many others. In each case, auditors collected large fees but delivered little of value and thousands of innocent people lost their jobs, savings, pensions and investments. To take just one example - Carillion entered liquidation in January 2018. It had about 43,000 employees (19,500 in the UK) and £7 billion of liabilities to 30,000 small businesses, most of whom will lose almost everything owed to them. The pension scheme deficit of £2.6 billion will force employees to lose some of their pension rights. Carillion had non-current assets of £2,163m, and £1,571m of this was goodwill, which had not been amortised for years and this helped to overstate the profits which was a boon for executives collecting profit-related pay. For the period 2009 to 2017, Carillion's debts rose by 297%, whereas the value of its long-term assets grew by just 14%. From December 2009 to January 2018, the total debt owed by Carillion increased from £242 million to an estimated £1.3 billion. In the five-and-half-year period from January 2012 to June 2017, Carillion paid out £333 million more in dividends than it generated in cash from its operations. *None of this aroused any interest from auditors.* KPMG audited the company for 19 years and always gave the company a clean bill of health.

The 2007-08 banking crash showed that auditors delivered little of any social value. Some banks collapsed within days of receiving a clean bill of health<sup>18</sup>. They had danger written all over them but the Nelsonian auditing firms saw nothing wrong. UK taxpayers provided £1,162 billion to support and rescue distressed banks, including £532 billion to recapitalise Lloyds and RBS, and £106 billion to nationalise Northern Rock and Bradford and Bingley<sup>19</sup>.

Lehman Brothers had a leverage ratio of more than 30 to 1. With this leverage, a 3.3% drop in the value of assets would wipe out the entire value of equity and make the bank technically insolvent. About 80% of Lehman's income came from speculative activities. No matter how clever, no one can win all the bets on financial horses, but that did not occur to auditors. Lehman Brothers received an unqualified audit opinion on its annual accounts on 28 January 2008 from Ernst & Young, followed by a clean bill of health on its quarterly accounts on 10 July 2008. By early August it was experiencing severe financial problems and filed for bankruptcy on 14 September 2008. The bank used an accounting gimmick codenamed Repo 105. Under this \$50 billion scheme, Lehman sold assets just before its financial year-end for around 5% less than the balance sheet value, with an agreement to buy them back shortly into the next accounting period for the amount of sale plus interest. The resulting cash was used immediately to pay debt and thus show lower liabilities and improved leverage ratio. The US insolvency examiner said that "the only purpose or motive for the transactions was reduction in balance sheet ... there was no

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<sup>18</sup> Prem Sikka, "Financial Crisis and the Silence of the Auditors", *Accounting, Organizations and Society*, Vol. 34, No. 6-7, 2009, pp. 868-873

<sup>19</sup>National Audit Office, Taxpayer support for UK banks: FAQs, <https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>

substance to the transactions<sup>20</sup>". Ernst & Young collected \$31 million in fees in 2007 and knew that Repo 105 had been used for several years by Lehman. The insolvency examiner concluded that "... the firm's outside auditor, was professionally negligent ...". A subsequent writ by the New York attorney general alleged that

"E&Y substantially assisted Lehman Brothers Holdings Inc. ...now bankrupt, to engage in a massive accounting fraud, involving the surreptitious removal of tens of billions of dollars of securities from Lehman's balance sheet in order to create a false impression of Lehman's liquidity, thereby defrauding the investing public<sup>21</sup>"

Just before the crash, Bear Stearns had shareholder funds of \$11.8 billion (£7.4 billion), assets of \$384 billion (£240 billion), which could not easily be converted to cash, and a derivatives portfolio with a face value of \$13.4 trillion (£8.4 trillion). It had a leverage ratio of over 35 to 1 and could therefore barely absorb a decline of around 3% in its assets. For nearly six years before its demise, almost all of the pre-tax profits at Bear Stearns came from speculative rent-seeking activities. It received an unqualified audit opinion on 28 January 2008 from Deloitte. However, by 10 March its financial problems hit the headlines and on 14 March, with state support from the US, it was sold to JP Morgan Chase.

Northern Rock's financial statements for the year to 31 Dec 2006 received a clean bill of health from PwC on 27 February 2007. Yet a few weeks later depositors were queuing outside the bank trying to rescue their savings as concerns grew about the stability of the bank. The bank need soon racked up around £30 billion of emergency funding from the government<sup>22</sup>. In common with auditors of other banks, PwC also collected fee for consultancy. The House of Commons Treasury Committee expressed concern that "there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution<sup>23</sup>". A subsequent inquiry by the House of Lords Economic Affairs Committee<sup>24</sup> accused bank auditors of "dereliction of duty", "complacency" and basking in a culture of "box ticking" rather than delivering meaningful audits.

HBOS received a clean bill of health from KPMG even though one of the bank's senior employees raised red flags<sup>25</sup>. Auditors would not listen. In 2008, the government spent £37 billion to bail out the bank. In 2017, a HBOS bank branch manager and a number of his associates were convicted of loan fraud going back more than a decade. Some of the details are provided in a document codenamed "Project Lord Turnbull Report" and published by the All Party Parliamentary Group

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<sup>20</sup> US Bankruptcy Court Southern District of New York, (2010). In re Lehman Brothers Holding Inc., Report of Anton R. Valukas, 11 March 2010; <http://jenner.com/lehman/VOLUME%203.pdf>.

<sup>21</sup> <http://amlawdaily.typepad.com/032312e%26ycomplaint.pdf>; accessed 20 January 2014.

<sup>22</sup> The Guardian, MPs tackle PwC over Northern Rock role, 4 December 2007; <https://www.theguardian.com/business/2007/dec/04/northernrock>

<sup>23</sup> House of Commons Treasury Committee, The run on the Rock, January 2008, p. 115

<sup>24</sup> House of Lords Select Committee on Economic Affairs, Auditors: Market concentration and their role, March 2011.

<sup>25</sup> Atul Shah, The Politics of Financial Risk, Audit and Regulation: A Case Study of HBOS, London: Routledge, 2018

on Fair Business Banking<sup>26</sup>. Anthony Stansfeld, Police and Crime Commissioner for Thames Valley, estimates that more than £1bn could have been involved:

“The fraud was denied by Lloyds Bank for 10 years, in spite of it being apparent that senior members of the bank were aware of it at least as far back as 2008. It resulted in a great number of companies being ruined, and the lives and livelihoods of their owners and those that worked with them being destroyed.

“They were pursued for their personal guarantees, and lost their houses and possessions as the bank and its lawyers pursued them for all they owned. Families were split up, marriages ruined, and suicides resulted”<sup>27</sup>.

Yet no questions have been asked of auditors. The FRC did not examine audit failures exposed by the banking crash. Auditing firms know that regulators, especially the financial sector regulators, place reliance upon auditors but the neither the Financial Conduct Authority (FCA) nor the Prudential Regulation Authority (PRA) has brought any action against the firms for worthless audits. Other countries are not so accommodating. For example, the US Federal Deposit Insurance Corporation (FDIC), a government corporation providing deposit insurance to depositors, sued Grant Thornton for failing to discover fraud at a bank and secured damages of \$24 million<sup>28</sup>. The FDIC also sued PwC for alleged negligent audits of Colonial Bank<sup>29</sup>. In July 2018, the judge said that PwC “did not design its [Colonial Bank] audits to detect fraud” and awarded \$625 million to the FDIC<sup>30</sup>.

UK reforms have been minimalist and grudging. The audit industry has more or less carried on as before and scandals persist. In early 2018, Carillion collapsed and the chair of the House of Common Business, Energy and Industrial Strategy Committee said:

“Carillion’s annual reports were worthless as a guide to the true financial health of the company<sup>31</sup>”.

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<sup>26</sup> All Party Parliamentary Group on Fair Business Banking, Statement on release of draft Project Lord Turnbull Report - 21 June 2018, <http://www.appgbanking.org.uk/statements/statement-on-release-of-draft-project-lord-turnbull-report/>

<sup>27</sup> Statement from the Police and Crime Commissioner – Fraud, 19 January 2018; <https://www.thamesvalley-pcc.gov.uk/news-and-events/thamesvalley-pcc-news/2018/01/statement-from-the-police-and-crime-commissioner-fraud/>

<sup>28</sup> Grant Thornton, LLP v. FDIC, No. 1:2000cv00655 - Document 645 (S.D.W. Va. 2010); <https://cases.justia.com/federal/district-courts/west-virginia/wvsdce/1:2000cv00655/136/645/0.pdf?ts=1428387676>; also see <https://www.courtlistener.com/opinion/219065/grant-thornton-llp-v-fdic/>

<sup>29</sup> [http://online.wsj.com/public/resources/documents/PWC\\_rulingpdf.pdf?mod=article\\_inline](http://online.wsj.com/public/resources/documents/PWC_rulingpdf.pdf?mod=article_inline)

<sup>30</sup> Reuters, PwC must pay FDIC \$625.3 million over bank’s collapse: U.S. judge, 2 July 2018; <https://www.reuters.com/article/us-at-t-directv-now/pwc-must-pay-fdic-625-3-million-over-banks-collapse-u-s-judge-idUSKBN1JS2CB>

<sup>31</sup> <https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/carillion-shareholders-17-19/>; 19 February 2018.

A report by parliamentary committees<sup>32</sup> concluded that in

“failing to exercise professional scepticism towards Carillion’s accounting judgements over the course of its tenure as Carillion’s auditor, KPMG was complicit in them”.

In April 2016 BHS<sup>33</sup> collapsed. It had been audited for a decade by PwC. The firm had a long-standing relationship with its CEO, Sir Philip Green, and provided auditing and consultancy services to BHS and its parent company. The audit partner responsible for the overall quality of the audit, supervision of the audit team and issuing the audit report spent just two hours on the job to conclude that BHS was a going concern, the very heart of the audit failure. He appeased directors by backdating his audit report<sup>34</sup>.

Auditors have failed to draw attention to frauds, fiddles, massaged profits and inflated balance sheets even when the ‘red flags’ have been evident. Directors are complicit in such shortcomings, but if they could be relied upon to come clean no society would spend vast sums on external audits.

## **REGULATORY INACTION**

Despite a steady stream of scandals, the structure and regulation of audit market has remained unchanged. Auditing firms dominate the FRC and through it, collude with company directors to formulate accounting and auditing rules which they then pretend to independently apply and attest (see chapter 2). The wording in audit reports obfuscates auditor responsibility. The routine statement is that financial statements give a true and fair view because they comply with extant accounting standards. There is no mention that the big companies and the audit industry collude to manufacture accounting standards, or that this mechanical approach to audits has enabled auditors to abdicate responsibility for assessing the appropriateness of company accounting practices. After all, auditors are paid to give an informed opinion on financial affairs of businesses.

Fee dependency and conflicts of interests arising from the sale of non-auditing services have continued. The threat of lawsuits could act as a pressure point, but it is almost impossible for any individual stakeholder to sue audit firms or the audit partner responsible for negligence as the firms enjoy too many liability concessions. The UK accounting regulator, the Financial Reporting Council (FRC) admits that

“Across the Big 4, the fall in quality is due to a number of factors, including a failure to challenge management and show appropriate scepticism across

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<sup>32</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, May 2018; <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

<sup>33</sup> House of Commons Work and Pensions and Business, Innovation and Skills Committees, BHS, London: House of Commons, July 2016.

<sup>34</sup> SKY News, Banned BHS auditor 'spent two hours signing off retailer's accounts', 21 June 2018; <https://news.sky.com/story/banned-bhs-auditor-spent-two-hours-signing-off-retailers-accounts-11411768>

their audits, poorer results for audits of banks. There has been an unacceptable deterioration in quality at one firm, KPMG. 50% of KPMG's FTSE 350 audits required more than just limited improvements, compared to 35% in the previous year<sup>35</sup>.

No firm has been barred from securing new business or shut-down. The regulatory response is to levy puny fines and business-as-usual continues. The audit industry, together with the Institute of Chartered Accountants in England and Wales (ICAEW), has long used strategies for organising reforms off the agenda. Rather than reflecting upon its own failures, it routinely blames others for audit failures. Producers of goods/services do not blame their failures on consumers for expecting higher quality products/services or duty of care, and they try to meet social expectations. In sharp contrast, the audit industry castigates people for expecting higher quality audits, ethical conduct and a duty of care (the technical jargon is the 'expectation gap'<sup>36</sup>) and this was evident in response to the Carillion scandal<sup>37</sup>. Its stale response has been to tweak accounting/auditing standards, codes of ethics, and disciplinary arrangements, all under the control of the auditing industry<sup>38</sup>. When that does not work, high profile individuals are enrolled to produce soothing reports to say how audit would be transformed in the future<sup>39</sup>. This way, public opinion is massaged, journalists and legislators are disarmed, reforms are postponed and auditing drifts from one crisis to another and fees keep rolling in. No questions are asked about whether profit-seeking auditing firms, the private police force of capitalism, are capable of delivering good audits, and how the current accounting/auditing standards have become tools of stagnation. Risks of audit failures have been transferred, as evidenced by BHS and Carillion, to suppliers, employees, pension scheme members, taxpayers and local communities, but the auditing industry are oblivious to the massive social and economic consequences. There is little evidence to show that corporate governance models and values are standardised, yet the emphasis is on developing standardised approaches to audits. Rather than transforming audits, regulators have been devoted to securing compliance with outdated and failed models of audits. Unsurprisingly, the FRC, the auditing regulator has been described as "chronically passive", "timid", "useless" and "toothless"<sup>40</sup>.

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<sup>35</sup> Financial Reporting Council, Big Four Audit Quality Review results decline, 18 June 2018; <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline>

<sup>36</sup> Prem Sikka, Anthony Puxty, Hugh Willmott and Christine Cooper, "The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence", *Critical Perspectives on Accounting*, Vol. 9, No. 3, 1998, pp. 299-330

<sup>37</sup> *Economia*, Bill Michael: on KPMG and the profession, 8 February 2018; <https://economia.icaew.com/en/features/february-2018/bill-michael-on-kpmg-and-the-profession-carillion-profile>

<sup>38</sup> Prem Sikka and Hugh Willmott, "The Power of 'Independence': Defending and Extending the Jurisdiction of Accounting in the UK", *Accounting, Organizations and Society*, Vol. 20, No. 6, 1995, pages 547-581.

<sup>39</sup> Tony Puxty, Prem Sikka and Hugh Willmott, "Mediating Interests: The Accountancy Bodies' Responses to the McFarlane Report", *Accounting and Business Research*, Vol. 27, No. 4, 1997, pp. 323-340.

<sup>40</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, *Carillion*, London: House of Commons, May 2018, <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>.

## THE NEED FOR REFORM

Some commentators have openly said that “the conventional audit is probably no longer worth paying for<sup>41</sup>”. During the course of our investigation many people have asked us why in view of the regularity of their failures and involvement in bribery, corruption, tax dodging, price-fixing and other predatory practices<sup>42</sup>, accounting firms are permitted to conduct audits at all. Even by the feather-duster standards of the FRC, some 27% (19% in 2017) of the audits are substandard<sup>43</sup>. Imagine if that routinely applied to the production of cars, aeroplanes, medicine or food. The producers would be sued and shut-down and governments would step in. But that does not happen to auditing firms. They continue to be defended by regulators and governments, and, in a so-called ‘free market’ economy enjoy the protection of a state-guaranteed market for auditing. A study examined the stakeholder value generation by big accounting firms and rated it as “junk” and said that there was:

“little evidence of effective risk management with inadequate understanding and capability to monitor governance, cultural and human capital risk factors. This applies to both external audit services, which are not fit for purpose in this respect, and internal risk control systems within each individual firm.

... the core business model itself is neither societal in nature nor reconciled and integrated with its business model<sup>44</sup>”.

Audit is a trust engendering technology and has been grievously abused. Even the City folk are saying that auditors have had their “heads in the sand” and must provide a far more rounded view of companies’ health than the current statutory “truth and fairness” opinions<sup>45</sup>. The mantra in the auditing industry is that it needs to restore trust in audits, something that has been banded around for nearly fifty years, but the industry has been remarkably unable or unwilling to do so. The writing is on the wall and alternatives to audit firms and current conceptions of audits need to be considered. Audits by accounting firms are a means to an end – which is to secure accountability of big business and protect stakeholders – including customers, employees, pensioners and shareholders - from sleaze by preventing publication of misleading financial statements and perpetration of financial abuses, fraud and fiddles. Some say that this is the last chance saloon and legislators must soon call time. The industry has organised its own accountability off the political agenda. There are tomes of auditing standards, but hardly anything on auditor accountability

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<sup>41</sup> London Evening Standard, It's still the human element that counts, 23 January 2008 (<http://www.standard.co.uk/news/its-still-the-human-element-that-counts-6672357.html>; accessed 27 January 2014)

<sup>42</sup> Richard Brooks, 208, op cit; Austin Mitchell and Prem Sikka, 2011, op cit.

<sup>43</sup> Financial Reporting Council, Report and Financial Statements for the Year Ended 31 March 2018; <https://www.frc.org.uk/getattachment/4f46c7dd-f0b7-43d6-96c9-c52136281a18/FRC-Annual-Report-and-Financial-Statements-2018.pdf>

<sup>44</sup> Paul Kearns and Stuart Woollard, Auditing the “Big 4” Accounting Firms – Preliminary Report, The Maturity Institute, 23 October 2017; <http://www.hrmaturity.com/wp-content/uploads/2017/11/Big-4-Project-Preliminary-Reportv.8.pdf>

<sup>45</sup> Financial Times, Scope and quality of audits needs reform, say City chiefs, 22 October 2018; <https://www.ft.com/content/c3edd6e6-d3c3-11e8-a9f2-7574db66bcd5>

to stakeholders. Parliamentary committees have rightly called for a break-up of the big four firms<sup>46</sup> in order to reduce their power and ensure that they cannot hold governments and regulators to ransom. This needs to be accompanied by reforms to enhance transparency, audit quality and public accountability of the industry.

This report puts forward reforms which are likely to be opposed by the big firms, accountancy trade associations and their corporate beneficiaries, but wiser souls will know that the industry can't continue to short-change society. As KPMG chairman<sup>47</sup> put it: "We are an oligopoly — that is undeniable ...I can't believe the industry will be the same [in the future]. We have to reduce the level of conflicts and . . . demonstrate why they are manageable and why the public and all stakeholders should trust us".

This report is organised in 12 further chapters.

Chapter 2 provides a background to the UK accounting industry. It shows that the big four accounting firms dominate the market for external auditing. It provides details of the regulatory system for external audits and shows that regulators are effectively captured by the auditing industry.

Chapter 3 argues that audit industry needs to be restructured and that financial auditors must act exclusively as auditors, as is the norm in almost all other sectors. The firms must be restructured and focus exclusively on audits and with no possibility of engaging in the sale of non-auditing services to anyone as the lure of consultancy fees has constantly undermined auditor independence and quality of audits.

Chapter 4 considers the possibility that the current big four firms could decline to big three. The biggest threat is likely to be the reckless pursuit of profits by accounting firms, including willingness to engage in predatory practices and "criminal wrongdoing". The firms have also used their size to hold UK government to ransom. The only way forward is to expand the number of suppliers in the audit market, especially at the top-end of the market.

Chapter 5 recommends that a state appointed body should directly conduct real-time audits of financial enterprises. This would increase the number of suppliers and also facilitate greater competition in the audit market.

Chapter 6 calls for expansion of the supply of auditing services through abolition of barriers to entry and a mandatory system of joint audit for all large companies.

Chapter 7 calls for the creation of an independent body to appoint and remunerate auditors of large companies. It also calls for the big four firm share of the audits of businesses with turnover above £200 million and a balance sheet total of over £2 billion to be capped at 50% of the market.

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<sup>46</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, May 2018;

<https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

<sup>47</sup> Financial Times, Big Four accountancy firms plan for forced break-up, 16 May 2018; <https://www.ft.com/content/6c07f5d8-591b-11e8-bdb7-f6677d2e1ce8>

Chapter 8 calls for compulsory change of audit firms after five years unlike the current term of twenty years. It also requires that audit tenders for a client or a portfolio of clients be published.

Chapter 9 argues that poor audit quality is the outcome of a corrosive organisational culture which receives little public exposure. Under intense time budget pressure, members of audit teams resort to irregular auditing practices and even falsification of audit work. It raises questions about the composition of audit teams, offshoring of audit work and reliance by auditors on work which is not performed by staff under their control and supervision. Such practices are part of profit maximisation by firms but are not disclosed. The chapter puts forward a number of suggestions for public exposure of the injurious culture of the firms and to thereby create pressures upon the firms to address the damaging impact of their flawed organisational culture.

Chapter 10 argues that the incidence of audit *liability* can act as an important pressure point for firms to improve audit quality, but UK liability laws are weak. It calls for changes to empower stakeholders.

Chapter 11 argues that the financial and transparency reports published by the big firms are very economical with information. One reason for that is that the firms have effectively been making their own rules. This must end.

Chapter 12 notes some of the regulatory failures in financial reporting and auditing, sanctions against failing firms, lack of urgency by the regulators and failure to eradicate poor practices. It concludes that the current regulators are unfit-for-purpose and need to be replaced. It recommends that all accounting principles/standards must be set by parliament and an independent Companies Commission can fill in the details. It recommends that auditors duties must be stated in the Companies Act and auditors must have duty to detect/report fraud and irregularities and actively consider whether the reporting entity is a going concern. Auditing standards would be set by the Companies Commission.

Chapter 13 concludes the report with brief summary and reflections.

## CHAPTER 2 THE ACCOUNTING INDUSTRY

Due to historical antagonisms, the UK has a number of professional accountancy bodies. At 31 December 2017, the six main bodies operating in the UK and Republic of Ireland (ROI) had 360,124 professionally qualified accountants out of an estimated global total of around 3 million<sup>48</sup>. This is nearly 12% of the global total even though the UK and ROI economies account for around 3-3.5% of the global gross domestic product (GDP). It is the highest number of professionally qualified accountants per capita in the world and more than the rest of the EU put together. The UK-based membership of each of the major professional accountancy bodies is shown in Figure 2.1<sup>49</sup>.

**Figure 2.1  
UK Membership of Major Accountancy Bodies**

Growth of Members in the UK & ROI	ACCA	CIMA	CIPFA	ICAEW	CAI	ICAS	AIA	TOTAL
<b>Total numbers for 2017</b>	<b>94,622</b>	<b>82,587</b>	<b>12,630</b>	<b>126,560</b>	<b>23,905</b>	<b>18,528</b>	<b>1,292</b>	<b>360,124</b>
% growth (16 - 17)	4.3	3.2	-2.4	1.2	5.3	2.3	-6.2	<b>2.6</b>
% growth (13 - 17)	17.6	10.2	-2.3	5.0	18.5	7.6	-14.4	<b>9.9</b>
% compound annual growth (13 - 17)	4.1	2.5	-0.6	1.2	4.3	1.9	-3.8	<b>2.4</b>

At 31 December 2017, the professional bodies also had 163,809 UK-based registered students which in due course will swell their ranks. The skewed enrolment of graduates in the accounting industry deprives other sectors of educated labour and affects the economic performance of the nation. Accountants are in demand because 'accounting think' has colonised UK business, governmental and institutional practices. Almost all businesses are required to publish audited accounts. The statutory market of auditing and insolvency provides comparative job security, high financial rewards and is attractive to graduates.

In the surveillance society, one set of accountants prepares accounts. Then another set, often labelled "internal auditors", arrives to say that organisational procedures are appropriate and followed. Subsequently, another set labelled "external auditors" arrive to tell the first two that all was well. When businesses go belly-up, another set of accountants, this time acting as insolvency practitioners, arrives to downsize or liquidate the business. Accountants collect vast fees and salaries at every stage of the life cycle of a business and serious questions need to be asked about the social contribution of this bloated sector.

The UK incurs enormous social cost to produce accountants, but it has neither resulted in superior economic performance nor stability. The unprecedented investment in accounting has not resulted in good financial reporting, better audits, and freedom from frauds and fiddles, safe pension schemes, absence of tax dodging

<sup>48</sup> <https://www.ifac.org/about-ifac>

<sup>49</sup> Financial Reporting Council, Key Facts and Trends In the Accountancy Profession, July 2018, p. 4; <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf>

and money laundering, or abundance of good corporate governance. Financial engineering is rife as companies develop ruses to inflate profits and assets. Too many companies are mired in scandals and produce opaque accounts, which are routinely described by auditors as ‘true and fair’.

The state guaranteed market of external auditing is reserved for accountants belonging to select few professional bodies. In order to be eligible to conduct external audits an individual must hold a qualification from one of the Recognised Qualifying Bodies<sup>50</sup> (RQBs), as designated under the Companies Act 2006. The Financial Reporting Council (FRC) decides the eligibility of a body as a RQB. The following bodies are currently designated as RQBs (Table 2.1).

<b>Table 2.1</b>
<b>RECOGNISED QUALIFYING BODIES</b>
1. Association of Chartered Certified Accountants (ACCA)
2. Association of International Accountants (AIA)
3. Chartered Accountants Ireland (CAI)
4. Institute of Chartered Accountants in England and Wales (ICAEW)
5. Institute of Chartered Accountants of Scotland (ICAS)

The body licensing an individual to act as an auditor must be recognised as a Recognised Supervisory Body (RSB) by the Financial Reporting Council (FRC). The RSBs licence individuals and firms to act as auditors. The employees of such firms and individuals do not need to be licensed auditors. The licensed firms must purchase professional liability insurance, submit to practice inspection by the RSB and comply with various rules. The following bodies are currently designated as RSBs (Table 2.2).

<b>Table 2.2</b>
<b>RECOGNISED SUPERVISORY BODIES</b>
1. Association of Chartered Certified Accountants (ACCA)
2. Chartered Accountants Ireland (CAI)
3. Institute of Chartered Accountants in England and Wales (ICAEW)
4. Institute of Chartered Accountants of Scotland (ICAS)

Accountancy bodies also licence their members to sell consultancy services, including tax advice, so that they can use their professional soubriquet to distinguish themselves from other suppliers. The professional bodies may discipline all members for failure to comply with the rules and codes.

## **AUDITORS**

In May 2018, the UK had 23,473 registered statutory auditors<sup>51</sup>, operating as sole traders, partnerships and limited liability companies of various sizes. Figure 2.2<sup>52</sup>

<sup>50</sup> In recent past CIPFA was recognised as a RQB. As its education scheme puts less emphasis on audits, its RQB status was revoked in December 2017.

<sup>51</sup> Financial Reporting Council, Developments In Audit 2018, October 2018; <https://www.frc.org.uk/getattachment/5e1ac2d1-f58c-48bc-bb91-1f4a189df18b/Developments-in-Audit-2018.pdf>

shows that at 31 December 2017, 5,660 firms<sup>53</sup> were registered with RSBs and authorised to conduct statutory external audits in the UK and Republic of Ireland (ROI).

**Figure 2.2**  
**Accounting Firms Registered with RSBs**

Number of Principals per Firm	ACCA	ICAEW	CAI	ICAS	TOTAL
1	1,137	1,136	404	56	<b>2,733</b>
2 - 6	566	1,562	382	108	<b>2,618</b>
7 - 10	11	142	12	9	<b>174</b>
11 -50	5	92	10	8	<b>115</b>
50+	0	16	2	2	<b>20</b>
<b>Total as at 31.12.17</b>	<b>1,719</b>	<b>2,948</b>	<b>810</b>	<b>183</b>	<b>5,660</b>
<b>Total as at 31.12.16</b>	<b>1,856</b>	<b>3,121</b>	<b>844</b>	<b>189</b>	<b>6,010</b>
<b>Total as at 31.12.15</b>	<b>1,982</b>	<b>3,256</b>	<b>894</b>	<b>199</b>	<b>6,331</b>

The firms undertake around 100,000 statutory audits a year. The state-guaranteed market is not accompanied by any performance or value-for-money indicators. Partners in the largest firms tend to be ICAEW/ICA/CAI members and are licensed by them, but the monitoring of their audits of listed companies and disciplining for poor audits is conducted by the FRC. The RSBs publish annual reports on their operations.

## MARKET DOMINATION

The 2017 data relating to the top 10 UK accounting firms provides some indication of the structure of the industry (Table 2.3<sup>54</sup>). The market is dominated by the big four accounting firms whose income dwarfs all major competitors. KPMG is the smallest of the big four firms and its income exceeds the combined fees of the firms occupying positions 5-10 in the table.

<sup>52</sup> Financial Reporting Council, Key Facts and Trends In the Accountancy Profession, July 2018, p. 25; <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf>

<sup>53</sup> On 29 November 2018, 5449 firms were shown on the statutory register of auditors. <http://www.auditregister.org.uk/Forms/Statistics.aspx>

<sup>54</sup> Data as per the Top 75 Firms survey 2018, February 2018, published by Accountancy Daily.

It is also a little misleading to describe the firms as accounting and/or auditing firms because their combined income from these services is a small fraction of their total income and is dwarfed by income from other services. On their websites and promotional material, the big firms describe themselves as providers of 'professional services', rather than providers of accounting and auditing services. Only 36% of PwC's fee income is from accounting and auditing services (firms don't always split the two) and for Deloitte, Ernst & Young and KPMG they form 28%, 29% and 26% respectively. The remainder is from consultancy services to audit and non-audit clients. Tax advice forms a major proportion of the firms' income.

**Table 2.3**  
**UK Accounting Market**

<b>Firm</b>	<b>2017 Total Income £m</b>	<b>2017 Audit &amp; Accntng Income £m</b>	<b>2017 Tax Inc £m</b>	<b>2017 Pre-tax Profit £m</b>	<b>UK Partners</b>	<b>UK Offices</b>
1. PwC	3,598	1,296	881	865	953	30
2. Deloitte	3,380	932	691	608	696	29
3. Ernst & Young	2,348	689	634	464	685	18
4. KPMG	2,172	556	505	301	623	22
5. Grant Thornton	500	155	135	78	185	27
6. BDO	456	151	107	91	193	18
7. RSM	319	115	81	49	135	36
8. Smith & Williams on	245	27	41	39	252	12
9. Moore Stephens	198	109	39	n/a	180	36
10. Mazars	174	71	35	32	134	18

Nevertheless, auditing is an important jurisdiction for the firms as it gives them unimpeded access to senior management in businesses and opens doors for the sale of a variety of consultancy services. It provided access to ministers and senior servants as the state is continuously pre-occupied with management of economic crisis.

Despite a series of scandals and measures to promote auditor choice (see later chapters), the big four firms' share of the FTSE 350 market increased from 95% to 98%. In Germany, big four firms have 94% of the 130 largest listed company audits and almost 100% of audit fee income. In the USA they have 79% of the 3,000 largest public company audits and collect 96% of audit fees<sup>55</sup>. For the period 2014 to 2017, the big four firms controlled around 78% of the audit of UK listed companies. In France, the big four firms audit 100% of the listed companies but because of a

<sup>55</sup> Financial Reporting Council, Developments in Audit 2018, October 2018; <https://www.frc.org.uk/getattachment/5e1ac2d1-f58c-48bc-bb91-1f4a189df18b/Developments-in-Audit-2018.pdf>

system of compulsory joint audits their share is effectively reduced to 50% of the audit market for listed companies<sup>56</sup>. The FRC data shows that for 2017, the number of Public Interest Entities<sup>57</sup> (PIEs) audited by PwC, Deloitte, Ernst & Young and KPMG were 533, 337,287 and 464 respectively. The next biggest are BDO and Grant Thornton with 100 and 69 clients respectively<sup>58</sup>.

The domination of the big four firms has been aided by a close business relationship with financial institutions. The big firms handle most of the major insolvencies, many of which are instigated by financial institutions in their capacity as secured lenders. Before 2014 it was common practice for banks and other major lenders to insert clauses in leveraged facility agreements to restrict borrower's choice of auditors to one of the big four firms. This was outlawed by the European Union Directive 2014/56/EU (the "Directive") and implemented in the UK by the Statutory Auditors and Third Country Auditors Regulations 2016, but the legacies remain.

The alumni effect is also a factor in the market power of the big four accounting firms as companies often appoint auditors from the firms familiar to their directors and officers. Nearly a fifth of FTSE 100 chief executives are accountants<sup>59</sup>. Some 64% of FTSE100 finance directors are linked to the big four accounting firms and 61 out of the 100 audit committee chair positions at the highest level of UK companies are held individuals who previously worked for at least one of the big four firms or one of their predecessor firm<sup>60</sup>. The alumni group also provides political support. It is common for the 100 Group, essentially finance directors of FTSE100 companies, to support the interests of the big four firms. For example as a possible split of the big four firms and a 'cap' on the number of FTSE 350 clients is being considered, the chair of the 100 Group said that such a move would be "detrimental"<sup>61</sup>. The alumni effect is a huge money spinner but also has implications for audit quality. A branch of research shows that the corporate executives' background as partners or managers in audit firms equips them with "extensive knowledge of audit procedures and negotiation tactics. As a result, executives could use their higher-order ability to hide

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<sup>56</sup> Trends in Auditor Market Concentration in Select European Countries, 6 November 2018; <https://www.auditanalytics.com/blog/trends-in-auditor-market-concentration-in-select-european-countries/>

<sup>57</sup> PIEs are defined by the European Union (EU) Directives 2013/34/EU on accounting (the Accounting Directive) and 2014/56/EU on statutory audits (the Audit Directive). The definition is governed by the law of a member state whose secure transferable securities (equity and debt) are admitted to trading on a regulated market in the EEA; and credit institutions and insurance undertakings i.e. mostly listed companies plus banks and insurance companies, whether listed or not.

<sup>58</sup> Financial Reporting Council, Key Facts and Trends In the Accountancy Profession, July 2018; <https://www.frc.org.uk/getattachment/27725654-8bd9-4623-a410-ef1661a69649/Key-Facts-and-Trends-2018.pdf>

<sup>59</sup> Economia, Fifth of FTSE 100 CEOs are accountants, 19 February 2018; <https://economia.icaew.com/en/news/february-2018/fifth-of-ftse-100-ceos-are-accountants>

<sup>60</sup> Accountancy Daily, Two thirds of FTSE 100 CFOs are ex-Big Four, 4 December 2017; <https://www.accountancydaily.co/two-thirds-ftse-100-cfos-are-ex-big-four>

<sup>61</sup> SKY News, Finance chiefs warn against capping big four's audit share, 2 November 2018; <https://news.sky.com/story/finance-chiefs-warn-against-capping-big-fours-audit-share-11543056>

misstatements or to avoid current-period adjustments when the external auditor finds misstatements<sup>62</sup>.”

## **FINANCIAL REPORTING COUNCIL (FRC) FRC Authority**

The FRC is the main regulator of the auditing industry. It was incorporated in March 1990 and became a public body in its current form in 2004<sup>63</sup>. It was formed in the aftermath of scandals to address concerns about the quality of financial reporting and audits. It sets accounting, auditing and actuarial standards as well as the corporate governance code. The FRC issues a code of ethics which has a bearing on the non-auditing services that auditors may be able to sell to audit clients. Following the 2016 implementation of the 2014 EU Audit Regulation and Directive, the government has designated the FRC as the UK Competent Authority for audit with responsibility for the regulation of statutory audit; including setting auditing and ethical standards, monitoring and enforcement. The FRC monitors, investigates and enforces the statutory audit of public interest entities, which are mainly listed companies and Lloyd's syndicates. As most of these are carried out by big accounting firms, the monitoring of the quality of their audit work falls to the FRC.

The RSBs carry out their regulatory functions under legally binding delegation agreements with the FRC. The conditions for performance of these Regulatory Tasks are agreed with each of the bodies in respect of their members in the following areas:

- the application of the FRC's criteria for the purpose of determining whether persons are eligible for appointment as statutory auditors, the registration of such persons, keeping the register and making it available for inspection (Registration);
- procedures for maintaining the competence of such persons (Continuing Professional Development);
- monitoring of statutory auditors and audit work except where retained by the FRC (Audit Monitoring); and
- investigations and imposing and enforcing sanctions in relation to breaches of relevant requirements by statutory auditors except where retained by the FRC (Enforcement).

The FRC has delegated the majority of investigation and sanctioning of non-public interest cases to the RSBs.

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<sup>62</sup> Anne Albrecht, Elaine Mauldin, and Nathan J. Newton (2018) Do Auditors Recognize the Potential Dark Side of Executives' Accounting Competence?. The Accounting Review, In-Press.

<sup>63</sup> Hansard, House of Lords Written Question HL8896, 25 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-06-25/HL8896/>

## Financial Reporting

Historically, the contents and purpose of company accounts has been specified by parliament in the Companies Acts. Companies Act 2006 states that company directors are responsible for preparation and public filing of “true and fair” accounts, In the case of individual companies, the accounts must comprise a balance sheet as at the last day of the financial year, and a profit and loss account. Where a company has subsidiary undertakings there is an obligation to prepare “true and fair) group accounts in the form of consolidated accounts. The Companies Act requires that directors of a company must not approve accounts, unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss of the company, in the case of individual accounts, and of the undertakings included in the consolidation, in the case of the company's group accounts. The Companies Act 2006 does not provide a detailed specification of the accounting rules to be used in the preparation of company accounts, but it recognises the standards issued by the FRC.

Since 2005, UK companies have been able to prepare their accounts in accordance with the International Financial Reporting Standards (IFRS) formulated by the International Accounting Standards Board (IASB) and adopted by the European Union. The FRC has adopted the framework pushed by the IASB. It is not irrelevant to note that the parent company of IASB, now known as the International Financial Reporting Standards Foundation (IFRSF), is based in Delaware so that it can avoid taxes on its income<sup>64</sup>. The IFRSF is funded by the big four accountancy firms and about 200 corporations, many of whom have a history of accounting abuses and auditing failures. The FRC claims that IFRS represents a global system of accounting. But that is simply not true. After the banking crash, the US has refused align its accounting standards with the IFRSs and Japan does not fully use it either. Besides, accounting standards, like other social arrangements, are the outcome of social negotiations and bargaining, but the FRC has handed the entire arena to giant corporations and accounting firms.

What is the purpose of requiring companies to publish audited financial statements? Parliamentary debates can provide some answers. During the passage of the Companies Act 1929, audited accounts were described as more than just for the “protection of shareholders and investors, wholly or even mainly<sup>65</sup>”. During the passage of the Companies Act 1948, audited accounts were considered to be “in the interests and protection of the public<sup>66</sup>”. During the passage of the Companies Act 1967, the then President of the Board of Trade said, “It is right, both from the point of view of efficiency and of fair distribution of rewards, that full information should be available to shareholders, employees, creditors, potential investors, financial writers and the public as a whole<sup>67</sup>”. Another supporter of the Bill added: “modern company laws should be concerned not just with the interests of the shareholders but with the

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<sup>64</sup> Kees Camfferman and Stephen A Zeff, *Financial Reporting and Global Capital Markets: A History of the International Accounting Standards Committee, 1973-2000*, Oxford: Oxford University Press, 2007.

<sup>65</sup> Hansard, House of Commons Debates, 21 February 1928, col. 1523

<sup>66</sup> Hansard, House of Lords Debates, 18 February 1947, col. 745

<sup>67</sup> Hansard, House of Commons Debates, 14 February 1967, col. 360

contribution of the company to the economic efficiency of the whole community<sup>68</sup>. The Opposition benches supported the Bill and added that “We need a number of figures to be able to make that comparison, and it is this inquiry by those interested in the company, whether as an onlooker or as a shareholder in a number of companies, which is so important to improve the performance of companies in any particular industry<sup>69</sup>”. A 1975 report<sup>70</sup> issued by the accountancy bodies did not consider financial reporting to be a private matter between the company and its shareholders. It recognised that there were diverse needs of various stakeholder groups, including employees, suppliers, the government and the general public. Yet the FRC has neglected the interests of stakeholders.

In a landmark House of Lords judgment in *Caparo Industries Plc v Dickman* [1990] UKHL 2 (08 February 1990) the law lords had an opportunity to consider the purpose of company accounts and stated that

“one purpose of providing the statutory information might be to enable the recipient to exercise whatever rights he has in relation to his proprietary interest by virtue of which he receives it, by way, for instance, of disposing of that interest. I can, however, see no ground for supposing that the legislature was intending to foster a market for the existing holders of shares or debentures by providing information for the purpose of enabling them to acquire such securities from other holders who might be minded to sell.”

“... I therefore conclude that the purpose of annual accounts, so far as members are concerned, is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts. “

The FRC set out its stall in 1990 and in complete contrast to the House of Lords decision and parliamentary sentiments; its “Statement of Principles” stated that

- “The objective of financial statements is to provide information about the reporting entity’s financial performance and financial position that is useful to a wide range of users for assessing the stewardship of the entity’s management and for making economic decisions.
- That objective can usually be met by focusing exclusively on the information needs of present and potential investors, the defining class of user.
- Present and potential investors need information about the reporting entity’s financial performance and financial position that is useful to them in evaluating the entity’s ability to generate cash (including the timing and certainty of its generation) and in assessing the entity’s financial adaptability<sup>71</sup>”.

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<sup>68</sup> Hansard, House of Commons Debates, 14 February 1967, col. 403.

<sup>69</sup> Hansard, House of Commons Debates, 14 February 1967, col. 444

<sup>70</sup> Accounting Standards Steering Committee, *The Corporate Report*, London: ASSC, 1975.

<sup>71</sup> Accounting Standards Board, *Statement of Principles*, London: ASB, 1999. The ASB started issuing accounting standards in 1990 and was part of the FRC. In 2012, it was

The above is notable for “*focusing exclusively on the information needs of present and potential investors*” and the assertion that whatever is good for investors is somehow also good for other stakeholders, including employees, suppliers, pension scheme members, the state, local communities and anyone else affected by corporate practices. None of this is borne out by the collapse of BHS, Carillion, banks and numerous other scandals. In any case little is known about how investors process information.

The FRC framework is based on a schema advanced by the International Accounting Standards Board (IASB) which has long asserted that

“the objective of general purpose financial reporting is to provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions depend on the returns that those investors, lenders and other creditors expect from investing in the entity’s debt and equity instruments or from providing credit to the entity. Their expectations about returns depend on their assessment of the prospects for future net cash inflows to the entity<sup>72</sup>”.

Again, the emphasis is on “*future*” cash flows. The IASB/FRC conceptual framework is informed by Chicago economics and based on a set of arguments initially developed by the US-based accounting standard setter, the Financial Accounting Standards Board (FASB) in the 1970s. The framework has been in limbo for many years as it could not easily address many of contemporary accounting issues. In the FRC and IASB framework “mark-to-market” or fair value have become the key drivers of financial reports even though markets are volatile, uncertain, driven by bubbles, manipulations and poor assessment of risks by credit rating agencies. A number of IFRS’s enforce the application of fair value reporting, that is, capitalizing expected future earnings of a firm’s assets into their on-going revaluations and IFRS 13 on Fair Value Measurement<sup>73</sup> sets out a general ‘fair value hierarchy’ to inform accountants how to value assets.

- Asset value can be based on quoted prices in active markets for identical assets or liabilities,
- Quoted prices for similar assets or liabilities in active markets, or
- A reporting entity can develop and model, using unobservable inputs, to generate a valuation (using the best information available in the circumstances).

Traditionally, financial statements have been based on invoices, contract notes, costing records and even market values of tangible assets. However, tangible assets are increasingly replaced by intellectual property (patents, logos, software,

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replaced by the Accounting Standards Council but the framework established by the ASB, with some modification, has remained central to the promulgation of accounting standards.

<sup>72</sup> International Accounting Standards Board, Staff Paper: Conceptual Framework – October 2017; <https://www.ifrs.org/-/media/feature/meetings/2017/october/iasb/conceptual-framework/ap10b-sweep-issue-flowchart-chapter1.pdf>.

<sup>73</sup> <https://www.iasplus.com/en/standards/ifrs/ifrs13>

trademarks, copyrights, etc.) and complex financial instruments. Companies are keen to improve their reported performance by including such items in their financial statements, but in the absence of active markets consisting of numerous buyers/sellers and where everyone is a price-taker rather than a price-maker, it is almost impossible to verify the valuation of company specific intellectual property. Nevertheless, the FRC permits companies to generate their own numbers through what has become known as 'mark-to-model' or 'mark-to-myth' as some critics have called it. Traditionally the numbers assigned to assets, liabilities, income and expenses in corporate financial statements were verifiable and could be corroborated from actual transactions, but that is not necessarily the case now.

The FRC, under the influence of the IASB, has diluted "reliability" as criteria in financial reporting and has replaced it with "faithful representation", which permits plenty of scope for inserting educated guesses in company accounts, albeit the ones based on fancy models, algorithms and formulas. The FRC approach to financial reporting has diluted the traditional transactions and realisation based model of financial reporting in favour of one aligned with markets and valuation models. One consequence of the market based approaches is that companies can report gains/profits because market prices have gone up even though assets/liabilities have not been realised i.e. not turned into cash or near-cash.

For a long time 'prudence' was considered to be a fundamental accounting concept and required that companies should not anticipate profits and must make provision for foreseeable losses at the earliest possible opportunity. The FRCs adoption of IFRSs has resulted in abandonment or at least severe dilution of the concept of prudence and companies have been required to make provisions for losses only when they were incurred. The shortcomings of the accounting standards and FRC's oversight of financial reporting were exposed 2007-08 banking crash as many banks had continued to postpone the write-off of toxic assets and bad loans in their balance sheets. This was known, and led to a collapse of trust in the valuation of assets on bank balance sheets, which in turn triggered the crisis in August, 2007, by freezing inter-bank lending. The FRC and the use of IFRSs was heavily criticised by the parliamentary Banking Standards Commission<sup>74</sup>.

Later chapters of this report will show that the accounting standards approved by the FRC significantly obscured the transparency at banks, Carillion, BHS and elsewhere.

## **Auditing Standards**

The auditors' duties, rights and powers are specified in the Companies Act 2006. In general, auditors are required to state whether in their opinion the annual accounts give a true and fair view of the state of affairs and the balance sheet and profit or loss of the company or group at the end of the financial year. Unlike the directors' duties, the legislation does not fully spell the auditors' duties though there are some exceptions. For example, the Building Societies Act 1986, Financial Services Act 1986, Banking Act 1987 and their subsequent revisions impose duties on auditors to report irregularities to financial sector regulators even without client knowledge. The

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<sup>74</sup> UK House of Lords and House of Commons Parliamentary Commission on Banking Standards: Changing banking for good, June 2013.

same duties are not imposed in other segments of the economy even though there are considerable concerns about auditor duty to detect/report fraud and actively reporting on whether at the date of the balance sheet, a business is a going concern. The statutory vacuum has enabled the FRC to specify auditor duties through auditing standards.

The FRC promulgates auditing standards which cover auditor duties and working practices. These are drafted by working parties and committees dominated by the auditing industry, and big firms in particular. The auditing standards are often based on the lowest common denominator and have been a mechanism for limiting audit work, auditor responsibility and liability.<sup>75</sup> The FRC has adopted auditing standards set by the International Auditing and Assurance Standards Board (IAASB) which is part of the International Federation of Accountants (IFAC). The IFAC is a trade association that represents accountancy bodies in most countries. It is funded by the accountancy bodies from the UK and elsewhere. While there are many auditing standards, there are no standards on auditor accountability to the public, or even a requirement for auditors to publish meaningful information about their affairs or giving access to societal stakeholders to their files.

### **FRC Colonisation**

The Chairman and Deputy Chairman of the FRC are appointed by the Secretary of State for Business, Energy & Industrial Strategy (BEIS). The composition of its current board<sup>76</sup> is shown in Table 2.4.

**Table 2.4**  
**FRC Board Members**

<b>Name</b>	<b>Business Links</b>
Sir Winfried Bischoff (Chairman); appointed 1 April 2014	Chairman of Lloyds Banking Group plc (2009-2014); CEO and then Chairman of Schroders plc (1984-2000); Chairman of Citigroup Europe (2000-2009) and interim CEO and then Chairman of Citigroup Inc (2007-2009); Since 1983 he has served on the boards of 10 major public companies (5 in the UK, 3 in the US, 2 in Europe)
Gay Huey Evans (Deputy Chairman); Appointed 1 April 2012	Formerly vice chairman, Investment Banking & Investment Management at Barclays. Prior to that President of Tribeca LLC and Head of Governance at Citi Alternative Investments (EMEA) and Director of the Markets Division at the Financial Services Authority (1998-2005); various senior management positions with

<sup>75</sup> Prem Sikka, "Audit Policy-making in the UK: The Case of "The auditor's considerations in respect of going concern", European Accounting Review, Vol. 1, No. 2, 1992, pp. 349-392.

<sup>76</sup> As per <https://www.frc.org.uk/about-the-frc/structure-of-the-frc/frc-board/frc-board-members>

	Bankers Trust Company in New York and London between 1984 - 1998
Stephen Haddrill (Chief Executive Officer); Appointed 16 November 2009	Previously Director General, Fair Markets Group at the Department of Trade and Industry (DTI); previously Director of Employment Relations, and Consumer Affairs at DTI; Also held a number of other positions at DTI
David Childs (Chair of the Conduct Committee); Appointed 1 May 2014	Managing Partner of Clifford Chance from 2006 until 30th April 2014
Paul Druckman (Chair of the Corporate Reporting Council); Appointed 1 January 2017	Past President of the ICAEW; Takeover Panel member
Nick Land (Chair of the Codes and Standards Committee); Appointed 1 April 2011	Former chairman of Ernst & Young; non-executive director of Thames Water Utilities Ltd and Astro Lighting Ltd; previously been a non-executive director of Vodafone Group plc, Ashmore Group plc, BBA Aviation plc, Alliance Boots GmbH and Royal Dutch Shell plc; advisor to the board of Dentons UK and Middle East LLP and chairs the Private Equity Reporting Group of the British Venture Capital Association; chairman of the board of trustees of the Vodafone Group Foundation
Olivia Dickson (Non- Executive Director); Appointed 2 July 2012	Non-executive Director of the Royal London Group, and a non-executive adviser to the Senior Partner and Managing Partner of Travers Smith LLP; previously a non-executive Director and Chair of the Risk Committee of Canada Life, a non-executive Director and Chair of the Remuneration Committee of Virgin Money plc, a non-executive Director of Investec plc, a Trustee Director and Chair of the Risk Committee of the Mineworkers' Pension Scheme, a non-executive Director and Chair of the Risk and Compliance Committee of Aon Limited and as a member of the Financial Services Authority's Regulatory Decisions Committee and the Pensions Regulator's Determinations Panel; Senior Adviser to the Financial Services Authority, a Managing Director and Head of European Exchange Traded Derivatives Brokerage at JP Morgan and a non-executive Director and Chair of the Audit Committee of the London International Financial

	Futures Exchange.
Mark Zinkula (Non-Executive Director); Appointed 1 April 2017	Chief Executive Officer of Legal & General Investment Management; previously at Aegon Asset Management where he was Global Head of Fixed Income
Mark Armour (Non-executive Director); Appointed 2 July 2012	Non-Executive Director and member of the Audit Committee of Tesco PLC, a Member of the Takeover Panel; previously Non-Executive Director, Chairman of the Audit Committee and a member of the Remuneration Committee of SABMiller PLC.
Sir Brian Bender KCB (Non-executive Director); Appointed 1 March 2014	Retired British civil servant, who served as the Permanent Secretary of the Ministry of Agriculture, Fisheries and Food (later the Department for Environment, Food and Rural Affairs) and the Department of Trade and Industry (later the Department for Business, Enterprise and Regulatory Reform).
John Coomber (Non-executive Director); Appointed 23 July 2015	Joined the Board of Pension Insurance Corporation as a Non Exec Director in 2006, was appointed Chief Executive Officer in 2009 until June 2015 and continued as a Director until May 2017; also Chairman of MH (GB) Limited; previously director of Swiss Re, Euler Hermes, Chairman of The Climate Group, Chairman of Climatewise and a member of the Deutsche Bank Climate Advisory Board
Roger Marshall (Non-executive Director); Appointed 1 November 2010	Former PwC partner; now on a number of Boards and committees including Old Mutual plc and Pensions Insurance Corporation, where he Chairs the Audit Committees
Keith Skeoch (Non-executive Director); Appointed 1 March 2012	Co-Chief Executive of Standard Life Aberdeen plc; previously Head of Global Equities with James Capel (HSBC Securities from 1996)
Julia Unwin CBE (Non-Executive Director); Appointed 1 April 2018	Former Chief Executive of the Joseph Rowntree Foundation, a Charity Commissioner, Chair of the Refugee Council and Deputy Chair of the Food Standards Agency.
Jenny Watson CBE (Non-Executive Director); Appointed 1 April 2018	Chair of the House of St Barnabas, and of the Independent Complaints Panel at the Portman Group; non-executive director at the Financial Ombudsman Service.

The FRC board and operations are dominated by those with links to the big accountancy firms. Of the 15-member current main board, five are Big Four alumni, three of which came from one firm, PwC.

In November 2017, amidst intense public scrutiny, the FRC decided to publish a Register of Interests<sup>77</sup> and it lists details of board and committee members' appointments, offices and directorships currently and for the past ten years, their membership of professional bodies and trade unions, membership of an audit firm pension schemes, and 'relevant declarations in respect of family and close personal relationships. The FRC Register shows that out of the 10 members of the FRC's codes and standards committee, four come from the Big Four, while five members of the 13-strong conduct committee have a Big Four background. Of the 44 names appearing on the Register, 18 are ICAEW members, one is a CIMA member, and two are ICAS members. The evidence shows that partners from firms implicated in accounting, auditing and tax avoidance scandals are welcome at the FRC and sit on its committees. It is to be expected that they are selected for their expertise; and that the need to be independent, objective and serve the broader public interest is impressed upon them. However, what 'independence', 'objectivity' and 'public interest' means is inevitably conditioned by their education, income, wealth and business interests.

The FRC sponsored accounting standards affect calculations of solvency, liquidity, leverage, profit/loss and assets and liability. Accounting standards have distributional effects as they influence the distribution of income, wealth, risks, pension rights, supplier security and employee pension rights. Therefore, it is vital that such effects are considered in making rules, but they rarely are. The entrenchment of 'corporate think' could be challenged and the debate on the purpose and effectiveness of the FRC could be enriched by a plurality of stakeholder perspectives. However, there is virtually no representation of employees, suppliers, trade unions, or pension scheme members even though such stakeholders are routinely affected by accounting and auditing practices. There are also concerns about oversight by the state when it is noted that the senior civil servant at the Department of Business, Energy and Industrial Strategy (BEIS), responsible for managing the department's relationship with the UK audit regulator, is married to FRC chief executive Stephen Haddrill<sup>78</sup>.

### **FRC Resources and Public Accountability**

Until 2009, the FRC was partly funded by the government. Since then, the Government has progressively withdrawn its financial contribution to the FRC and it ceased to provide direct funding from 2016 onwards. Whereas from 2009-2016, the FRC received £2.7 million from the government, it is presently funded<sup>79</sup> by the UK

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<sup>77</sup> [https://www.frc.org.uk/getattachment/0739443f-82e5-44e5-9d86-33c73de4fb63/Section-A-Final-RoI-data\\_for-publication-11-October-2018.pdf](https://www.frc.org.uk/getattachment/0739443f-82e5-44e5-9d86-33c73de4fb63/Section-A-Final-RoI-data_for-publication-11-October-2018.pdf)

<sup>78</sup> *Economia*, BEIS denies conflict of interest over FRC relationship, 1 November 2017, <https://economia.icaew.com/news/november-2017/beis-messes-up-over-frc-relationship>

<sup>79</sup> Financial Reporting Council, *Strategy 2018/21 Budget and Levies 2018/19*, London: FRC, March 2018; [https://www.frc.org.uk/getattachment/644a8555-41b3-45c8-8f09-51114f2183ff/FRC-Strategy-2018-21-\(March-2018\).pdf](https://www.frc.org.uk/getattachment/644a8555-41b3-45c8-8f09-51114f2183ff/FRC-Strategy-2018-21-(March-2018).pdf)

accountancy bodies boosted by annual Preparers Levy raised from listed companies, i.e. large companies with a turnover of £500m, various government departments, local authorities and public sector organisations, insurance companies and pension schemes. In 2016/17, the FRC raised nearly £32 million.

FRC board meetings are not held in the open and minutes are not publicly available. The FRC's mode of public accountability is annual reports, press releases and a short annual open public meeting where the public can ask some questions<sup>80</sup>, but may not necessarily receive answers.

## **FRC Disciplinary Action**

Disciplinary action against auditors for audit failures is overseen by the FRC's Conduct Committee. The Case Management Committee advises on the handling of disciplinary cases. Each case is assigned a group of at least 3 Case Management Committee members. The present membership of the Committees, somewhat sanitised after the Carillion and BHS failures, includes individuals currently or previously connected with PwC, Ernst & Young, KPMG, GlaxoSmithKline, Standard Chartered, Conoco and a number of law firms<sup>81</sup>. Previous memberships are heavily colonised by individuals connected with firms and businesses implicated in audit failures, tax avoidance and related anti-social practices<sup>82</sup>. No doubt the FRC would argue that individuals declare their conflict of interests and are then excluded from selected proceedings, but the point remains that their worldviews are embedded in the institution and inform notions of good/bad audits and related practices. Their worldviews determine whether any case is worthy of investigation. The Committees lack presence of stakeholders injured by accounting, auditing and corporate governance failures

The FRC criterion for making disciplinary judgments is that an individual's conduct "fell significantly short of the standards reasonably to be expected of them". This is a dilution of the previous benchmark which was that "the conduct or quality of work of the firm fell below that which was to be expected"<sup>83</sup>. The "significantly short" criterion is problematical as this makes many matters acceptable even though they are short of what may be acceptable to public at large. In addition, the FRC uses accounting/auditing standards and code of ethics as benchmarks, which have been crafted by itself. Therefore, it does not use any independent benchmarks in making assessments of accounting and auditing failures.

The whole process is fundamentally flawed in that the same body sets the rules, investigates failures and then acts a judge and jury

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<sup>80</sup> The minutes of the 2017 meeting provide a flavour of the tone of the meeting.

<sup>81</sup> As per <https://www.frc.org.uk/about-the-frc/structure-of-the-frc/conduct-committee/conduct-committee-members>

<sup>82</sup> For some evidence, see Appendix 5, Financial Reporting Council, The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS, November 2017; <https://www.frc.org.uk/getattachment/646bb35a-f39f-4d75-a12e-6d2480e0b2a7/HBOS-Report-Nov-2017-FINAL.pdf>

<sup>83</sup> For example, see the Joint Disciplinary Scheme report on Barings auditors - Coopers & Lybrand, Gareth Maldwyn Davies and Andrew Charles Turner, October 1998.

If the accountants under scrutiny satisfy the benchmarks, their conduct is considered to be satisfactory even though the benchmarks themselves may be deficient. For example, for a long time the FRC has permitted auditors to sell non-auditing services, albeit subject to restrictions in the aftermath of scandals. When considering the lack of independence in a disciplinary case its starting point is whether accountants complied with the code of ethics and if so that is not considered to lead to unacceptable conduct even though the provision of non-audit services results in erosion of independence. The FRC accounting standards did not require BHS, a wholly-owned subsidiary, to publish cash flow statements<sup>84</sup>. Its cash flows could not be untangled from the accounts of its parent company (Taveta Investments) as it had a number of additional subsidiaries. The net result is that the FRC's accounting standards ensured that BHS published opaque financial statements and failed to inform stakeholders of solvency and liquidity of the company. Compliance with such standards in FRC's universe is considered to be good.

The FRC has handed out disqualification and suspensions from professional body membership to individuals, as well as fines for the individuals and firms. The disciplinary hearings are not open to the public and how the evidence available to the FRC is weighted or filtered is not known. Before announcing disciplinary penalties the FRC negotiates them with accountancy firms and the relevant RSB, but the same privilege is not available to any complainant or those affected by the audit failures. In its quasi-judicial capacity, the FRC permits firms and the individual auditors to appeal against the FRC's initial conclusions, but stakeholders have no such rights.

## **SUMMARY AND DISCUSSION**

This chapter has provided background to the UK accounting industry. The UK has the highest number of accountants per capita in the world yet financial reporting and auditing practices are poor. The auditing industry is dominated by four big accounting firms. The industry has regulators, resulting in waste, duplication and obfuscation. None have independence from the auditing industry. The FRC is the main regulators, but it is too close to the industry. It is colonised by individuals from large corporations, big firms and the ICAEW. Through the FRC, representatives of the big accounting firms and corporations effectively set accounting and auditing standards. Accounting and auditing standards have distributional effects for society and a wide variety of stakeholders, but the FRC's structures have little or no representation from societal stakeholders. The capture of the FRC encourages 'group think' which privileges the interests of the firms and corporations and neglect of the wider societal interests. Neither the RSBs nor the FRC hold their board meetings in the open. Their minutes are not publicly available. The domination of the FRC confers advantages on corporate interests in that they are privy to developments and possible policy options whilst others are not.

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<sup>84</sup> Financial Reporting Council, Accounting and Reporting Policy FRS 102 - Staff Education Note 1Cash flow statements; <https://www.frc.org.uk/getattachment/ed90f95c-4180-426c-b543-c688d127f7a9/SEN-01-Cash-flow-statements-FINAL-FINAL-FINAL.pdf>

## **CHAPTER 3**

### **AUDITORS MUST ACT EXCLUSIVELY AS AUDITORS**

#### **THE AUDITING STALL**

Audits matter to stakeholders, governments, regulators and markets. In sharp contrast, auditing is a shrinking part of the work of major accounting firms and they are more focused on expanding consultancy services. Majority of the partners at major firms are associated with the provision of non-auditing services. Big firms are willing and able to lowball audits in the hope of appeasing directors and making excessive returns from the sale of other services. Staff in major firms are incentivised to sell consultancy services and their various offices are set income generating targets and often their promotion, salary increments and bonuses depend on meeting those targets.

In the contemporary world, audits are delivered by many organisations, including HMRC, the National Audit Office, health and safety inspectors, immigration officers and others. In all cases, auditors act exclusively as auditors. Unlike the financial auditors from the private sector, public sector auditors are neither appointed nor remunerated by the auditees and thus do not have dependency upon companies which can buy their silence and acquiescence. Public sector auditors are not permitted to use audit as a stall for selling other services or assist auditees with creative compliance and exploitation of regulations. Any effective auditor must have freedom from auditees and be aware of the various pressures, some obvious and subtle, which tend to influence attitude and thereby erode slowly but surely independence<sup>85</sup>. Non-auditing services result in an identification of the interests of auditors and their clients and economic bonds make it psychologically impossible for auditors to be independent of audit clients. A compromised auditor can neither design nor implement effective audit strategies and can easily ignore material misstatements in financial statements or fraud.

In the aftermath of scandals (for example, after the Enron and WorldCom scandals), selective restrictions have been placed on the sale of non-auditing services to audit clients, but many money spinners for the big firms are excluded. The basic dysfunctional business model of accounting firms which bundles together audit and non-auditing services has not been disrupted. The next scandal, once again shows that auditor independence was compromised through fee dependency and conflict of interests. The ever elaborate codes of ethics legitimise the sale of consultancy to audit clients by big firms. They have neither eliminated conflicts nor improved quality of audits and firms have shown willingness and ability to bypass them. An elaborate charade about Chinese Walls and internal checks is enacted, but has neither restrained the sale of consultancy services to audit clients nor eliminated conflict of interests. In 2012, the FRC stated:

“We are concerned that, more than seven years after the Ethical Standards were introduced, we are not able to report any improvement in this area. Firms must reconsider the adequacy of their procedures and training in this

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<sup>85</sup> Mautz, R.K.; Sharaf, H.A., *The Philosophy of Auditing*, Sarasota, Florida: AAA, 1961.

area. They should also increase the level of focus on this area in their own internal quality reviews<sup>86</sup>”.

In 2013, the FRC said,

“number of specific issues relating to compliance with the requirements of the Ethical Standards were identified across all firms. These included references to targets for the cross-selling of non-audit services to audited entities in partner appraisal documentation; failure to consult the Ethics Partner on the appropriateness of contingent fee arrangements for certain tax services; key partners involved in the audit from other network firms not being identified as such or monitored for potential rotation; and instances where shareholdings in audited entities were not disposed of on a timely basis<sup>87</sup>”

By 2014, the FRC said:

“Sufficient consideration is not always given to the appropriateness of providing non-audit services when an entity becomes an audit client or is subsequently listed. Firms should ensure they have appropriate procedures in place to monitor the ongoing provision of non-audit services to existing clients<sup>88</sup>”

The soft-touch regulation of the FRC has done little to wean firms away from intoxication with private profits from the sale of non-auditing services to audit clients. It is now time to end this and legally separate the delivery of financial audits from all other services, as is the norm for almost all other auditors. This would require a break-up of the major auditing firms.

## **DEGRADATION OF AUDITS**

Auditor independence is just one part of the audit quality jigsaw. The sale of non-auditing services to audit clients compromises independence as auditors report on the very transactions that they themselves created. By acting as a business adviser or consultant the auditor acquires a mind-set which favours taking orders from directors, following their instructions and becomes subservient to their interests. Many case studies ranging from Carillion<sup>89</sup>, Ted Baker<sup>90</sup>, MG Rover<sup>91</sup>, Enron,

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<sup>86</sup> Financial Reporting Council, Audit Quality Inspections Annual Report 2011/12, 13 June 2012; <https://www.frc.org.uk/getattachment/6de6e86c-b028-41fc-a8ed-fd898a22b4c2/Audit-Quality-annual-report-2011-2012.pdf>

<sup>87</sup> Financial Reporting Council, Audit Quality Inspections Annual Report 2012/13, 29 May 2013; <https://www.frc.org.uk/getattachment/00526830-1bd2-4178-9169-6b044bd93334/AQR-Annual-Report-2012-13.pdf>

<sup>88</sup> Financial Reporting Council, Audit Quality Inspections Annual Report 2013/14, 28 May 2014; <https://www.frc.org.uk/getattachment/3e0dd4e8-1e0b-49ad-a382-dc595beaee61/AQR-Annual-Report-2013-14.pdf>

<sup>89</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, May 2018; <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

<sup>90</sup> Financial Reporting Council, In The Matter Of The Executive Counsel To The Financial Reporting Council - And - (1) KPMG Audit Plc (2) Michael Francis Barradell, 20 August

WorldCom, Maxwell, Lehman Brothers and the 2007-08 banking crash can be provided to highlight the intoxication of accountancy firms with consultancy fees, often at the expense of audit quality. However, here we focus on the audit of BHS by PwC as it exemplifies the quest for profits at almost any cost.

PwC is no stranger to conflict of interests. For example, the 2009 FRC audit inspection report noted that PwC was not merely the auditor but also the actuary to the group's pension scheme. It said that "These arrangements were not consistent with the underlying principles of the Ethical Standards, due to the independent actuary's reliance on PwC's valuation leading to an unacceptable level of self-review threat<sup>92</sup>". Such concerns are routinely dismissed and here is how a PwC partner defended the firm's approach to selling consultancy services to audit clients.

"We have very strict rules and process in place to consider the risks that could compromise an audit ... There have already been several reviews of auditing practices and conflicts of interest and they have given a clean bill of health<sup>93</sup>".

The 2016 collapse of BHS showed that non-audit fees charged by PwC far exceeded the audit fees and the same partner was responsible for both services. Not only the audit partner, but also the senior audit manager and audit manager were actively delivering non-auditing services.

The FRC report on audit failure at BHS<sup>94</sup> noted that

"The lack of supervision by Steve Denison [PwC partner in-charge of audit] and A [the senior audit manager] is striking given that they both recorded substantial amounts of time on non-audit services for the same clients in the period from 1 January 2015 to 9 March 2015. Whilst Steve Denison recorded 31 hours on non-audit services in this period, he recorded just two hours on the BHS audit".

PwC's time recording shows that Steve Denison recorded one hour on the Taveta Group audit on 12 February and one hour of work on 9 March 2015 but no time at all between those dates and no further time after 9 March 2015"

Large fees were at stake and the FRC noted that

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2018; <https://www.frc.org.uk/getattachment/1ed59106-88d6-4af9-b0a6-21c87b8d7a13/KPMG-and-Michael-Francis-Barradell-PFAM-20-August-2018.pdf>

<sup>91</sup> Financial Reporting Council, In the Matter of (1) Deloitte & Touche, (2) Maghsoud Einollahi and The Executive Counsel To The Financial Reporting Council

<sup>92</sup> The Telegraph, Auditors get slammed for shoddy ethics by FRC, 14 September 2010; <https://www.telegraph.co.uk/finance/newsbysector/supportservices/8000848/Auditors-get-slammed-for-shoddy-ethics-by-FRC.html>

<sup>93</sup> The Guardian, Big Four auditors under fire over consultancies, 6 September 2010; <https://www.theguardian.com/business/2010/sep/06/auditors-financial-sector-regulators>

<sup>94</sup> Financial Reporting Council, In the matter of: The Executive Counsel To The Financial Reporting Council - And - (1) Stephen John Denison, (2) PricewaterhouseCoopers LLP, 10 August 2018; <https://www.frc.org.uk/getattachment/433f3df8-d0ef-456b-8a26-aeb55f65489b/BHS-Particulars-of-Fact-and-Acts-of-Misconduct.pdf>

“In 2014, the Taveta Group [parent company of BHS] paid PwC £355,000 in audit fees and £2,859,778 in non-audit fees. PwC’s report to Taveta’s audit committee suggests that the figure was even higher, at £3,303,000. The value of non-audit services that PwC sold to the Taveta Group therefore exceeded the value of the audit services that it sold to the Taveta Group by a factor of eight. In 2012 and 2013 the factor was three and in 2015 the factor was five. In addition, the Respondents charged Taveta a contingency fee in relation to a pensions incentive exercise ... The fees generated from this non-audit work risked inappropriately influencing the Respondents’ judgment or behaviour”

It is worth bearing in mind that EU restrictions on the sale of non-auditing services by statutory auditors to PIEs came into force in mid-2014, but there was a two year transition period and the restriction became binding in mid-2016. Under this, the maximum non-audit fees that the statutory auditor of a PIE can charge is one year is set at 70% of the average of the audit fees billed over the last three year. This was an empty gesture as the firms were already averaging about 70%<sup>95</sup>. Nevertheless, it provides a lens for looking at the BHS debacle. Was PwC preparing for the new rules or ignoring them until it had to follow them? BHS was not a PIE but why would the firm treat a large company differently?

At BHS:

“Steve Denison, A and B [audit manager] were involved in performing this non-audit work. PwC was also appointed as liquidator of a number of dormant subsidiaries in the Taveta Group. Steve Denison was the single point of contact at PwC for Sir Philip Green and had a central role in the provision of non-audit services generally. Steve Denison had a long or close business association with the client”

The PwC audit partner had been involved in numerous consultancy services which had a direct effect on the financial statements that he and PwC team audited. For example, he played a leading role in the “Disposal of 25% of Top Shop” and generated some £700,000 in fees for PwC. He also dealt with “the Arcadia and Bhs pension scheme deficits”; “Reorganising the group structure”; and “Delivering creative ideas around the use of property assets”. In 2014, Steve Denison stated: “I continue to receive great feedback from the senior people at my clients (Sir Philip Green and Paul Budge at Arcadia and [ ]). As a result, the incidence of them asking the other firms for help or advice is very limited.”

Auditors failed to perform adequate tests to verify fixed, assets, investments, loans, income, costs and much more. The parliamentary report and the FRC report noted that BHS turnover had been declining for several years and the group had been making significant losses. It had to make provisions for loss-making stores and also had a significant deficit on its pension schemes. BHS had been technically insolvent for many years and was dependent for its survival upon financial support from its parent company and other companies controlled by the family of Sir Philp Green. In 2015 that support had conditions attached to it. None of it bothered the auditors. The

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<sup>95</sup> David Gwilliam, Chie Min Teng and Oliver Marnet, How does joint provision of audit and non-audit services affect audit quality and independence? A review. London: ICAEW, 2014.

company continued to receive its customary unqualified audit report and the world was assured that it was a going concern. That assurance was worthless. The FRC noted that:

“[Auditors] gave no consideration to how these matters may have impacted BHS’ ability to continue as a going concern. They failed to gather any audit evidence on which to conclude that the going concern assumption was appropriate<sup>96</sup>”.

All auditing firms claim to have internal procedures for identification and control of conflicts of interests. They boast ethics committees to avoid conflict of interests. Yet year-after-year, the sale of non-auditing services to BHS was approved by PwC as the company was a big money-spinner. The services to BHS required input from PwC teams associated with pensions, insolvency, restructuring and other services. Yet no one raised questions about conflict of interests. The whole organisation failed at every level as it prioritised profits above everything else. Flushed with success of managing BHS and other audits, PwC chairman pocketed remuneration of £3.8 million in 2016.

Did the BHS scandal encourage reflection and change PwC practices? The FRC’s 2017 audit quality inspection report noted that

“Most of the identified breaches related to the holding of prohibited investments and the commencement of non-audit services for audited entities in advance of obtaining the audit partner’s approval (similar to last year). They also included cases where the firm’s Ethics Partner was not consulted on a timely basis regarding the level of independence threats associated with non-audit fees for listed entities exceeding audit fees<sup>97</sup>”.

An approval from the audit partner is hardly a check on anything as in the case of BHS the same partner was engaged in providing auditing and non-auditing services. The BHS debacle did not encourage any reflections and obsession with approval from the audit partner even though the policy was shown to be highly defective. The 2018 Audit Inspection report noted that:

“the firm’s testing of compliance with personal independence requirements (for example, holding prohibited investments) does not ensure that all partners and staff are subject to periodic testing”, and “firm’s systems relating to non-audit services do not require audit engagement partner approval before personnel obtain time codes for non-audit engagements ... There is also no

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<sup>96</sup> Financial Reporting Council, In the matter of: The Executive Counsel To The Financial Reporting Council - And - (1) Stephen John Denison, (2) Pricewaterhousecoopers LLP, 10 August 2018; <https://www.frc.org.uk/getattachment/433f3df8-d0ef-456b-8a26-aeb55f65489b/BHS-Particulars-of-Fact-and-Acts-of-Misconduct.pdf>

<sup>97</sup> Financial Reporting Council, PwC LLP Audit Quality Inspection 2017, June 2017; <https://www.frc.org.uk/getattachment/268c1302-ed75-4313-bed5-e78f5a9003e5/PwC-LLP-Audit-Quality-Inspection.pdf>

central monitoring of the delegation of the audit engagement partner's responsibility for approving non-audit services<sup>98</sup>"

## **RICHES FROM CONFLICTS OF INTEREST**

The performance related pay and the accompanying pressure to sell non-audit services to audit clients is a major factor behind degradation of audits. Here are a few examples<sup>99</sup>:

"Deloitte's audit directors and managers referred to cross-selling when trying to secure promotions, according to the AIU. At Ernst & Young, the AIU found some staff had attached their personal sales data in their annual appraisals.

PricewaterhouseCoopers had changed its bonus criteria to emphasise business growth, which jumped from 25% to 40% as a proportion of its KPIs. Meanwhile, audit quality portion dropped from 25% to 20%".

... audit quality was not significantly represented in the performance assessments at KPMG".

"E& Y ... was criticised for a salesman-like culture. Partners were singled for taking 'inappropriate credit' for cross selling non-audit services and the firm was rapped on the knuckles for taking on non-audit work without the level of paperwork needed to prove "safeguards had been properly considered"; and "a number of "partner candidate files" contained "inappropriate references of selling non-audit services to their audit clients."

Deloitte has been criticised for seconding employees to client firms – a practice which the report said could impair the firm's ability to take an objective view when conducting an audit<sup>100</sup>. One of the firm's audit stated that "as your auditors we would proactively provide you with pragmatic and commercial solutions, whilst being mindful of our independence", and; "The firm's quality control procedures for audit tender documents do not require a review by its independence or audit compliance departments<sup>101</sup>".

The 2018 Audit Quality Inspection report on Ernst & Young noted that "The firm does not centrally monitor the approval of the provision of non-audit tax services to PIEs which are permissible only if a specific exemption, based on criteria requiring

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<sup>98</sup> Financial Reporting Council, Audit Quality Inspection PwC 2018, June 2018; <https://www.frc.org.uk/getattachment/17862aa1-e033-4a86-93b7-d60dd7edd7c8/PwC-LLP-Public-Report-2017-18.pdf>

<sup>99</sup> Accountancy Age, Audit watchdog shines light on Big Four's cross-selling, 11 December 2009; <https://www.accountancyage.com/aa/news/1782096/audit-watchdog-shines-light-big-fours-cross-selling>

<sup>100</sup> Accountingweb, Lack of professional scepticism pervades Big Four audits, says FRC, 14 September 2010; <https://www.accountingweb.co.uk/business/financial-reporting/lack-of-professional-scepticism-pervades-big-four-audits-says-frc>

<sup>101</sup> Financial Reporting Council. Deloitte LLP Audit Inspection Report 2015, May 2015; <https://www.frc.org.uk/getattachment/9e7b6253-e56e-4d4e-bfea-a7596cae0daa/Deloitte-LLP-Public-Report-2014-15.pdf>

significant judgement, applies”; and “Threats to auditor independence arising from the provision of certain actuarial non-audit services created a risk that a reasonable and informed third party would conclude that the auditor’s independence was, or was likely to be, impaired”<sup>102</sup>. The 2016 Audit Quality Inspection report<sup>103</sup> on Ernst & Young noted that “The firm provided non-audit services to an entity without adequately assessing whether the safeguards in place to reduce or eliminate potential threats to independence were likely to be effective”.

The 2015 Audit Inspection Report on KPMG stated that “there was insufficient evidence that the audit team had given appropriate consideration to independence threats, and related safeguards, arising from the provision of non-audit services”<sup>104</sup>. The 2016 report again noted that “there was insufficient evidence that the audit team and the firm’s Ethics Partner had adequately considered all matters relevant to assessing the appropriateness of non-audit services, in particular the significance of any related threats to the auditor’s objectivity”<sup>105</sup>.

The firms lack effective internal procedures even to comply with the feather-duster standards of the FRC. As long as the audit firms are hired and fired by the companies they audit, they cannot be independent because fee dependency necessarily aligns their interests with those of the clients. Yet the charade of independent audits continues.

## **HISTORY OF FAILURES**

The concerns about conflict of interests impairing auditor independence and are not new and have been well documented in many official reports. Here are a few examples. A 1976 government report on the collapse of Roadships Limited concluded that

"Independence is essential to enable auditors to retain their objectivity which enables their work to be relied upon by outsiders. It may be destroyed in many ways but significantly in three; firstly, by auditors having a financial interest in the company; secondly, by the auditors being controlled in the broadest sense by the company; and thirdly, if the work which is being done is in fact work which has been done previously by the auditors themselves acting as accountants ... we do not accept that there can be the requisite

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<sup>102</sup> Financial Reporting Council. Ernst & Young Audit Quality Inspection Report 2018, <https://www.frc.org.uk/getattachment/08bfc242-0e02-4460-8fbc-f18c23902e93/Ernst-Young-LLP-Public-Report-2017-18.pdf>.

<sup>103</sup> Financial Reporting Council, Ernst & Young LLP Audit Quality Inspection 2016, May 2016; <https://www.frc.org.uk/getattachment/cac7e46c-376f-44e2-97d9-b65a04d96baf/Ernst-Young-LLP-Public-Report-2015-16.pdf>

<sup>104</sup> Financial Reporting Council. KPMG LLP and KPMG Audit Plc Audit Quality Inspection Audit Quality Inspection Report 2016, May 2015; <https://www.frc.org.uk/getattachment/aac1a278-7cf4-40fe-995b-aae11f9e9c73/KPMG-LLP-Public-Report-2014-15.pdf>

<sup>105</sup> Financial Reporting Council. KPMG LLP and KPMG Audit Plc Audit Quality Inspection Audit Quality Inspection Report 2016, May 2016; <https://www.frc.org.uk/getattachment/93494442-a287-4ac4-a23c-96fdcd3edca1/KPMG-LLP-Public-Report-2015-16.pdf>

degree of watchfulness where a man is checking his own figures or those a colleague ..... for these reasons we do not believe that [the auditors] ever achieved the standards of independence necessary for a wholly objective audit<sup>106</sup>.

Another report on the 1979 collapse of Burnholme & Forder concluded that

"in our view the principle of the auditor first compiling and then reporting upon a profit forecast is not considered to be a good practice for it may impair their ability to view the forecast objectively and must endanger the degree of independence essential to this work<sup>107</sup>".

In 1992, after the Maxwell frauds, the UK House of Commons Social Security Committee recommended that pension fund auditors should not be allowed to carry out non-auditing services for their audit clients<sup>108</sup>. However, auditing industry used its financial and political resources to resist the imposition of a complete ban on the sale of consultancy services.

The issues were raised again after the 2001 Enron scandal and a US Senate Committee hearing noted that the company's auditor Arthur Andersen was "involved with Enron's activities on a day-to-day basis<sup>109</sup>". The report,

"condemned the very concept of an integrated audit, not only for diluting the outside auditor's independence, but also for reducing the effectiveness of an outside audit by allowing the auditor to audit its own work at the company. Mr. Sutton called it a "terrible idea," while Mr. Campbell called it a "horrible practice and I do not think it should be permitted".

... When you are making over \$40 million a year, the auditor is not likely to come to the Audit Committee and say anything other than that they are independent<sup>110</sup>".

Northern Rock was a casualty of the 2007-08 banking crash. It received its customary clean bill of health from PwC. The firm was paid £500,000 in 2006 for audit work compared to £700,000 in 'non-audit fees', specifically 'in respect of securitisation transactions and the raising of wholesale funding'. The 2008 Treasury Committee report said:

"We are also concerned that there appears to be a particular conflict of interest between the statutory role of the auditor, and the other work it may undertake for a financial institution. For example, PricewaterhouseCoopers received £700,000 in non-audit fees largely comprised of fees relating to

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<sup>106</sup>Department of Trade and Industry, Roadships Limited, London: HMSO, 1976, pp. 243, 249, 250

<sup>107</sup> Department of Trade and Industry, Burnholme & Forder Limited, London: HMSO, 1979, p.71.

<sup>108</sup> Accountancy Age, 12 March 1992, p 1; Accountancy, April 1992, p 18.

<sup>109</sup>US Senate Permanent Subcommittee on Investigations, The Role of the Board of Directors in Enron's Collapse, July 2002.

<sup>110</sup> US Senate Permanent Subcommittee on Investigations, 2002, op cit, pp, 54-55.

assurance services in connection with Northern Rock's actions in raising finance". We note the work being undertaken by the accounting boards in respect of this issue and recommend that both they and the FSA give swift consideration to such particular conflicts in financial institutions<sup>111</sup>".

In a fragmented regulatory structure, matters got tossed between the FSA and the FRC and little has changed. A 2009 Treasury Committee report on the banking crisis noted that

"We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised. Representatives of the investor community told us of their scepticism that audit independence could be maintained under such circumstances. This problem is exacerbated by the concentration of audit work in so few major firms. We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity<sup>112</sup>".

The response of the auditing industry, accountancy trade associations and regulators has been to resist change and then only make minimal adjustments, generally on the terms preferred by the big auditing firms. The auditing industry remains mired in conflict of interests. Under pressure, the sale of some non-auditing services has been restrained, for example following the US Sarbanes-Oxley Act 2002, but has not forced auditors to act exclusively as auditors. This pattern of indulgence has emboldened auditing firms.

## **PREDATORY PRACTICES ARE EMBEDDED**

US Senate Committee inquiries<sup>113</sup> have shown that big accountancy firms have an elaborate network for developing and marketing tax avoidance schemes. Staff are trained and incentivised to sell the schemes, and despite all the claims about internal check and controls audit clients have been targeted. There has also been a steady parade of the same in the UK. Their trade has been the subject of parliamentary hearings<sup>114</sup> and adverse court rulings<sup>115</sup>. In 2013, the big four accountancy firms

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<sup>111</sup>House of Commons Treasury Committee, The run on the Rock, 24 January 2008, page 115; <https://publications.parliament.uk/pa/cm200708/cmselect/cmtreasy/56/56i.pdf>

<sup>112</sup> House of Commons Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, 12 May 2009; <https://publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

<sup>113</sup> For example, see US Senate Permanent Subcommittee on Investigations, US Tax Shelter Industry: The Role of Accountants, Lawyers, And Financial Professionals - Four KPMG Case Studies: FLIP, OPIS, BLIPS and SC2, Washington DC: USGPO, 2003; The Role of Professional Firms in the US Tax Shelter Industry; Tax haven abuses: The enablers, the tools and secrecy,.

<sup>114</sup> For example see, UK House of Commons Committee of Public Accounts, HM Revenue & Customs 2010–11 Accounts: tax disputes, London: The Stationery Office, 2011; UK House

became the subject of a hearing into their tax avoidance practices by the UK House of Commons Committee of Public Accounts. Just before the hearing the Committee received evidence from a former senior PwC employee stating that the firm's policy was that it would sell a tax avoidance scheme which had only a 25% chance of withstanding a legal challenge, or as the Committee chairperson put it:

“you are offering schemes to your clients—knowingly marketing these schemes—where you have judged there is a 75% risk of it then being deemed unlawful. That is a shocking finding for me to be told by one of your tax officials<sup>116</sup>”.

Representatives of the other three firms admitted to “selling schemes that they consider only have a 50% chance of being upheld in court”. This did not result in regulatory action by any of the regulators even though it raised issues about ethics, relationship with audit clients and the nation's tax revenues. In the absence of an independent regulator, the consultancy side of accountancy firms is regulated by the ICAEW, which simultaneously promotes and protects the firms. Despite strong court judgements, no firm has ever been disciplined. When pressed, the chief executive of the ICAEW said:

“You ask whether any of the major firms has been the subject of an adverse disciplinary finding in relation to advisory work on taxation. I can confirm that no such findings have been made either by the ICAEW or by the Financial Reporting Council<sup>117</sup>”.

Auditors sell tax avoidance schemes their audit clients and then report on the financial statements based upon those schemes. Ernst & Young did so, as shown by the case of *GDF Suez Teesside Limited v Revenue And Customs [2018] EWCA Civ 2075*. Another example is the case of *Iliffe News and Media Ltd & Ors v Revenue & Customs [2012] UKFTT 696 (TC) (01 November 2012)*. Ernst & Young devised a tax avoidance scheme for its audit client, a highly profitable media company which wanted to conceal its profits and defeat employees' claims for higher pay, amongst other things. The company owned a number of newspaper titles and was advised to treat its mastheads as a new asset. These were all transferred to the parent company for a nominal sum, and then immediately leased back to the subsidiaries for annual royalties. Over a five year period, the subsidiaries paid royalties of £51.6 million and published lower profits. This intragroup transaction did not result in any

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of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms, London: The Stationery Office, 2013; UK House of Commons Committee of Public Accounts, Tax Avoidance—Google; London: The Stationery Office, 2013; UK House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms (follow-up), London: The Stationery Office, 2015; UK House of Commons Committee of Public Accounts, Collecting tax from high net worth individuals, London: The Stationery Office, 2017.

<sup>115</sup> Austin Mitchell and Prem Sikka, *The Pin-Stripe Mafia: How Accountancy Firms Destroy Societies*, Basildon: Association for Accountancy & Business Affairs, 2011.

<sup>116</sup> UK House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms, London: The Stationery Office, 2013.

<sup>117</sup> Letter from the ICAEW chief executive to Austin Mitchell MP, dated 5 December 2012.

transfer of cash to an external party, but the subsidiaries claimed tax relief on the royalty payments. The company's board minutes, as reproduced in the court papers, noted that

“[Ernst & Young] had confirmed that if the newspaper titles and/or mastheads were registered as trade marks in the ownership of [INML], it was possible for the latter [i.e. INML] to charge the newspaper companies a fee for the use of the former in a tax efficient manner that would significantly lessen the transparency of reported results. It was agreed to progress this matter in consultation with [E&Y]<sup>118</sup>”.

In view of the seriousness of the above revelations, a formal complaint was lodged with the FRC by Austin Mitchell MP on 5 December 2012. The tax transactions took place during years 2003 to 2005, but a complaint could only be lodged after the legal judgment as without that nothing would have been known about the unsavoury practices. On 13 February 2013, the FRC said it was a matter for the accountancy body licensing Ernst & Young. A complaint had already been lodged on 5 December 2012 with the ICAEW, the RSB responsible for licensing Ernst & Young and its partners. On 20 December 2012, the ICAEW chief executive promised to respond. As is usual in matters relating to big firms, a period of silence ensued and nothing further was heard. The matter was taken-up by The Independent newspaper in a story published on 18 January 2016. When prodded, the ICAEW said: “We will always look at any scheme if it is ruled unlawful but it does not follow that if a tax case is lost disciplinary action will automatically follow<sup>119</sup>” and the matter was still “live”. This face saving statement still did not result in any speedy response. Eventually, on 11 November 2016, some four years after the original complaint, the ICAEW responded and said that the firm had destroyed some of the earlier files, but it nevertheless concluded that everything was fine and in line with the extant rules i.e. the firms can continue to sell tax avoidance schemes which the courts say are unlawful and auditors can continue to provide assurances that their interventions “would significantly lessen the transparency of reported results”. Apparently, none of this impaired auditor independence and everything was ethical as per the rules devised by auditing industry itself. The ICAEW sought to limit damage by claiming that the revised code of ethics might make it difficult for the firms to engage in the above practices, but did not explain why the same had previously been permitted. It did not explain its own role in crafting the rules either. The Nelsonian practices of the regulators only embolden the firms.

Another Ernst & Young scheme for an audit client was declared to be unlawful. The scheme involved loans between companies in the same group and its ultimate aim was to enable the company making the interest payment to claim tax relief on this expense, whilst enabling the company receiving the interest to avoid tax. This scheme was sold to Greene King, a leading pub retailer and brewer. Tax relief on payments of £21.3 million was at stake and the agreement, as the tax tribunal noted,

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<sup>118</sup> *Iliffe News and Media Ltd & Ors v Revenue & Customs* [2012] UKFTT 696 (TC) (01 November 2012).

<sup>119</sup> The Independent, ‘Big Four’ audit firms never examined over illegal tax plans, 18 January 2016; <https://www.independent.co.uk/news/uk/crime/emb-0000-big-four-audit-firms-never-examined-over-illegal-tax-plans-a6818126.html#r3z-addoor>

required that Ernst & young would take a percentage of the tax avoided by adoption of its scheme. After a prolonged legal battle the scheme was declared to be unlawful by the court judgment in *Greene King Plc & Anor v Revenue and Customs [2016] EWCA Civ 782*.

The role of PwC in mass marketing tax avoidance schemes was exposed by what became known as Luxembourg Leaks (or Luxleaks). Since November 2014, some 28,000 pages of tax agreements, returns and other papers relating to over 1,000 businesses have been available on the website of the International Consortium of Investigative Journalists<sup>120</sup>. The papers provide details of tax avoidance schemes and relate to giant corporations, such as Accenture, Amazon, Deutsche Bank, Disney, Dyson, FedEx, Heinz, IKEA, JP Morgan, Pepsi, Procter & Gamble, Shire, and many more. The 28,000 pages did not contain even one instance where PwC made any mention of ethics, morality, or the possible social impact of lost tax revenues. A PwC crafted scheme in the case of *Vocalspruce Ltd v The Commissioners for HMRC [2014] EWCA Civ 1302* was described by the judge as “fiction” and declared to be unlawful

The UK Supreme Court heard the case of *Commissioners for Her Majesty's Revenue and Customs v Pendragon plc and others; [2015] UKSC 37*. It related to a VAT avoidance scheme designed and marketed by KPMG. The scheme enabled car retailing companies to recover VAT input tax paid while avoiding the payment of output tax. The court declared the scheme to be unlawful and the judge said that:

“In my opinion the KPMG scheme was an abuse of law”.

The US case of *Salem Financial Inc. v United States, No. 10-192T (Ct. Fed. Cl. Sept. 20, 2013)* shows how the big auditing firms market avoidance schemes on a global scale, playing one country's tax system against another's. In this example, KPMG collaborated with Barclays PLC to mass market a tax avoidance scheme to several global corporations, including AIG, Microsoft, Prudential, Wachovia, Wells Fargo, Bank of New York Mellon, and Branch Banking & Trust (BB&T). The purpose of the scheme was to generate hundreds of millions of dollars of foreign tax credits through paper transactions and thus reduce the US tax liabilities of the clients. The scheme was declared to be unlawful and the judge said that the scheme was “driven solely by the sham circular cash flows of the Trust”. He described the scheme as “an economically meaningless tax shelter” and said that the conduct of those persons from BB&T, Barclays, KPMG ... who were involved in this and other transactions was nothing short of reprehensible”.

KPMG were both auditors and tax advisers to the P&O group and designed a scheme to enable P&O to artificially generate a tax credit of £14m. It was thrown out by the tax tribunal in the case of *Peninsular & Oriental Steam Navigation Company v Revenue & Customs [2013] UKFTT 322 (TC)*. The scheme involved a series of transactions between the UK and Australian subsidiaries to boost tax credits on dividend income. The judges said that the

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<sup>120</sup> <http://www.icij.org/project/luxembourg-leaks>

“scheme was designed and implemented for no reason other than tax avoidance” and contrived transactions were “all part of an elaborate trick designed to exploit [tax legislation]. ... P&O and its subsidiaries played out a scripted game of charades (paragraph 69 of the judgment)”.

A Deloitte scheme enabled a number of companies to generate tax deductible losses through complex financial transactions. Amongst others, the scheme was sold to Ladbroke Group International (LGI), a betting company. The key idea was for two subsidiaries to deliberately transact with each other in order to generate a tax loss in one of them. The group suffered no real loss overall. Ladbrokes tax director told the court that he had “been approached by Deloitte with a proposal for a tax planning opportunity involving a total return swap... and a novation of loans to extract reserves” (*Travel Document Service & Anor v Revenue & Customs [2015] UKFTT 582 (TC)*). Ladbrokes admitted it sought to avoid tax, but argued that the special transactions fell outside the scope of anti-avoidance rules. The First-Tier Tribunal threw out the scheme and said that the evidence

“seems to us to provide unequivocal confirmation that at the very least one of LGI’s main purposes in becoming a party to the relevant loan relationships was to secure a tax advantage”.

Deloitte and Ladbrokes appealed and the £71 million scheme was once again thrown out by the Upper Tribunal (*Travel Document Service & Anor v Revenue & Customs [2017] UKUT 45 (TCC) (07 February 2017)*).

The global economy is yet to fully recover from the 2007-08 banking crash, but auditing firms have done their best to deplete the public purse. A mass marketed avoidance scheme designed by Deloitte was sold to Deutsche Bank and UBS, amongst others. The scheme centred on bankers receiving a specially created class of shares in companies specifically formed in Jersey and the Cayman Islands. The banks paid banker bonuses into the schemes without having to account to HMRC for income tax or national insurance contributions for the staff or their own liabilities on earnings. After 12 years of litigation and a series of court battles, the matter eventually went to the UK Supreme Court and its judgement in the case of *UBS AG v HMRC and DB Group Services v HMRC [2016] UKSC13* rejected the scheme because “It had no business or commercial rationale beyond tax avoidance”. The judges added:

“In our society, a great deal of intellectual effort is devoted to tax avoidance. The most sophisticated attempts of the Houdini taxpayer to escape from the manacles of tax ... structuring transactions in a form which will have the same or nearly the same economic effect as a taxable transaction but which it is hoped will fall outside the terms of the taxing statute. It is characteristic of these composite transactions that they will include elements which have been inserted without any business or commercial purpose but are intended to have the effect of removing the transaction from the scope of the charge.”

The above is a small sample of the services provided by auditors to their current, past and potential clients. Ethics and integrity are a vital part of any trust

engendering technology, but are in short supply in the auditing industry. Any attempt to restore trust in the industry would require a reconstruction of the auditing industry. Such attempts are resisted. We engage with the counter arguments and then outline proposals for a reconstruction of the industry.

## **RESISTANCE TO REFORMS**

A myth promoted by the auditing industry is that the purchase of auditing and non-auditing services from the same firm somehow results in lower costs. Such myths are not supported by research<sup>121</sup> which shows that when companies invite competitive tenders, shop around and purchased auditing and non-auditing services from two separate firms, they received a lower price. However, this focus on private costs does not consider the social consequences of poor audits due to conflict of interests or auditors auditing their own work.

The firms object to any legally enforced split of the auditing business from the rest. They say that this will prevent them from delivering high quality audits or recruit good staff. We are not persuaded by such arguments. In the contemporary world high quality audits are conducted by many organisations. The National Audit Office (NAO), Her Majesty's Revenue and Customs (HMRC), Health and Safety Inspectors and food hygiene inspector are just some examples of the audit only organisations. They recruit highly capable, effective and multidisciplinary staff. The NAO recruits multidisciplinary audit teams well versed in accounting, auditing, law, information technology, pensions, tax and other disciplines. The same goes for HMRC as well. Numerous organisations perform audit only tasks and recruit audit staff for that purpose. It is hard to see why recruitment of multidisciplinary staff for delivery of company audits would be a problem for auditing firms. With appropriate rewards, working environment and career progression, auditing firms too can recruit and retain staff to deliver effective audits. There is nothing to prevent them from recruiting and incorporating staff with information technology, pensions, tax and other skills into audit teams.

There is some recognition that major firms need to address the conflict of interests. For example, KPMG<sup>122</sup> and Deloitte<sup>123</sup> have indicated their willingness to phase out, over a period of time, non-audit work for FTSE 350 audit clients. May be some might even stretch the constraint to PIEs. However, this gesture does not address the issues. Firstly, the constraint is predicated upon the assumption that the absence of non-auditing services will strengthen auditor independence, if so it should apply to all large companies. There is no logic in having a multi-tiered system where some

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<sup>121</sup> For example, see Dan A. Simunic, The Pricing of Audit Services: Theory and Evidence, *Journal of Accounting Research*, Spring, pp. 161-190, 1980; Dan A. Simunic, Auditing, consulting and Auditor Independence, *Journal of Accounting Research*, Autumn, pp. 679-702, 194.

<sup>122</sup> Financial Times, KPMG acts to avert 'conflicts of interest' of non-audit work, 8 November 2018; <https://www.ft.com/content/6d03b1c6-e33f-11e8-8e70-5e22a430c1ad?kbc=6b683eff-56c3-43d9-acfc-7511d974fc01>

<sup>123</sup> David Sproul, Breaking up the Big Four is not the answer to audit problems, *Financial Times*, 8 November 2018; <https://www.ft.com/content/e0fbc3d0-e2b2-11e8-a8a0-99b2e340ffeb>

sector auditors will have comparatively greater degree of independence but less is in others. Secondly, The KPMG/Deloitte proposals will not apply to sizeable listed companies beyond the 350 ranking. Even if the proposals were expanded to PIEs, they would not have applied to BHS and equivalent unlisted companies, hospitals or universities. Big names, such as Arcadia, British Steel, Clarks, Dyson, Iceland, Marshall Group, Matalan, Specsavers, Thames Water, Wilko and others, all with diverse stakeholder and regulatory interests would be excluded. They will not apply to multinational companies operating in the UK either ranging from Facebook, Microsoft, Amazon, eBay, Deliveroo and many others. Thirdly, the past record (for example, BHS) shows that the firms cannot be trusted to police themselves as profit making opportunities are too tempting (see later chapters). As long as the sale of non-auditing services is possible the firms are likely to exploit them. Fourthly, in the absence of additional changes, the KPMG/Deloitte proposals do not increase the numbers of suppliers providing auditing services.

## **SUMMARY AND DISCUSSION**

Audit quality has many facets. One of these is the requirement that auditors must be independent of the auditees and must not have any conflict of interests. They must not be a party to the transactions under scrutiny. Auditor independence is compromised by the sale of consultancy services to audit clients and is a major factor in audit failures. This is acknowledged in numerous authoritative reports, many written by eminent accountants (acting as DTI inspectors) and regulators. Despite periodic tweaking of the rules, auditors have continued to sell a variety of consultancy services to audit clients. The firms' espousal of ethical conduct and the internal mechanisms for controlling the provision of non-auditing services to audit clients and safeguarding auditor independence have failed as the lure of profits is too strong. Regulators have recorded the conflicts and the failures but taken no effective action, as they have been too close to the auditing industry. The regular parade of scandals has continued to give visibility to the issues and confidence in the auditing industry can't be restored by mere tweaking at the edges.

We recommend that statutory audits for large companies<sup>124</sup>, as defined by the Companies Act 2006, be performed by auditors whose sole business is to conduct external audits. The equivalent requirements will also apply to other entities requiring a statutory audit. The entity authorised to perform statutory audits must not be permitted to perform any consultancy or advisory function for the audit client, with the exception of any statutory returns which need to be signed by the auditors. This would require accounting firms to change their business model and legally separate the audit side of their business from the rest. The ownership of the auditing business and the rest must be legally separate and distinct and without any cross-holdings. Any other business controlled or owned by directors or partners delivering audits must be forbidden from selling any kind of consultancy services to the audit client. The above would require changes to the Companies Act and related legislation. It

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<sup>124</sup> According to the October 2018 publication 'Business Population Estimates For The UK And Regions 2018', published by the Department for Business, Energy & Industrial Strategy, the UK had 7,510 large companies;  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/746599/OFFICIAL\\_SENSITIVE\\_-\\_BPE\\_2018\\_-\\_statistical\\_release\\_FINAL\\_FINAL.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/746599/OFFICIAL_SENSITIVE_-_BPE_2018_-_statistical_release_FINAL_FINAL.pdf)

will be a criminal offence for statutory auditors of large companies and other entities to offer or perform non-auditing services for audit clients. The legal separation of audit business from the rest would protect partners and senior employees from endemic conflict of interests. It would also simplify administration as the firms would not need to apply the torturous procedures for containing conflict of interests arising from the sale of non-auditing services.

Some audit firms have told us that profit margins on audit work are low as the firms rely on non-audit work to make bigger gains i.e. a tacit admission of lowballing. They say that this cross-subsidy would disappear with the emergence of the audit only firm and therefore audit costs would need to rise. The firms were unable to provide evidence to support their assertions. The threatened rise in audit fees assumes that all providers will move in the same direction and the hourly charges of the partners (in some cases more than £1,500 per hour) and other staff would remain unchanged. Effective competition may erode such niches. If it does not, a small increase in audit costs may occur and may well be worth paying to secure robust audits. It will be considerably less than the price of not having robust audits, as shown by banks, BHS, Carillion and other audit failures.

A restructuring of the auditing industry along the above lines addresses some of the issues about conflict of interests and auditor independence, which in turn can encourage auditors to be robust and improve the way in which an audit is conducted. However, there are many issues that it does not address. It does not increase the number of suppliers in a highly segmented auditing market and thus competition and choice is not improved. This is so because after the split the major firms will still be big compared to their competitors. Therefore, attention needs to be paid to reforms which can bring new suppliers, shrink the size of the big four firms and encourage expansion of mid-tier firms. Such issues will be dealt in the later chapters.

The restructuring of the audit market would also encourage fairer competition in the consultancy industry. Currently, legislation enables auditing firms are to secure easy access to senior corporate personnel and sell other services. The auditor's evaluation of systems, risks and internal controls can also become a consultancy opportunity. The law does not permit other suppliers of consultancy the same access to corporate records or senior personnel. Therefore, the competition occurs on unfair terms. The separation of auditing removes that inbuilt advantage for auditing firms.

## **REFORMS**

- Statutory auditors of large companies and other entities must act exclusively as auditors.
- The audit business of accounting firms must be legally separate from everything else, with no cross holdings.
- Auditors and their associates cannot sell any non-auditing services, with the exception of delivering statutory returns, to audit clients.
- It will be a criminal offence for statutory auditors of large companies and any entities related to them to offer or perform non-auditing services for audit clients.
- Members of the audit team cannot join the staff of the audit client for five years after ceasing to be a member of the audit team.

## **CHAPTER 4 BIG FOUR BECOME THE BIG THREE?**

### **INTRODUCTION**

The domination of the audit market by the big four firms can increase instability. There is always the possibility that the big four firms can shrink to big three and thus further reduce choice at the top-end of the market. It is, however, unlikely that governments would permit any further mergers amongst the big firms to concentrate the supply and thus create possibilities of turmoil caused by the collapse of a giant firm. The likelihood of the big four firms becoming the big three will therefore be from other avenues. Over the years, major firms have pressurised governments to secure liability concessions with the claim that a mega lawsuit could drive them out of business. Therefore, they have been showered with liability concessions, so much so that it is now difficult, if not impossible, to successfully sue auditors for large sums even when they admit to being negligent. The diminution in audit quality has been the inevitable casualty of the indulgence shown to them though lawsuits against auditors are rare. Big firms have moved far away from audits as they chase consultancy riches. It is their willingness to bend the rules and make profits at almost any cost which is likely to reduce the big four to three. This chapter argues that the threat to a major firm is more likely to arise from its pursuit of profits and their own anti-social practices.

### **ARTHUR ANDERSEN AND ENRON**

Prior to its demise, Arthur Andersen was one of the big five accounting firms. Its partners became officeholders for the ICAEW and the FRC and played a key role in the drafting of auditing standards and codes of ethics. The 2001 Enron scandal revealed extensive frauds at what was then the biggest bankruptcy in US history. Almost overnight the company's share price crashed from \$90.75 to \$0.67. The company operated through a labyrinth of offshore companies, including 692 subsidiaries in the Cayman Islands and 119 in the Turks and Caicos. Its accounts always received the customary clean bill of health from its auditors, Arthur Andersen. The US Department of Justice accused Arthur Andersen of going easy on Enron because of a long, cosy relationship and extensive audit and non-audit fees. For the year 2000, the firm's consulting fees accounted for more than half of the \$52 million that it generated from Enron.

The Enron scandal showed that audit partners and senior managers were incentivised to sell consultancy services to audit clients. Their financial rewards were directly connected to the sale of consultancy services to audit clients. In 1999, an Andersen audit manager, objected to Enron's accounting and off balance sheet financing schemes. This was not well received by Enron's directors and he was promptly removed from his job of providing oversight and approval of accounting issues to Andersen's audit team<sup>125</sup>. The independence of Andersen's audits was

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<sup>125</sup> CNN, Andersen auditor questioned Enron, 2 April 2002;  
[https://money.cnn.com/2002/04/02/news/companies/andersen\\_bass/](https://money.cnn.com/2002/04/02/news/companies/andersen_bass/)

also further questioned because former Andersen personnel occupied over 300 middle and senior management positions at Enron<sup>126</sup>. In many cases, the one-time juniors were auditing their former bosses in accordance with the processes designed by their former seniors. The alumni links enabled Andersen to sell internal auditing services to Enron, making Andersen part of the management of the audit client<sup>127</sup>.

A US Senate Committee investigation examined some of Enron's transactions and concluded that each "involved deceptive financial structures utilizing multiple SPEs [Special Purpose Entities] or joint ventures, asset or stock transfers, and exotic forms of financing. All relied on a major financial institution to provide funding, complex funds transfers, and intricate structured finance deals. In the end ... transactions appear to have had no business purpose other than to enable Enron to engage in deceptive accounting and tax strategies to inflate its financial results or deceptively reduce its tax obligations<sup>128</sup>". Arthur Andersen participated in the structuring and problematic accounting treatment of many dubious transactions and received large amounts of non-audit fees. Another report concluded that "the evidence available to us suggests that Andersen did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements<sup>129</sup>".

In view of the intense public scrutiny and negative publicity, many clients deserted the firm. It faced numerous lawsuits. Regulators were also concerned that Andersen partners shredded more than one ton of records relating to Enron after being reminded by an Andersen lawyer about the firm's document-handling policy. The US Securities and Exchange Commission (SEC) secured a criminal conviction against the firm for "obstruction of justice<sup>130</sup>". The judge said that Andersen had shown a "callous, reckless disregard for its duty to investors and the public trust for decades". The conviction effectively ended Andersen's auditing business as under US law the SEC cannot accept audit reports issued by convicted felons. In 2005, the US Supreme Court<sup>131</sup> quashed the conviction because of serious errors in the instructions given by the trial judge to the jury. However, the firm's reputation was damaged not only by the Enron but also by other accounting scandals, notably at Waste Management, Sunbeam, the Baptist Foundation of Arizona and WorldCom.

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<sup>126</sup> Nick Cohen 'Without Prejudice: Half-baked bean counters: UK accountancy scams could never happen in Britain, they say: Don't believe it for a moment': The Observer, 7 July 2002

<sup>127</sup> Washington Post, Enron's 'Outside' Accountants Also Did Inside Audit, 14 December 2001; [https://www.washingtonpost.com/archive/business/2001/12/14/enrons-outside-accountants-also-did-inside-audit/42bfe359-5af1-462c-99f6-bedcf5589dd2/?utm\\_term=.c78d32c92bec](https://www.washingtonpost.com/archive/business/2001/12/14/enrons-outside-accountants-also-did-inside-audit/42bfe359-5af1-462c-99f6-bedcf5589dd2/?utm_term=.c78d32c92bec)

<sup>128</sup> US Senate Permanent Subcommittee on Investigations, Fishtail, Bacchus, Sundance, and Slapshot: Four Enron Transactions Funded and Facilitated by U.S. Financial Institutions, USGPO: Washington DC, 2002; <https://www.gpo.gov/fdsys/pkg/CPRT-107SPRT83559/pdf/CPRT-107SPRT83559.pdf>.

<sup>129</sup> William C. Powers, Jr., Raymond S. Troubh and Herbert S. Winokur, Jr., Report on Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp., Austin: Wilmer, Cutler & Picketing, 2002  
; <http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

<sup>130</sup> Securities Exchange Commission, SEC Statement Regarding Andersen Case Conviction, 15 June 2002; <https://www.sec.gov/news/press/2002-89.htm>

<sup>131</sup> ARTHUR ANDERSEN LLP V. UNITED STATES (04-368) 544 U.S. 696 (2005) 374 F.3d 281, reversed and remanded.

Financial markets began to penalise companies for association with Andersen and its audit licences in many states had been revoked. The firm was unable to revive its auditing business though it was not formally convicted or dissolved.

The demise of Arthur Andersen further concentrated audits in what became the big four firms. It was not long before KPMG, one of the big four firms, faced regulatory action and faced uncertain future.

## **KPMG AND TAX**

KPMG has a history of profiting from aggressive tax avoidance schemes. A turning point came when the US tax authorities were no longer willing to indulge the firm. The head of the US Internal Revenue Service (IRS) said:

“During my tenure at the Internal Revenue Service, the low point came when we discovered that a senior tax partner at KPMG (one of the Big Four, which by virtue of their prominence set standards for the others) had advocated — in writing — to leaders of the company’s tax practice that KPMG make a “business/strategic decision” to ignore a particular set of I.R.S. disclosure rules. The reasoning was that the I.R.S. was unlikely to discover the underlying transactions, and that even if we did, any penalties assessed could be absorbed as a cost of doing business<sup>132</sup>”.

A US Senate report concluded that

“KPMG devoted substantial resources and maintained an extensive infrastructure to produce a continuing supply of generic tax products to sell to clients, using a process which pressured its tax professionals to generate new ideas, move them quickly through the development process, and approve, at times, illegal or potentially abusive tax shelters<sup>133</sup>”.

The background is that in 2002, the US Justice Department, filed a suit compelling the firm to disclose information about tax avoidance schemes marketed by it. KPMG grudgingly complied, but withheld a substantial number of documents. The lack of co-operation persuaded the US Senate Permanent Subcommittee on Investigations to launch an inquiry<sup>134</sup>. The Senate investigation found that KPMG had an extensive organisational structure for developing, marketing and implementing tax avoidance schemes. Enormous pressure was put on accountants and lawyers working in the firm’s tax unit to sell avoidance schemes and meet revenue generating targets. The staff were encouraged to make misleading statements to potential buyers, such as claiming that a scheme was no longer available for sale, even though it was, apparently hoping that reverse psychology would persuade the client to buy the

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<sup>132</sup>Mark W. Everson, Lawyers and Accountants Once Put Integrity First, New York Times, 18 June 2011; <https://www.nytimes.com/2011/06/19/opinion/19everson.html>

<sup>133</sup> US Senate Permanent Subcommittee on Investigations, The Role of Professional Firms in the US Tax Shelter Industry, Washington DC: USGPO, 2005.

<sup>134</sup> US Senate Permanent Subcommittee on Investigations, US Tax Shelter Industry: The Role of Accountants, Lawyers, And Financial Professionals - Four KPMG Case Studies: FLIP, OPIS, BLIPS and SC2, Washington DC: USGPO, 2003.

product. KPMG tax personnel were directed to contact existing clients about the product, including KPMG's own audit clients. Client presentations were done on chalkboards or erasable whiteboards, and written materials were retrieved from clients before leaving a meeting. Another measure taken by senior KPMG tax professionals was to counsel staff not to keep certain revealing documentation in their files or to clean out their files, again, to limit detection of firm activity. Potential clients had to sign "non-disclosure" agreements.

Buyers of tax avoidance schemes are frequently comforted by independent legal opinions stating whether the particular tax product is permissible under the law and, whether it can withstand a legal challenge by the tax authorities. The US Senate Committee found that KPMG drafted its own prototype tax opinion letter supporting the tax product and used this prototype as a template for the letters it actually sent to its clients. It used a friendly law firms to provide a favourable opinion letter. In some cases, KPMG itself obtained the client's opinion letter from the law firm and delivered it to the client, apparently without the client's actually speaking to any of the lawyers at the firm. The Senate Committee stated that the evidence indicates that "KPMG collaborated with the law firm ahead of time to ensure it would supply a favorable opinion letter".

KPMG did not disclose the existence of 500 schemes to the US IRS. Senior personnel were aware of its legal obligations but chose to ignore them. The firm performed internal cost-benefit analysis and concluded that profits from dubious and tax avoidance schemes would far exceed any penalties. A senior person wrote

"Based upon our analysis of the applicable penalty sections, we conclude that the penalties would be no greater than \$14,000 per \$100,000 in KPMG fees. ... For example, our average deal would result in KPMG fees of \$360,000 with a maximum penalty exposure of only \$31,000 ...<sup>135</sup>".

On the above basis, the firm decided to proceed. A senior executive wrote: "I believe the rewards of a successful marketing of the OPIS [name of a tax avoidance scheme] product . . . far exceed the financial exposure to penalties that may arise. Once you have had an opportunity to review this information, I request that we have a conference with the persons on the distribution list . . . to come to a conclusion with respect to my recommendation. As you know, we must immediately deal with this issue in order to proceed with the OPIS product<sup>136</sup>."

After the US Senate Committee investigations, the Department of Justice considered criminal charges against KPMG. If convicted the firm would have forfeited its audit licence, leading to its possible demise in the US and elsewhere. Some feared that this would reduce the audit market to three big players and the "too big to fail" and the "too few to fail" syndrome prevailed. In August 2005, the Department of Justice announced that

"KPMG LLP (KPMG) has admitted to criminal wrongdoing and agreed to pay \$456 million in fines. ... In the largest criminal tax case ever filed, KPMG has

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<sup>135</sup> Page 26 - US Senate Permanent Subcommittee on Investigations (2003), op cit.

<sup>136</sup> Page 27, US Senate Permanent Subcommittee on Investigations (2003), op cit.

admitted that it engaged in a fraud ...The agreement provides that prosecution of the criminal charge against KPMG will be deferred until December 31, 2006 if specified conditions-including payment of the \$456 million in fines, restitution, and penalties-are met<sup>137</sup>.

KPMG also had to agree to supervision for good behaviour by an independent monitor for a period of 3 years. In January 2007, the US authorities dropped the criminal charges against KPMG. A number of the firm's (former) personnel were prosecuted and received prison sentences.

The above examples show that under the weight of their own anti-social practices, the big firms can shrink from four to just three. Robust regulators may well be constrained by the "too big to fail" and "too few to fail" syndrome to take decisive action. Such constraints may embolden the firms and reduce incentives for improving audit quality. The inescapable conclusion is that audit market needs more providers and this cannot easily be secured without trimming the size of the big firms.

## **HOLDING GOVERNMENTS TO RANSOM**

Large corporations have a history of using financial and political resources to secure regime changes<sup>138</sup> and economic advantages. In neoliberal democracies, corporations have long used their resources to fund political parties and shape government policies. Big accounting firms also play the game and have used political donations to promote their policy preferences<sup>139</sup>. They have used small island regimes to squeeze concessions from the UK government. A good example of this is the emergence of the limited liability partnership law (LLP) in the UK via the Island of Jersey.

A notable feature of the last thirty years has been a series of statutory liability concessions to auditors (see later parts of this report). Yet auditing firms have continued to demand more and more. When the UK government was not considered to be receptive, the firms decided to hold it to ransom. Price Waterhouse (now part of PwC) and Ernst & Young jointly spent more than £1 million of their own money to privately draft a Bill and asked the tax haven of Jersey to enact it<sup>140</sup>. Its leading politicians duly promised to "fast track"<sup>141</sup> it. On 21 May 1996, Jersey published its Limited Liability Partnerships (Jersey) Law 199). The law gave accountancy firm partners considerable protection from negligence lawsuits. LLPs registered in Jersey

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<sup>137</sup> US Department of Justice, KPMG to Pay \$456 Million for Criminal Violations in Relation to Largest-Ever Tax Shelter Fraud Case, 29 August 2005, [https://www.justice.gov/archive/opa/pr/2005/August/05\\_ag\\_433.html](https://www.justice.gov/archive/opa/pr/2005/August/05_ag_433.html)

<sup>138</sup> Stephen Kinzer, *Overthrow: America's Century of Regime Change from Hawaii to Iraq*, Times Books, 2007.

<sup>139</sup> For example, see *The Guardian*, Big four accountancy firms donate £1.9m in services to political parties since 2009, 10 July 2012; <https://www.theguardian.com/politics/2012/jul/10/lobbying>

<sup>140</sup> For further details of this episode see Prem Sikka, *Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey*, *Accounting, Auditing and Accountability Journal*. 21(3): 398-426, 2008.

<sup>141</sup> *Financial Times*, 7 August 1996, p. 6.

were to be exempt from all corporate/income taxes. LLPs were not required to publish audited accounts.

Price Waterhouse and Ernst & Young exerted pressure on the UK government to enact similar legislation by openly saying that they “want to go to Jersey” and Ernst & Young indeed “threatened to move its headquarters to Jersey<sup>142</sup>” with the full knowledge that such possibilities would cause economic turbulence and persuade elected government to capitulate. The threats were supported by the ICAEW and amplified through the press.

In reality, the threats had little purchase because the firms could hardly sack all their staff and take clientele with them to Jersey. At best, the firms were likely to set-up ‘brass plate’ operations whilst retaining their niches and lucrative fees in the UK. To operate in the UK (regardless of the place of their domicile), the firms would have needed to be licensed by the UK regulators and subjected to the full application of the UK laws. As there would have been little change to the substance of the trade by Ernst & Young and Price Waterhouse, some legal experts concluded that any move by the firms to hide behind the Jersey liability laws would be treated by the courts as a ‘sham’ deliberately designed to disadvantage creditors. The prevailing legal opinion was that if a Jersey registered partnership and its individual partners were sued for negligence while they still carried on their business in the mainland, an English judge would not listen to the argument that they are a Jersey LLP.

The Jersey Bill did not have a smooth passage and received a lot of local and international criticism. When it finally completed its parliamentary passage, an Ernst & Young senior partner said:

“Having worked closely with the States of Jersey and Price Waterhouse to bring about the LLP law, we are pleased to see it finally being enacted<sup>143</sup>”.

The firms had never intended to locate in Jersey and likened the threat to a “cosh with which to threaten the government if it fails to come up with a workable LLP law<sup>144</sup>”. Price Waterhouse and Ernst & Young partners argued:

“behind the scenes that the move to Jersey was a stick to beat the then Tory government and Labour opposition into agreeing that a UK-wide LLP Law was necessary. If that failed, they were serious about a move ... PW insiders say it still wants a UK LLP law and the threat of Jersey move is still a good stick to beat them with<sup>145</sup>”.

In such a climate, the UK government promised equivalent legislation “within a week<sup>146</sup>” and then “at the earliest opportunity<sup>147</sup>” and issued a consultation paper in

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<sup>142</sup> The Guardian, 8 November 1996.

<sup>143</sup> Accountancy Age, 29 May 1998, p. 1.

<sup>144</sup> Financial Times, 11 June 1998, p. 11.

<sup>145</sup> Accountancy Age, 4 June 1998, p. 9.

<sup>146</sup> Financial Times, 3 July 1996, p. 7.

<sup>147</sup> Hansard, House of Commons, 7 November 1996;

<https://publications.parliament.uk/pa/cm199697/cmhansrd/vo961107/text/61107w08.htm>

1997, followed by a Bill in 1998 and law (Limited Liability Partnerships Act 2000) which came into force on 6 April 2001. The government's capitulation was "warmly welcomed" by Price Waterhouse. An Ernst & Young senior partner crowed:

"It was the work that Ernst & Young and Price Waterhouse undertook with the Jersey government ..... that concentrated the mind of UK ministers on the structure of professional partnerships. ....The idea that two of the biggest accountancy firms plus, conceivably, legal, architectural and engineering and other partnerships, might take flight and register offshore looked like a real threat ..... I have no doubt whatsoever that ourselves and Price Waterhouse drove it onto the government's agenda because of the Jersey idea<sup>148</sup>".

Neither Price Waterhouse nor Ernst & Young or any other major accounting firm shifted its operations from the UK to Jersey. The firms used their political and financial resources to hold the government to ransom.

Further ransom threats cannot be ruled out, especially as governments consider reforms to the auditing firms. The big firm may react with threats to withdraw from the audit market or curtail their involvement in some sectors until governments relent. This inevitably poses questions about who governs – big auditing firms or democratically elected governments.

## **SUMMARY AND DISCUSSION**

There is always a possibility that the big four firms can be reduced to three. This threat substantively arises from their own reckless pursuit of profits and self-interest rather than from anything else. Arthur Andersen had extensive fee dependency on Enron and was deeply enmeshed in the sale of non-auditing services. KPMG was obsessed with making profits at almost any cost and eventually admitted "criminal wrongdoing" and paid \$456 million fine, but escaped more severe regulatory response because it was considered to be "too big to close". Such constraints erode public confidence in the regulatory system and it is essential that no supplier of audit is beyond the reach of the regulators.

Similar pattern has been repeated in other countries which can have repercussions for the UK. For example, ChuoAoyama Audit Corporation was the Japanese affiliate of PwC from 2000 to 2006. The unit had to close after three (former) partners were found guilty of lying in conspiracy with executives in a scandal that brought down cosmetics maker Kanebo<sup>149</sup>. The firm was suspended from securing business for two months and the Japanese regulator said that the

"engagement partners of the firm certified willfully Kanebo's falsified annual reports for the five periods, ending March 1999, March 2000, March 2001, March 2002 and March 2003, as not containing such falsities", and

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<sup>148</sup> Accountancy Age, 29 March 2001, p. 22.

<sup>149</sup> The Telegraph, Former PwC accountants guilty of conspiracy, 9 August 2006; <https://www.telegraph.co.uk/finance/2945147/Former-PwC-accountants-guilty-of-conspiracy.html>

accountants “willfully certified Kanebo's falsified annual reports for the five periods<sup>150</sup>”.

Clients deserted the firm and it could not be revived. At the time of writing KPMG is facing intense public and regulatory scrutiny in South Africa over its links with the Gupta family and VBS Mutual Bank<sup>151</sup>.

No one has ever forced auditing firms to accept dubious clients, collude with clients, sell consultancy services to audit clients, falsify accounts, create conflict of interests, issue misleading audit reports or engage in criminal wrongdoings. It has all been done voluntarily in pursuit of private profits and bonuses. Some of the self-destructive impulses will be reduced by elimination of the lure of non-auditing services and other reforms recommended in this report.

The Jersey LLP excursion by Price Waterhouse and Ernst & Young shows that the ‘too big to fail’ firms are able to hold governments to ransom. That grates with democratic sensibilities and needs to be addressed. This requires more suppliers in the audit market and a scaled reduction in the size of the firms so that they cannot hold democratically elected governments to ransom.

## **RECOMMENDED REFORMS**

- Increase the number of suppliers in the audit market

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<sup>150</sup> Financial Services Agency, Disciplinary Actions against an Audit Firm and Certified Public Accountants, 10 May 2006; <https://www.fsa.go.jp/en/news/2006/20060510.html>

<sup>151</sup> Financial Times, KPMG under fresh attack in South Africa over 'great bank heist', 11 October 2018; <https://www.ft.com/content/c295e612-cd5b-11e8-b276-b9069bde0956>

## CHAPTER 5 A STATUTORY AUDITOR FOR THE FINANCIAL SECTOR

The UK audit market is dominated by the big four firms. The previous chapter noted that their reckless pursuit of private profits may reduce that number of three, with negative consequences for competition and choice and the ‘too few to fail’ syndrome would continue to constrain regulators from taking robust action. Major initiatives are needed by the government to bring new suppliers into the audit market and also curb the size of the big four firms so that no firm is too big to regulate. Opportunities for the mid-tier firms to grow and compete also need to be created. However, there are difficulties and barriers to entry (see later chapters) need to be negotiated. It will take considerable time for the mid-tier firms to grow and match the big four firms, assuming that they can generate sufficient capital. In November 2018, BDO and Moore Stephens, the sixth and the ninth largest firms, announced their intention to merge<sup>152</sup>. The merged entity will become the fifth largest firm, but will barely equal 30% of the fee income of KPMG, the smallest of the big four firms. Even if all of the fifth to the tenth biggest audit firms were to merge, that merged entity would still be smaller than the smallest of the big four firms (see chapter 2). So mergers alone will not restructure the audit market.

A number of additional initiatives are needed. This chapter proposes the creation of a state-backed statutory auditor to provide real-time audits for the financial sector through a new statutory body. This would introduce the much-needed fifth big supplier of audit services and improve regulation in the crisis-ridden financial sector. The arrangements proposed in this chapter would apply to around 1,500 banks, building societies, credit unions, insurers and major investment firms regulated by the Prudential Regulation Authority (PRA). This would result in the migration of t audits from the big four firms to the new statutory auditor and reduce the size of the big firms and enable mid-tier firms to compete with them. The statutory auditor would also enable regulators to intervene affectively and get an early warning of damaging developments.

The financial sector needs effective and timely audits. Above all, it has to secure trust in financial transactions. The sector has been a serial offender and often immersed in mis-selling, tax avoidance, bribery, corruption, money laundering, abusing borrowers, sanctions busting and much more. A 1997 government report on the share-price scandal at Guinness said that too many executives in the financial sector have a

"cynical disregard of laws and regulations ... cavalier misuse of company monies ... contempt for truth and common honesty. All these in a part of the City [of London] which was thought respectable<sup>153</sup>".

Little has changed. The UK financial sector remains populated by operators who compete ferociously to maximise corporate profits and personal gains and exercise little restraint and have little/no regard for law or ethical conduct. Whilst some

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<sup>152</sup> Financial Times, BDO set to become UK’s fifth-largest accountancy firm, 25 November 2018; <https://www.ft.com/content/4bedea66-efdc-11e8-ae55-df4bf40f9d0d>

<sup>153</sup> Department of Trade and Industry, Guinness PLC, London: HMSO, 1997.

become rich, society has to clear up the mess arising from a collapse of trust, crashes, frauds and fiddles as the financial contagion infects the whole society. The UK regulatory structures have been remarkably ineffective and regulators often have little idea of what goes on inside financial enterprises. Audits can provide a window. Instead of directly auditing the financial sector, regulators have relied upon accounting firms. This has done little to improve the quality of regulation, or audits or equipped regulators to deal with emerging issues. A specially created statutory body must take charge of the audits of organisations in the financial sector.

The UK has experienced a banking collapse in every decade since the 1970s<sup>154</sup> and each showed that audits were deficient. The 2007-08 banking crash has once again demonstrated the folly of relying on auditing firms to uphold trust and integrity in the sector. Financial sector regulators do not appoint or remunerate auditors. They do not licence auditors or inspect the quality of their work. They use data from financial statements to make assessments of capital adequacy, leverage, solvency and liquidity, but do not directly set accounting or auditing standards. They do not have unhindered access to the staff and files of auditors. Auditors do not owe a duty of care to the regulators, but somehow are supposed to be the eyes and ears of regulators. There are supposed to be regular meetings between financial sector auditors and regulators, but the 2007-2008 crash showed that such meetings either did not happen or achieved little. Auditors continued to issue duff reports and taxpayers picked up the tab. "Between 2008 and 2010, in the EU alone, 182 banks had to be given liquidity or debt guarantees by their governments - just to survive. Not one of them received a qualified audit report prior to the economic crisis that engulfed the world economy. Yet their accounts were laden with acres of accounting clutter that complied with every standard but added no more value than the worthless audit opinions attached to them<sup>155</sup>".

In the contemporary world, money moves almost instantaneously, but financial sector regulators place reliance on ex-post audits conducted by auditing firms not under their day-to-day control or supervision. Company financial statements are prepared to inform shareholders about corporate performance but even that must be doubted as shown by accounting scandals at Carillion, BHS and other places. The fair-value accounts contain unrealised gains and financial numbers which cannot easily be corroborated and have inflated profits and conversely during market downturns have depressed profits, creating wild swings and potential for financial instability. The regulator's main responsibility is to secure stability of the financial system and protect people from the destructive games played by the financial sector. Bank directors can take reckless risks and if they pay-off, banks make massive capital gains to reward and appease shareholders and markets. However, when those risks do not pay off, bankers are not disciplined as 'free market' ideology suggests they should be, but instead they are bailed out by taxpayers. Their decision-making is de-linked from financial responsibility. This is Soviet-style practice, and is at odds with the free market system. However, the risks taken by bank directors do not only potentially destabilise the firm, they can also have a

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<sup>154</sup> Duncan Needham, UK Monetary Policy From Devaluation to Thatcher 1967-82. London: Palgrave Macmillan, 2014.

<sup>155</sup> Emile Woolf, Time to make LLP partners accountable, Accountancy, April 2018; [https://library.croneri.co.uk/acmag\\_193509](https://library.croneri.co.uk/acmag_193509)

systemic impact – and destabilise markets, the wider financial system and the entire economy. Despite these known disastrous consequences, the accounts of individual enterprises, all prepared in accordance with accounting standards, reveal little, if anything, about the stability of the firm, and its likely impact on the financial system. This needs to change.

## **RECENT HISTORY OF FINANCIAL SECTOR AUDITS**

### **The 1970s**

The mid-1970s banking crash and the collapse of Ramor Investments, Pinnock Finance, London Capital Group, London and Counties, Grays Building Society and others showed that auditors were complicit in frauds. A stream of government reports exposed auditor complicity in corporate frauds and “disclosing considerably less than what they actually know<sup>156</sup>”. The government responded by passing the Banking Act 1979 and making the Bank of England the formal regulator of banks, but reform of auditing remained off the political agenda. The auditing industry showed no remorse. The auditing standards that guided auditors to make going concern assessments of enterprises urged them to be ‘passive<sup>157</sup>’ (i.e. auditors did not have to design any specific procedures to determine whether a business was a going concern) because this approach was more economical of audit effort and increased firm profits, but created the impression that auditors were doing more.

### **The 1980s**

In 1984, Johnson Matthey Bank (JMB), a subsidiary of Johnson Matthey, one of the five London gold bullion dealing banks, collapsed. Between 1980 and 1984, its loans grew from £34 million to £450 million. Prior to its demise, JMB had been experiencing difficulty in collecting loans from two groups of companies in Pakistan. Each of these loans amounted to more than 10% of its capital and further advances continued. Just one borrower accounted for 93% of the capital base of JMB; at least nine times greater than the Bank of England’s official guidelines<sup>158</sup>. Up to half of the JMB's portfolio consisted of doubtful debts and losses were estimated to be in the region of £250 million. Under the Banking Act 1979, loans exceeding 10% of the issued capital were supposed to be notified to the supervisory authorities, but this had not been done. The published accounts gave no indication of the financial problems and JMB received the customary unqualified audit opinions from auditors Arthur Young (now part of Ernst & Young). There was concern that the crisis could spread to other banks, especially as JMB had £1.94 billion of deposits and £4.6 billion of forward contracts in foreign exchange, all of which would have gone into default. The Bank of England rescued JMB and in July 1985 by buying it for £1 and subsequently pumped-in more than £100 million to stabilise it. The government asked the police to investigate suspected frauds<sup>159</sup>. In January 1986, the Bank of England, as the new owner of JMB, sued auditors Arthur Young (now part of Ernst & Young)

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<sup>156</sup> Emile Woolf, *Auditing Today* (Third Edition), Hemel Hempstead: Prentice Hall, 1986, p. 511.

<sup>157</sup> Prem Sikka, *Audit Policy-making in the UK: The Case of "The auditor's considerations in respect of going concern"*, *European Accounting Review*, Vol. 1, No. 2, 1992, pp. 349-392.

<sup>158</sup> *The Independent*, *Arrest in Johnson Matthey case*, 16 November 1997.

<sup>159</sup> *The Times*, *City fraud squad called in to investigate JM Bankers*, 18 July 1985.

for breach of duty<sup>160</sup>. Eventually, Arthur Young paid £25 million in an out-of-court settlement<sup>161</sup>. The then Chancellor of the Exchequer said that “it rapidly became clear both that the Bank [Bank of England] had fallen down badly in the exercise of its supervisory responsibilities and that JMB's auditors, Arthur Young, had also failed to do their job adequately<sup>162</sup>”.

Around the same time, attention also focused on the conduct of the auditors of Lloyd's of London who had failed to spot overstatement of profits<sup>163</sup>. Once again the government sought to revamp the regulatory structures. The Building Societies Act 1986, the Financial Services Act 1986 provided the new regulatory architecture for the finance industry. The Banking Act 1987 streamlined the supervision of banks with further powers conferred upon the Bank of England. Provision of false or misleading information to the banking regulators, or withholding relevant information was now to be a criminal offence. The government wanted to impose upon auditors a duty to report fraud (actual or suspected) to the Bank of England even without the knowledge of the client organisation. Such policies were pursued in the interests of investor protection and market stability but the auditing industry opposed them.

The auditing industry was once again indulged. The government did not impose a ‘duty’ upon auditors to report irregularities or suspected fraud to regulators. It just gave them a ‘right’ to do so. The legislation also required auditors and regulators to meet regularly. The folly of relying upon auditing firms continued to make headlines. In 1988, under the weight of £100 million frauds, investment broker Barlow Clowes collapsed<sup>164</sup>. The broker marketed a fund which offered higher yields from investment in low-risk government gilt-stocks. This was not viable and Clowes actually invested in high risk investments. Through complex offshore structures in Gibraltar and Jersey, Clowes operated a bond washing and tax avoidance scheme that turned highly taxed income into low-taxed capital gains. The auditors were conspicuous by their silence.

## **The 1990s**

### **BCCI**

The twentieth century's biggest banking frauds took place at the Bank of Credit and Commerce International (BCCI), a bank controlled by the Abu Dhabi royal family. In July 1991, the Bank of England closed BCCI. At the time of its closure BCCI had some 1.4 million depositors across the world. Around 14,000 people worldwide lost their jobs<sup>165</sup>. Until 1986, the bank was audited jointly by Ernst & Whiney and Price Waterhouse. Thereafter, Price Waterhouse became the sole auditors. BCCI's auditor sold non-auditing services to the bank, and the firm's partners received loans and

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<sup>160</sup> The Guardian, Bank serves JMB writ, 30 January 1986.

<sup>161</sup> The Times, Auditor pays 25m pounds to settle JMB dispute, 22 October 1988.

<sup>162</sup> House of Lords Economic Affairs Committee, Auditors: Market concentration and their role, London: House of Lords, 30 March 2011.

<sup>163</sup> The Guardian Lloyd's gaffe spurs probe: Insurance market to investigate auditing error in annual results, 6 September 1985.

<sup>164</sup> Department of Trade and Industry, Barlow Clowes: report of Sir Godfrey Le Quesne to the Secretary of State for Trade and Industry. London: HMS, 1988

<sup>165</sup> Hansard, House of Commons Debates, 22 October 1992, cols. 574-89.

benefits from the bank. Despite evidence of managerial incompetence, fraud and a guilty plea of money laundering, auditors continued to issue unqualified audit reports<sup>166</sup>. The Bank of England explained that it granted a deposit-taking licence to BCCI because “auditors were not qualifying the reports<sup>167</sup>”. Commenting on the cosy relationship between the bank and its auditors, a US Senate Committee report said that there were numerous “warning bells”, and the auditors “could and should have done more to respond to them<sup>168</sup>”. The Committee concluded that

“BCCI’s accountants failed to protect BCCI’s innocent depositors and creditors from the consequences of poor practices at the bank of which the auditors were aware for years<sup>169</sup>”

It further added that:

“By agreement, Price Waterhouse, Abu Dhabi, BCCI, and the Bank of England had in effect agreed upon a plan in which they would each keep the true state of affairs at BCCI secret in return for cooperation with one another in trying to restructure the bank to avoid a catastrophic multi-billion dollar collapse. Thus to some extent, from April 1990 forward, BCCI’s British auditors, Abu Dhabi owners, and British regulators, had now become BCCI’s partners, not in crime, but in coverup. The goal was not to ignore BCCI’s wrongdoing, but to prevent disclosure of the wrongdoing from closing the bank. Rather than permitting ordinary depositors to find out for themselves the true state of BCCI’s finances, the Bank of England, Price Waterhouse, Abu Dhabi and BCCI had together colluded to deprive the public of the information necessary for them to reach any reasonable judgment on the matter, because the alternative would have been BCCI’s collapse<sup>170</sup>”.

To this day, there has been no independent UK inquiry into the BCCI frauds and successive governments have gone to considerable length to keep parliament and public in the dark<sup>171</sup>. Price Waterhouse also refused to provide crucial documents to the US Senate inquiry on the grounds that it was a national rather than a global firm.

In its evidence to an inquiry into the supervision of BCCI by the Bank of England, the ICAEW, despite being a statutory regulator, aligned itself with big auditing firms and opposed the imposition of any statutory ‘duty’ upon auditors to report material fraud to the regulators<sup>172</sup>. The government amended the legislation relating to banks, insurance

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<sup>166</sup> US Senate Committee on Foreign Affairs, 1992, op cit.

<sup>167</sup> Hansard, UK House of Commons Debates, 6 November 1992, col. 527;  
<http://www.parliament.the-stationery-office.co.uk/pa/cm199293/cmhansrd/1992-11-06/Debate-1.html>.

<sup>168</sup> US Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, Washington DC: USGPO, 1992, p. 4 and 259

<sup>169</sup> US Senate Committee on Foreign Relations, 1992, op cit, p.18.

<sup>170</sup> US Senate Committee on Foreign Relations, 1992, op cit, p. 440.

<sup>171</sup> Prem Sikka, Using freedom of information laws to frustrate accountability: Two case studies of UK banking frauds, Accounting Forum, Vol. 41, No. 4, 2017, pp. 300-317

<sup>172</sup> Bingham, The Right Honourable Lord Justice, Inquiry into the Supervision of The Bank of Credit and Commerce International, London: HMSO, 1992.

companies, building societies and financial services and placed upon the financial sector auditors a 'statutory duty' to report fraud<sup>173</sup> to the regulators. However, a 'duty' to 'actively' search for fraud was not placed upon the auditors of financial sector companies.

## Barings Bank

The weaknesses of the reliance on auditors were again exposed by the collapse of Barings Bank in 1995. It had debts of £850 million. The bank made considerable profits from speculative activities and its securities traders were inculcated into the ethos of "make profits, profits, and more profits"<sup>174</sup>, but such a culture was neither communicated nor was ever discussed between auditors and regulators. One of the bank's star traders Nick Leeson, based in Singapore, got his bets on derivatives wrong and used false accounts to cover his tracks. For many years, Barings had been audited by Coopers & Lybrand (C&L) which in turn required the Singapore office of C&L to audit the affairs of Baring Futures (Singapore) Pte Limited (BFS) for the year to 31st December 1994. The 1992 and 1993 accounts of BFS were audited by the Singapore office of Deloitte & Touche (D&T) who reported to C&L London for the purposes of its audit of the consolidated financial statements of Barings Plc. C&L audited all other subsidiaries of Barings in 1992, 1993 and 1994 either through its London office or other offices of affiliates in its global network. Barings always received the customary clean bill of health from its auditors. A subsequent inquiry by the Bank of England concluded:

"We do not consider that C&L [Coopers and Lybrand] London performed sufficient tests to satisfy themselves that the control over payments of margin and associated accounting balances were operating effectively ... they undertook insufficient compliance testing and relied inappropriately on their perception of [a named person's] experience ... Such testing as took place involve observing [a department's] handling of funding requests during an interim visit, with no analysis, and without proper scoping of the sample being tested; in consequence there was no effective test of funding requests ... or margin payments"<sup>175</sup>

The Barings audit reports were signed by UK-based firms, but the work in Singapore was carried out by the offices of C&L and D&T. The audit reports did not provide any clues about where the work was carried out. The Bank of England sought to interview key C&L and D&T audit personnel in Singapore and also examine audit files containing the alleged audit work. It was unable to and said:

"We have not been permitted access to C&L Singapore's work papers relating to the 1994 audit of BFS [Baring Futures (Singapore) Pte Limited] or had the

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<sup>173</sup> Hansard, House of Common, 15 February 1994, cols. 852-875.

<sup>174</sup> BBC News, How Leeson broke the bank, 22 June 1999;  
<http://news.bbc.co.uk/1/hi/business/375259.stm>.

<sup>175</sup> Board of Banking Supervision, Report of the Board of Banking Supervision inquiry into the circumstances of the collapse of Barings, London: HMSO, 1995;  
[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/235622/0673.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/235622/0673.pdf)

opportunity to interview their personnel. C&L Singapore has declined our request for access, stating that its obligation to respect its client confidentiality prevents it assisting us. ...We have not been permitted either access to the working papers of D&T or the opportunity to interview any of their personnel who performed the audit. We do not know what records and explanations were provided by BFS personnel to them<sup>176</sup>."

In the final analysis, the Bank of England was unable to fully investigate the audit failures, but still continued to rely upon auditors.

## **The 2000s**

### **Equitable Life**

Further shortcomings of reliance upon auditors were exposed by the collapse of Equitable Life, an insurance company, which had been trading since 1762. In the 1980s, it joined the frenzy for greater profits by promising exorbitant payouts to its 1.5 million policyholders. These could not be maintained, but Equitable continued to declare bonuses out of all proportion to its profits and assets. The company subsequently faced a shortfall and tried to renege on its promises, and made unsuccessful attempts to sell the business. From 2000 onwards, a scandal erupted. A report said that there were no internal management checks on the viability of the products sold and by the end of 2000 the society's liabilities exceeded its assets by £1.8 billion<sup>177</sup>. The audit process was considered to be inadequate, but year after year auditors dutifully provided a clean bill of health.

### **Independent Insurance**

In 2001, Independent Insurance collapsed due to frauds leaving some 500,000 policyholders without any insurance cover. In 2008, the company's auditor KPMG was considered to have been negligent and was ordered to pay a fine and costs amounting to £1.6 million by a disciplinary panel<sup>178</sup>. The audit partner was fined for failing to check the validity of three vital contracts which allowed the company to report a £22 million profit for 2000 rather than a probable loss of £105 million.

### **2007-08 Crash**

The 2007-2008 banking crash drew attention to the usual failures. None of the unsavoury practices used by banks to boost their profits were highlighted by auditors. Lord Lawson, former Chancellor of the Exchequers and architect of the post John Matthey Bank regime which required a dialogue between auditors and regulators said that he "was "puzzled and dismayed" by the decline of these informal channels of communication, which he believes could have given earlier warning of

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<sup>176</sup> Board of Banking Supervision, op cit, 1995: 15 and 153.

<sup>177</sup> Penrose, The Right Honourable Lord, Report of the Equitable Life Inquiry, London: TSO, 2014.

<sup>178</sup> The Guardian, KPMG admits negligence over Independent, 26 June 2008 (<http://www.theguardian.com/business/2008/jun/26/independentnewsmedia.insurance>; accessed 20 January 2014).

problems in the sector”<sup>179</sup>. In the 2007-2008 crash, all distressed banks received unqualified audit reports. In every case, auditors performed non-auditing services and increased their fees. Some banks collapsed within days of receiving an unqualified audit report. People picked up the tab. The House of Lords Economic Affairs Committee concluded:

“We do not accept the defence that bank auditors did all that was required of them. In the light of what we now know, that defence appears disconcertingly complacent. It may be that the Big Four carried out their duties properly in the strictly legal sense, but we have to conclude that, in the wider sense, they did not do so”<sup>180</sup>.

The House of Commons Treasury Committee noted

“the fact that the audit process failed to highlight developing problems in the banking sector does cause us to question exactly how useful audit currently is. ...We remain concerned about the issue of auditor independence. Although independence is just one of several determinants of audit quality, we believe that, as economic agents, audit firms will face strong incentives to temper critical opinions of accounts prepared by executive boards, if there is a perceived risk that non-audit work could be jeopardised”<sup>181</sup>.

The Parliamentary Commission on Banking Standards said:

“Auditors and accounting standards have a duty to ensure the provision of accurate information to shareholders and others about companies’ financial positions. They fell down in that duty. Auditors failed to act decisively and fully to expose risks being added to balance sheets throughout the period of highly leveraged banking expansion. Audited accounts conspicuously failed accurately to inform their users about the financial condition of banks”<sup>182</sup>.

On the relationship between auditors and financial regulators, the Commission said that:

“... in the past the relationship between supervisors and auditors has been dysfunctional. The Commission recommends that the Court of the Bank of England commission a periodic report on the quality of dialogue between auditors and supervisors. We would expect that for the dialogue to be effective, both the PRA and the FCA would need to meet a bank’s external

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<sup>179</sup> Financial Times, Lord Lawson baffled by bank auditors, 4 January 2011 (<http://www.ft.com/cms/s/0/8268c0da-1834-11e0-88c9-00144feab49a.html#axzz33QZBGXKf>; accessed 20 January 2014).

<sup>180</sup> UK House of Lords Economic Affairs Committee, Auditors: Market concentration and their role, London: TSO, 2011, p. 40.

<sup>181</sup> House of Commons Treasury Committee, Banking Crisis: reforming corporate governance and pay in the City, London: TSO, 2009, P.110.

<sup>182</sup> House of Lords and House of Commons, Parliamentary Commission on Banking Standards: Changing banking for good, June 2013; <https://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf>

auditor regularly, and more than the minimum of once a year which is specified by the Code of Practice governing the relationship between the external auditor and the supervisor<sup>183</sup>”

The UK taxpayers have provided £1,162 billion to support and rescue distressed banks<sup>184</sup> and also absorbed the resultant austerity, wage freezes and degradation of life. To date, there has been no systematic investigation of the audit failures at banks by the FRC, the FCA, the PRA or any of the RSBs. Matters get tossed around from one regulator to another as shown by the HBOS investigation.

## **HBOS**

HBOS was the biggest casualty of the 2007-08 banking crash<sup>185</sup> and became the subject of a £37 billion bailout. HBOS had always received unqualified audit reports from KPMG, its auditor. A number of reports examined the HBOS failure<sup>186</sup>. The reports raised questions about the quality of external audits, but the FRC showed little curiosity. The banking regulator told the Treasury Committee that he was “surprised and shocked” by the “mutual distrust” that had built up between the FSA and the auditors prior to the crisis. The Committee noted that while some meetings between the FSA [at that time the Financial Services Authority was the regulator] and KPMG did take place, these were infrequent and there was only a single telephone call in the whole of 2006 to discuss HBOS<sup>187</sup>”. Some eight years after the bailout of HBOS, the House of Commons Treasury Committee said that:

“The regulators failed, both before and after the HBOS crisis. Seven years after the bank’s collapse, we now know just how badly. And not because the regulators showed a spirit to learn the lessons of the past. It took persistent pressure from the Treasury Committee to ensure these failures weren’t swept under the carpet”<sup>188</sup>.

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<sup>183</sup> House of Lords and House of Commons, Parliamentary Commission on Banking Standards: Changing banking for good, June 2013;

<https://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf>

<sup>184</sup> National Audit Office, Taxpayer support for UK banks: FAQs,

<https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>

<sup>185</sup> For further information see Atul Shah, *The Politics of Financial Risk, Audit and Regulation: A Case Study of HBOS*, London: Routledge, 2018.

<sup>186</sup> For example, see Parliamentary Commission on Banking Standards, ‘An accident waiting to happen’: The failure of HBOS, London: House of Commons and House of Lords, 2013, <https://publications.parliament.uk/pa/jt201213/jtselect/jtpcbcs/144/144.pdf>; Bank of England, *The failure of HBOS plc (HBOS) A report by the Financial Conduct Authority (FCA) and the Prudential Regulation Authority (PRA)*, London: BoE, November 2015; House of Commons Treasury Committee, *Review of the reports into the failure of HBOS*, London: House of Commons, 2016;

<https://publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/582/582.pdf>

<sup>187</sup> House of Commons Treasury Committee, *Review of the reports into the failure of HBOS*, July 2016; <https://publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/582/582.pdf>

<sup>188</sup> House of Commons Treasury Committee, *HBOS failure: lessons for the regulators*, 26 July 2016; <https://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news-parliament-2015/hbos-report-published-16-17/>

Financial regulators rarely undertake comprehensive analysis of audit failures because they consider that to be the domain of the FRC. The Treasury Committee said:

"The Financial Reporting Council's decision not to investigate the auditing of HBOS prior to the completion of the PRA/FCA report was a serious mistake. The process by which it reached its decision suggests a lack of curiosity and diligence on the part of the FRC. Having seen the final PRA/FCA report, the FRC's belated decision to launch an investigation into the auditing of HBOS is welcome. Better late than never".

The 2016 Treasury Committee report noted that

"The auditing of HBOS is the one major element of the HBOS affair that has yet to be subject to adequate scrutiny. *The Committee will expect the FRC to undertake an extremely thorough analysis of the HBOS case.* Regardless of the outcome of the FRC's investigation process, it is likely that the Committee will want to consider its work and regulatory approach in more detail. The investigation announced on 27 June 2016 is better late than never. But the very tardy response by the FRC appears to be as inexplicable as it is unacceptable" (p.48, emphasis added).

In September 2017, the FRC abandoned its investigation of the 2007 audit of HBOS with the statement that

"there is not a realistic prospect that a Tribunal would make an Adverse Finding against KPMG in respect of the matters within the scope of the investigation. The firm's work did not fall significantly short of the standards reasonably to be expected of the audit<sup>189</sup>

The FRC has offered no evidence to support its conclusions. Following criticisms from the Treasury Committee, FRC admitted that it "should have adopted a more proactive role and acted more quickly<sup>190</sup>".

## **TIME FOR A NEW BEGINNING**

The UK financial sector has been involved in numerous accounting, auditing and governance failures. Despite this, the regulators have continued to rely upon auditors to alert them to problems and the result has always been the same – failure. Regulators have been concerned about accounting practices at banks but routinely expect auditors to address the issues<sup>191</sup>. Due to fee dependency auditors go along

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<sup>189</sup> Financial Reporting Council, Closure of investigation into KPMG's audit of HBOS plc. London: FRC, 19 September 2017

<sup>190</sup> Financial Reporting Council, The FRC's enquiries and investigation of KPMG's 2007 and 2008 audits of HBOS, November 2017; <https://www.frc.org.uk/getattachment/646bb35a-f39f-4d75-a12e-6d2480e0b2a7/HBOS-Report-Nov-2017-FINAL.pdf>

<sup>191</sup> Financial Services Authority, The Turner Review: A regulatory response to the global banking crisis, London: FSA, March 2009; [http://www.fsa.gov.uk/pubs/other/turner\\_review.pdf](http://www.fsa.gov.uk/pubs/other/turner_review.pdf).

with directors and dubious accounting practices prevail. The 2007-08 crash showed that auditors did not do anything to encourage prudent financial reporting. Banks had toxic assets, bad loans and financial security values based on fair value (wishful thinking) balance sheets. All were dutifully approved by auditors without any hint of professional scepticism. People can't afford further financial sector debacles. For regulators to be effective, they need real time information. Therefore continuous rather than ex-post audits are needed. The tortuous chain of communications between auditors and regulators has not worked and was in limbo before the 2007-08 crash. The reliance on external auditors means that the imminent regulatory issues receive little attention during audits. The reliance on external auditors also means that regulators can't easily build in-house knowledge. The Barings example shows that regulators can't even get access to audit files and staff to fully explore reasons for the bank's collapse<sup>192</sup>. Therefore, little is learnt from failures.

In a fragmented system, auditors and regulators do not work to identical standards or benchmarks. For example, in September 2014, the FCA fined Barclays Bank Plc £37,745,000 for failing to properly protect clients' custody assets worth £16.5 billion<sup>193</sup>. The main reason was 'significant weaknesses' in the bank's systems and controls during the period November 2007 to January 2012. This raised questions about the quality of external audits performed by PricewaterhouseCoopers (PwC), especially as auditors are required to evaluate systems of internal controls and also specifically report on segregation and security of client assets. The matter was referred to the FRC. In October 2017, it dropped the case by stating that

"there is not a realistic prospect that a Tribunal would make an Adverse Finding against PwC LLP in respect of the matters within the scope of the investigation".

Meanwhile the FCA chairman said that:

"some audit firms have not invested sufficiently in building their knowledge and understanding of the Client Asset Sourcebook (CASS) Rules and the FRC Standard. We continue to see Client Assets reports that are just not good enough.

... We continue to monitor this area but be warned: we have a very low tolerance for CASS failings, because of the significant customer detriment these can cause, and we expect auditors to identify CASS failings when they report to us<sup>194</sup>".

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<sup>192</sup>[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/235622/0673.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/235622/0673.pdf)

<sup>193</sup> Financial conduct Authority, Barclays fined £38 million for putting £16.5 billion of client assets at risk, 23 September 2014, <https://www.fca.org.uk/news/press-releases/barclays-fined-%C2%A338-million-putting-%C2%A3165-billion-client-assets-risk>

<sup>194</sup> Charles Randell, Ten years after Lehman: how accountants can make finance safer, 6 September 2018; <https://www.fca.org.uk/news/speeches/ten-years-after-lehman-how-accountants-can-make-finance-safer>

A major lesson from financial scandals is that regulators cannot rely upon accounting firms acting as external auditors. This system has been ineffective and dysfunctional and needs to be replaced.

We call for the creation of a new statutory body, equivalent to the National Audit Office, whose sole purpose would be to conduct real-time audits of banks, building societies, credit unions, insurers and major investment firms. The cost would be recovered through a levy on financial enterprises. The auditor would not be dependent for fees on client companies and would therefore be independent and robust. Through the new statutory body, the regulator would be able to examine whatever it deems to be of interest and can enforce prudent financial reporting practices and change the culture and practices at financial enterprises. It would also receive an early warning of emerging issues.

Currently, there is a morass of separate sets of overlapping books of accounts which get in the way of regulatory tasks, including measurement of capital adequacy, stress tests and risk management. Regulators are concerned with risk management, including systemic risks, but that is not the focus of audits or financial reporting. The FCA chairman explained<sup>195</sup> that the regulated entities end up with at least three sets of books.

- “First, the financial statements present the results and financial position of the entity for the reporting period, generally based on current market circumstances, adopting the principle of neutrality.
- Secondly, regulators then require a set of regulatory capital numbers to capitalise the entity on the basis of assumed levels of risk in their assets and operations reflecting, we hope, a more prudent view of the risk of future losses.
- And thirdly, regulators then require a further set of numbers to be prepared based on severe but plausible stress scenarios. For FCA solo-regulated firms, this is done through the firm’s Internal Capital Adequacy Assessment Process. On the basis of this further set of numbers, the FCA sets individual capital guidance for firms”.

Accounting firms are found wanting in all of the above. The audit quality has been poor and in the words of the FCA chairman: “the profession needs to address audit quality as a matter of urgency<sup>196</sup>”. Profit seeking audit firms are all too keen to appease management and the FCA chairman stated that:

“high quality auditing requires robust scepticism and challenge from auditors. Bringing this scepticism and challenge to bear is the core purpose of audit. The accounting profession needs to step up its game here, including ensuring that it benefits from — and matches — the scepticism and challenge inherent in the regulatory capital setting process<sup>197</sup>”.

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<sup>195</sup> Charles Randell, op cit., 2018.

<sup>196</sup> Charles Randell, op cit., 2018.

<sup>197</sup> Charles Randell, op cit., 2018.

The current financial reporting processes are unsuitable for regulatory purposes as accounting and auditing practices seek to produce standardised reports and do not recognise the specificities of the financial sector. As the FCA chairman put it:

“the current approach of financial reporting standards — in particular the neutrality principle and the lack of forward looking risk measurement — makes it inevitable that the financial statements of firms will not be sufficient for regulators to do their job in setting capital<sup>198</sup>”

The above echoes the 2013 conclusions of the Banking Standards Commission, which said that

“flaws in IFRS mean that the current system is not fit for regulators’ purposes<sup>199</sup>”.

The above issues cannot be addressed by a fragmented system where regulators do not control the audit process. The current annual meetings between auditors and regulators are no substitute for control and timely interventions by the regulators. The financial regulators can intervene in the appointment of auditors for financial enterprises<sup>200</sup>, but are unable to direct auditors on regulatory specificities. The proposed statutory auditor would work closely with the financial sector regulators and its files would be available to the regulator without any duty of confidentiality getting in the way. The statutory auditor would be accountable to parliament.

The auditing industry and financial sector auditors are on separate wavelengths and that distance would be reduced by the creation of a statutory auditor. For example, the Parliamentary Commission on Banking Standards recommended that banks should produce a separate set of audited accounts for regulators drawn up on the basis of prudence rather than based on IFRSs, which report unrealised gains, together with a reconciliation of the two financial statements<sup>201</sup>. The government expected the FRC to respond<sup>202</sup>, but nothing happened. Almost a year later, the House of Lords Select Committee on Economic Affairs revisited the issue and its chair said,

“since we cannot get IFRS to change in the way that we would like it to and because there has to be European Union agreement, which means that it is difficult to get any change, the way of cutting the Gordian knot was to say that banks should have two sets of accounts: one according to the IFRS rules and

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<sup>198</sup> Charles Randell, op cit., 2018.

<sup>199</sup> UK House of Lords and House of Commons Parliamentary Commission on Banking Standards: Changing banking for good, June 2013.

<sup>200</sup> <https://www.handbook.fca.org.uk/handbook/SUP/3.pdf>

<sup>201</sup> UK House of Lords and House of Commons Parliamentary Commission on Banking Standards: Changing banking for good, June 2013.

<sup>202</sup> The Government’s response to the Parliamentary Commission on Banking Standards, July 2013;

[https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/211047/gov\\_response\\_to\\_the\\_parliamentary\\_commission\\_on\\_banking\\_standards.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/211047/gov_response_to_the_parliamentary_commission_on_banking_standards.pdf)

another according to rules set down by the regulator to fit regulatory needs—that is the PRA/Bank of England<sup>203</sup>”.

The FRC chief executive did not fully appreciate the Committee’s concerns about risk management and said:

“We are a bit nervous about creating two sets of accounts for lots of sectors, because that undermines the principle that there should be comparability between companies of different kinds and investors should be able to make a decision about where to put their money based on that comparability”.

The Committee chair interjected and said:

“No, I am just talking about banks. Banks are different ... for banks which are regulated there should be a set of accounts that best meets the needs of the regulator”.

Eventually nothing happened and regulators continue to navigate the financial sector with faulty compasses. The statutory auditor proposed in this chapter, in collaboration with the regulators, can begin the task of developing measures and accounts that give visibility to systemic problems.

We are aware that big four firms would oppose the above development. The firms claim that unlike them the proposed statutory auditor would not be able to provide global coverage. This presupposes that the firms are global entities, which they are not. It is important to note that the firms are a loose collection of international networks and are not part of a global integrated firm. As individual firms they are subject to the laws and regulatory oversight applicable in their place of residence. They do not have identical standards. As national entities, the auditors of Barings (see earlier parts of this chapter) did not co-operate with the UK regulators. A similar position was encountered during the investigation of audit failures at BCCI<sup>204</sup> where Price Waterhouse did not cooperate with the US investigators. Similarly, after the Parmalat scandal Grant Thornton built liability firewalls by asserting that the

“Italian practice - one of Parmalat's auditors - was merely a member firm of an international network. It was independently owned and operated - and legally nothing to do with other firms bearing the Grant Thornton badge<sup>205</sup>”.

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<sup>203</sup> Unrevised transcript of evidence taken before The Select Committee on Economic Affairs Inquiry into Going Concern, 22 July 2014; <https://www.parliament.uk/documents/lords-committees/economic-affairs/High-Frequency-Trading-and-Going-Concern/ucEAC20140722Ev2.pdf>

<sup>204</sup> US Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, Washington DC: USGPO, 1992,

<sup>205</sup> Accountancy Daily, Special Reports - Parmalat - Myth, reality and the global firm. 1 February 2004; <https://www.accountancydaily.co/special-reports-parmalat-myth-reality-and-global-firm>

The international network of the firms has its own dynamics and is not accountable to national regulators. UK arm of a big four network can invite a member firm in another country to perform audit work, but such information is not communicated to stakeholders even though the firm is relying upon audit work performed by staff not under its direct control.

The proposed statutory auditor should not have any difficulty in auditing domestic units of financial enterprises. For international subsidiaries it can invite competitive tenders and can control and remunerate the firms so selected. Such a scenario would result in a fundamental change in the legal relationship. Currently, auditors owe a duty of care to the company and not to any regulator. In sharp contrast, the firm appointed by the statutory auditor to carry out the audit of a subsidiary would be in a principal-agent relationship with the statutory auditor. It would owe a duty of care to the statutory auditor. It will receive instructions from that body and would normally be obliged to show the work that it has performed and would be liable to the statutory auditor for negligence. Matters of control, accountability and liability can be specified in the contract. Though such processes the statutory auditor can provide global coverage, have access to auditor files and secure a duty of care from accounting firms.

The other objection that we have received is that the proposed system would be costly. Such an objection presupposes that the current system is efficient and less costly. The current system has failed for more than fifty years and has inflicted huge social cost on every citizen as demonstrated by financial crashes, bailouts, loss of economic output, wages, taxes and pensions.

## **SUMMARY AND DISCUSSION**

This chapter has called for the creation of a statutory body to provide audits for financial enterprises. It will effectively be the fifth largest supplier of external audit in the UK. It is needed because of the perennial failures of the financial sector auditors. After scandals auditing firms promise to do better next time, but have always been found wanting. As turbulence in the financial sector affects the whole economy, regulators need real-time information and also need to be aware of the emerging issues and culture of risk management at financial enterprises. Such matters are best addressed by the creation of a statutory auditor solely devoted to the audit of financial enterprises. This way, the regulators will be in a stronger position to address matters, enforce prudent accounting practices and check abuses and reckless risk-taking. The lines of communications between the auditor and the regulator would be much shorter and clearer. The legislation creating the new statutory auditor would ensure that auditors cannot obstruct regulators by sheltering behind a duty of confidentiality to audit clients.

An added benefit of the proposal is that it would reduce the concentration of audits in the big four firms and facilitate competition in the rest of the audit market.

## **RECOMMENDED REFORMS**

- A statutory body must be created to conduct real time audits of banks, building societies, credit unions, insurers and major investment firms.
- The statutory auditor will work closely with the financial sector regulators.
- The financial sector regulators shall have unhindered access to the files of the statutory auditor.

## **CHAPTER 6 EXPANDING THE SUPPLY OF AUDITING SERVICES**

The previous chapter explained how a state-backed auditor for the financial services industry would expand the provision of auditing. This needs to be supplemented by a number of other reforms. These include the removal of barriers to entry to the audit market, joint audits and possible sharing of technology and knowledge amongst large, medium and small auditing firms. The reforms recommended in this chapter would require legislation and independent enforcement.

The state is the key player in creating demand for statutory audits as it requires companies, local authorities, schools, universities, hospitals and other organisations to submit to mandatory financial audits. To ensure stability, it also needs to change the supply-side of auditing through specific institutional structures. It already does that in many arenas ranging from HMRC, immigration to health and safety. However, the supply side of external financial audits has been left to the private sector which has been a boon for auditing firms. The firms have bolted numerous consultancy services on to it, so much so that audits have become a second fiddle to other revenue generating practices. Successive governments should have challenged the shrinking competition, choice and quality in the audit market, but did little. They permitted big auditing firms to merge and facilitated increased concentration of audits and encouraged the “too few to close” syndrome. Poor audit quality has been the inevitable consequence and even after delivering poor audits, the same firms remain dominant. Such a state of affairs does not encourage firms to deliver meaningful audits.

### **REMOVE BARRIERS TO ENTRY**

The auditing part of the business of the big accounting firms has been shrinking as the firms are more focused on the sale of other services. The number of partners focused exclusively on audit is also comparatively small though not insignificant. Information technology changed the way data is recorded, analysed and interpreted and the next technological revolution is already here. Developments such as workflow automation, artificial intelligence, data analytics and blockchain are changing the nature of accounting, information processing and auditing. Artificial intelligence can analyse data and flag up unusual or specific patterns from different perspectives. Many big accounting firms have diversified by buying technology consultancies and are also collaborating with software and other technology companies to expand their business and develop new audit tools. These new tools will assist rather than replace auditors and over-reliance upon them can also be a source of dangers.

Some argue that it is feasible for technology companies to enter the statutory audit market and expand the supply of audits. Many are large well capitalised companies and can match the investment made by big accounting firms. The 2018 financial statements of PwC<sup>206</sup>, the largest UK auditing firm, show that the firm had non-current assets of £489 million which are used to deliver auditing and non-auditing

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<sup>206</sup> Available at <https://www.pwc.co.uk/annualreport/assets/2018/pdf/annual-report-2018-financial-statements.pdf>

services. Of course, its biggest resource is the people who provide services and in 2018 generated fees of £3,764 million and profits of £935 million. In principle, technology companies, and others, can match the investment and over a period recruit suitable staff, including accountants, and develop networks and reputation to deliver audits. However, there are barriers to entering the auditing market.

There are restrictive rules about ownership of auditing firms, effectively the majority of the voting rights in LLPs or limited liability companies delivering audits need to be held by qualified auditors. This is required by the EU Eighth Directive. Following modifications of Article 3 (4) of the 2006 Directive on Statutory Audit, in 2007, the EU commissioned a study<sup>207</sup> on the possibility of relaxing the ownership rules and inviting new entrants to expand the supply of audits. The key conclusions of the study<sup>208</sup> were:

- The audit market for major listed companies is dominated by the Big Four audit firms. For the smaller audit firms, important investments might be necessary over years in order to expand and to enter the international audit market.
- Analysis of an investment model developed to assess such potential expansion plans indicates that an audit firm owned by external investors, instead of auditors, might take more easily the decision to expand into the market of large audits. One of the reasons is that existing ownership structures may be estimated to increase audit firms' cost of raising capital by perhaps as much as 10%.
- Nevertheless, restrictions on access to capital appear to represent only one of several potential barriers to entry. There are other barriers which also play an important role: reputation, the need for international coverage, international management structures, and liability risk. The impact of liability risk on the cost of capital can be significant and may lead to capital rationing.
- There may also be good reasons for audit firms to stick to their current structures: for example, to retain their human capital. From the regulatory point of view, existing ownership structures have been justified by the necessity to protect independence of audit firms. However, the analysis of the decision-making processes in large audit firms indicates that alternative ownership structures are unlikely to impair auditor independence in practice. Specific conflicts of interest could be dealt with through the establishment of appropriate safeguards.

In 2008, the EU launched a consultation exercise<sup>209</sup>. The 2007-08 banking crash also persuaded the International Organization of Securities Commissions<sup>210</sup> and the

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<sup>207</sup> Oxera, Ownership rules of audit firms and their consequences for audit market concentration, October 2007; <https://www.oxera.com/wp-content/uploads/2018/03/Ownership-rules-of-audit-firms.pdf>

<sup>208</sup> EU Commission Press release IP/07/1570, Ownership rules for audit firms: Commission services publish independent study on the impact on the audit market, 23 October 2007; [http://europa.eu/rapid/press-release\\_IP-07-1570\\_en.htm?locale=en](http://europa.eu/rapid/press-release_IP-07-1570_en.htm?locale=en)

<sup>209</sup> EU Commission Press release IP/08/1727, Audit firms: Commission consults on ways to help create more market players, 18 November 2008; [http://europa.eu/rapid/press-release\\_IP-08-1727\\_en.htm](http://europa.eu/rapid/press-release_IP-08-1727_en.htm)

Organisation for Economic Co-operation and Development<sup>211</sup> (OECD) to launch papers. In the final analysis the ownership restrictions remained in place. The ICAEW<sup>212</sup> defines a member firm, including members of firm, who can deliver external audits, as

- a. a member engaged in public practice as a sole practitioner; or
- b. a partnership engaged in public practice of which more than 50 per cent of the rights to vote on all, or substantially all, matters of substance at meetings of the partnership are held by members; or
- c. a limited liability partnership engaged in public practice of which more than 50 per cent of the rights to vote on all, or substantially all, matters of substance at meetings of the partnership are held by members; or
- d. any body corporate (other than a limited liability partnership) engaged in public practice of which:
  - i. 50 per cent or more of the directors are members; and
  - ii. more than 50 per cent of the nominal value of the voting shares is held by members; and
  - iii. more than 50 per cent of the of the aggregate in nominal value of the voting and non-voting shares is held by members;

The accountant ownership rules erect barriers to the raising of capital and transfer of shares and thus prevent new suppliers from entering the auditing market. Such rules rarely exist in other sectors which compete to innovate or attract business. No one has suggested that only pilots can own airlines, only pharmacists can own pharmaceutical companies or only chefs should own food business. Throughout the commercial world there is a separation of ownership from the operations of companies. Airlines, pharmaceuticals and food companies exist in regulated sectors. Currently auditing firms sell a variety of services outside of the traditional sphere of accounting and auditing. There is nothing to prevent them for entering other markets. But their own market is hermetically sealed and prevents new entrants from increasing supply or introducing new technologies. This restriction enables auditing to earn economic rents and provides little reason for change.

In discussions with us, the big firms have asserted that as medium-tier firms were not capable of making the necessary investment they would find it difficult to challenge the big firm control of the audit market. The removal of ownership restrictions can enable mid-tier firms to secure new capital, or enter into alliances with others, and challenge the bigger firms. Many large companies can certainly match and even exceed the investment made by the big four firms.

The auditing industry has vigorously advocated reregulation and competition for other sectors, but not for itself. The auditing industry claims that the removal of

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<sup>210</sup> International Organization of Securities Commissions, Consultation Report, Exploration of Non-Professional Ownership Structures for Audit Firms, September 2009; <https://www.iasplus.com/en/binary/iosco/0909ownership.pdf>

<sup>211</sup> Organisation for Economic Co-operation and Development, Competition and Regulation in Auditing and Related Professions, 2009; <http://www.oecd.org/regreform/sectors/44762253.pdf>

<sup>212</sup> ICAEW Principal Bye-laws, available at <https://www.icaew.com/membership/regulations-standards-and-guidance/bye-laws/principal-bye-laws>

restrictions on ownership market will somehow damage audit quality because of the pursuit of profits by diverse shareholders and LLP investors. It is claimed that the presence of non-accounting owners will damage auditor independence. Such arguments are undermined by the firms' own pursuit of profits at almost any cost. Earlier part of this report noted the poor quality of audits at BHS, Carillion, banks and elsewhere. Auditor independence and audit quality has been damaged by the firms engaging in tax avoidance/evasion, bribery, corruption, money laundering and price fixing and generally taking up partisan positions close to the interests of their clients. A comparatively robust regulatory oversight enables airlines, food and drugs companies to deliver quality products and services. It is hard to see why the same cannot be done for all suppliers and entrants, corporate or otherwise, to the auditing industry.

## **TECHNOLOGY AND KNOWLEDGE-SHARING**

The big four firms have the capacity to invest in technology and data harvesting techniques. They claim that this increases efficiency of audits. They have indicated their willingness to share their technology and knowledge with mid-tier and other challenger firms, at a price. This they claim that this would reduce some of the barriers for entry to bigger audits i.e. provide technology for mid-tier firms, which could increase the supply of audit services in some segments of the market.

However, this presupposes that the quality standards of the big firms are par excellence, a claim that is undermined by numerous failures attributed to them. It also assumes that one-size technology would be suitable for large, small, medium-size audit clients across various sectors and localities. Technology is just one part of the equation of competition, choice and quality. The use of standard technology may also force auditors to standardise their audit processes rather than consider the specific circumstances of each client. The technology would remain the property of the big four firms and only they would have the details of the algorithm and codes embedded in any software and the ability to modify it. Mid-tier firms would effectively be leasing it and would never become the owners. Big four would have economic incentives to periodically tweak the software and generate an income stream. In time, mid-tier firms would become dependent on the big four firms for design of their audit strategies.

Mid-tier firms told us that they already have the appropriate technology and can also collaborate with specialist suppliers to create software specific to their needs. There was little/no enthusiasm to signing up to technology sharing agreements as there is concern that this would only increase the dominance of the big four firms. However, the sharing of technology and knowledge may be considered in the case of joint audits.

## **JOINT AUDITS**

Joint audits, i.e. two independent firms are jointly responsible for conducting statutory audits, forming audit opinion and sharing resulting liabilities, can enable small and mid-tier firms to grow and participate in the to-end of the statutory audit market. There are currently no joint audits in FTSE 350 market though they are

found in other places. For example, in June 2018 Old Mutual in addition to its current auditor, KPMG, appointed Deloitte as a joint external auditor<sup>213</sup>.

Joint audits can be problematical if the two firms do not coordinate their audit plan, working methods, approach to materiality, sampling thresholds, extent of tests and sharing of files. There is always a danger that the junior partner in the joint audits can be bullied by the larger firm into giving an unwarranted audit opinion and thus erode its independence. Some of the dangers have been highlighted by past episodes. For example, the Department of Trade and Industry (DTI) inspectors report on audit failures at Bernard Russell<sup>214</sup> noted that due to poor coordination by auditors, some aspects of audit were omitted altogether. The inspectors said:

“the precise extent of separate and common duties was never defined and agreed between them ... a danger that in the absence of mutual cooperation and detailed understanding each participant may assume that the other has carried out certain tests which in the result are neglected by both. This if there is to be any division of labour between joint auditors – as no doubt is both convenient and economic – it is essential that the precise extent of separate duties should be defined and agreed between them. It is prudent, of course, if only for reference purposes, that such agreement should be in writing<sup>215</sup>”.

Poor coordination and cooperation between two mid-tier firms was again highlighted in the DTI inspectors’ 1991 report on audit failures at Aldermanbury Trust. They advised:

“Regardless of how auditors choose to divide the audit work, each auditor has equal responsibility for the contents of the audit report. An auditor should not rely on the performance of work carried out by another without satisfying himself that such reliance is justified<sup>216</sup>”.

Joint audits came under scrutiny after the 1991 forced closure of the Bank of Credit and Commerce International (BCCI). It was the biggest banking fraud of the twentieth-century. To this day, there has been no independent investigation of the frauds in the UK, but some aspects of the audit came under scrutiny in an investigation by the US Senate Committee<sup>217</sup>. The annual audit of BCCI was divided between two of the then “Big Eight” accounting firms. Ernst & Whiney (now part of Ernst & Young) were responsible for auditing the holding company and BCCI Luxembourg and Price Waterhouse (now part of PwC) were responsible for the audit of BCCI Overseas in the Grand Cayman. This arrangement existed for the 15 years

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<sup>213</sup> Financial Times, Blow to KPMG as Old Mutual appoints second auditor; 12 July 2018; <https://www.ft.com/content/1730dac0-8521-11e8-96dd-fa565ec55929>

<sup>214</sup> Department of Trade and Industry, Bernard Russell Limited, London: HMSO, 1975.

<sup>215</sup> Department of Trade and Industry, Bernard Russell Limited, London: HMSO, 1975, para 46

<sup>216</sup> Department of Trade and Industry, Aldermanbury Trust plc, London: HMSO, 1991, para 9.74-9.77.

<sup>217</sup> US Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, Washington DC: USGPO, 1992.

of the bank's operations and neither of the auditors had an overall view of its activities, but they were content with that state of affairs.

According to Ernst & Whinney, the mounting treasury losses and failure of the senior management to promptly disclose them to the regulators forced it to question whether it could trust BCCI management though Price Waterhouse's confidence in directors remained unshaken. Ernst & Whinney had advised BCCI that if it were to continue to act as the bank's auditors, BCCI needed to achieve a marked improvement in the financial and managerial controls exercised throughout the group. In May 1986, Ernst & Whinney advised BCCI that unless they were permitted to assume responsibility for the whole audit and BCCI's management style were changed and its record keeping systems were improved, they would resign from their commission as auditors for BCCI. In 1986 Ernst & Whinney withdrew from the audit and Price Waterhouse became the bank's sole auditors. The exact reasons for Ernst & Whinney's resignation were not clear. The US Senate report noted that

"Price Waterhouse, for reasons that are not clear, but which may relate to the \$5 million a year being generated by BCCI-related work, remained with BCCI, and signed off on BCCI's books year after year until early 1990. At that time, recognizing that the financial hole inside the bank required emergency action, Price Waterhouse sought to avoid the risk of being destroyed together with BCCI by taking the information it had developed to the British regulators, and seeking further guidance from them<sup>218</sup>".

In the absence of independent investigation of BCCI frauds, few lessons, if any, have been learnt about joint audits. Eventually, in April 1996, a disciplinary committee fined Price Waterhouse £150,000 for its failures and costs of another £825,000<sup>219</sup> but hardly any questions were asked about joint audits.

Audit quality and processes are problematical in every sector and joint audits are no exception. Nevertheless, joint audits are found in Denmark, Germany, Switzerland and France. In South Africa, banks are required to have two external auditors and its Reserve Bank deputy governor stated that

"We like joint audits for big, systemically important banks. We think it gives us a higher level of quality assurance<sup>220</sup>".

In Denmark, the listed and state-owned companies were required to be audited by two independent auditors from 1930 through 2004. This requirement has been abolished but a number of companies have voluntarily retained joint audits

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<sup>218</sup> US Senate Committee on Foreign Relations, The BCCI Affair: A Report to the Committee on Foreign Relations by Senator John Kerry and Senator Hank Brown, Washington DC: USGPO, 1992, p. 272.

<sup>219</sup> Accountancy Age, BCCI: auditor hit with £1m in fines and costs, 19 April 2006; <https://www.accountancyage.com/aa/news/1790188/bcci-auditor-hit-gbp1m-fines-costs>

<sup>220</sup> Business Day, Banks have to thread the needle of joint auditors and rotation, 30 May 2018; <https://www.businesslive.co.za/bd/companies/financial-services/2018-05-30-banks-have-to-thread-the-needle-of-joint-auditors-and-rotation/>

In 1984, France extended the requirement of a mandatory joint audit to companies required to prepare consolidated financial statements though the practice goes back to a much earlier period<sup>221</sup>. Today, joint audits are enforced in France, where listed companies are required to appoint two different audit firms, who share the audit work and jointly sign the audit report. The two firms can be both big four, or large and small. As a result, the concentration of audit is less and the big four firms effectively control around 50% of the audit market for listed companies (Euronext Paris exchange). In the UK, for the period 2014 to 2017, the big four firms controlled around 78% of the audit market for listed companies<sup>222</sup>. This difference is almost entirely due to the practice of joint audits.

The possible benefit of joint audit, especially when a large and a medium-size firm work together, is that it enables the smaller firm to gain experience of auditing large entities. This experience enables them to secure the confidence of significant others and make bids for bigger audits. This way, barriers to entry in some segments of the audit market are reduced. Therefore, the number of firms capable to auditing larger entities increases. Joint audits can increase competition, choice and the availability of a readymade replacement to reduce turbulence caused by the demise of a big audit firm.

The Enron and WorldCom scandals, and the demise of auditors Arthur Andersen, raised the possibility of joint audits, but in the face of opposition from the big four firms, nothing changed. In order to reduce concentration of audits, joint audits need to be made mandatory. Such a possibility was considered by the 2010 EU Green Paper. It said that to:

“encourage the emergence of other players and the growth of small and medium sized audit practices, the Commission could consider introducing the mandatory formation of an audit firm consortium with the inclusion of at least one non-systemic audit firm for the audits of large companies. Such consortia would need to be established with clear lines of responsibility for the overall audit opinion as well a resolution/disclosure mechanism for differences in opinion between consortium members.

The concept of "joint audit" could also be one way of mitigating disruption in the audit market if one of the large audit networks fails<sup>223</sup>”.

The imposition of joint audits would inevitably require some fee sharing arrangements, which can reduce the fee income of some firms. Big four firms opposed the call for joint audits and a partner said that “the introduction of joint

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<sup>221</sup> Jere R. Francis, Chrystelle Richard, and Ann Vanstraelen (2009) Assessing France's Joint Audit Requirement: Are Two Heads Better than One?. *AUDITING: A Journal of Practice & Theory*: November 2009, Vol. 28, No. 2, pp. 35-63.

<sup>222</sup> Trends in Auditor Market Concentration in Select European Countries, 6 November 2018; <https://www.auditanalytics.com/blog/trends-in-auditor-market-concentration-in-select-european-countries/>

<sup>223</sup> European Commission, Green Paper - Audit Policy: Lessons from the Crisis, 13 October 2010, [http://www.europarl.europa.eu/meetdocs/2009\\_2014/documents/com/com\\_com\(2010\)0561\\_/com\\_com\(2010\)0561\\_en.pdf](http://www.europarl.europa.eu/meetdocs/2009_2014/documents/com/com_com(2010)0561_/com_com(2010)0561_en.pdf).

audits in the UK could increase the chance of fraud occurring and would not increase the audit quality<sup>224</sup>. However, in South Africa, Denmark, France and the UK, the big four firms act as joint auditors and it is hard find any statement to the effect that their audits promoted fraud or were substandard. Big firms seem to reach satisfactory fee and work sharing arrangements for joint audits. However, big four firms opposed the EU proposals whilst mid-tier firms supported them. The differences in interests and perspectives can be gauged from the following:

“On mandatory joint audits and consortia, the Big Four are negative as they believe it will impair audit quality and will cause co-ordination problems. They also believe that such an artificial attribution to smaller firms of a share in the market for larger audits could risk becoming a disincentive to them to grow.

Mid tier firms and SMPs [Small and Medium Sized Practitioners] strongly support joint audit and consortia where at least one non-systemic firm is included. They also highlight that joint audits are tried and tested and have worked in keeping concentration lower in France than in other Member States; they explain that in France there is currently an additional firm at the top end of the market. There have been other players but they were acquired by the Big Four. They also indicate that concentration is also lower in France at the next level of the market than in other Member States. Some believe that the participation of more networks and audit firms in the larger as well as public interest audits will enhance competition and can potentially raise quality. It has been submitted that consortia should not be fixed between any specific firms but should be put together on a case by case basis<sup>225</sup>.

The EU consultation also elicited concern from investors mainly fearing an increase of costs of audits and the dilution of responsibility. However, a study<sup>226</sup> examined the cost of joint audits in Denmark and France and concluded that “the Danish case evidences no higher costs (neither audit or total fees) and the higher cost observed on the audit and total fees in France could not be unambiguously attributed to joint audit ... we do not observe a higher quality associated with joint audit”.

The EU encouraged joint audits by giving special concessions to participants from audit tendering and rotation<sup>227</sup>. For example, companies opting for joint audit need not change the audit firm for 24 years (instead of 20 years) as long as a public

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<sup>224</sup> Accountancy Age, Joint audits will increase fraud: Big Four partner, 15 October 2010; <https://www.accountancyage.com/aa/news/1809014/joint-audits-increase-fraud-big-four-partner>

<sup>225</sup> European Commission, Summary of Responses - Green Paper Audit Policy: Lessons From The Crisis, 4 February 2011; [http://ec.europa.eu/finance/consultations/2010/green-paper-audit/docs/summary\\_responses\\_en.pdf](http://ec.europa.eu/finance/consultations/2010/green-paper-audit/docs/summary_responses_en.pdf)

<sup>226</sup> Cédric Lesage, Nicole V. S. Ratzinger-Sakel & Jaana Kettunen, Consequences of the Abandonment of Mandatory Joint Audit: An Empirical Study of Audit Costs and Audit Quality Effects, *European Accounting Review*, 26:2, 311-339, 2017.

<sup>227</sup> European Commission, European Parliament backs Commission proposals on new rules to improve the quality of statutory audit, 3 April 2014, [http://europa.eu/rapid/press-release\\_STATEMENT-14-104\\_en.htm](http://europa.eu/rapid/press-release_STATEMENT-14-104_en.htm); Q&A - Implementation of the New Statutory Audit Framework, 3 September 2014; [https://ec.europa.eu/info/system/files/questions-answers-03092014\\_en.pdf](https://ec.europa.eu/info/system/files/questions-answers-03092014_en.pdf)

tender takes place after the initial ten year period. The EU did not impose a mandatory joint audit requirement. Therefore, it had little effect on the market structure. The French experience<sup>228</sup> suggests that the joint audit system is effective in maintaining market openness and in mitigating the Big 4 domination in the long run. An investigation of the determinants driving changes in joint audit combinations suggests that best improvement in the market is from a combination of a Big four and a mid-tier firm rather than from the combination of two big four firms acting as joint auditors. Interestingly, despite the EU initiative the FRC has not produced any guidance for the UK firms considering participation in joint audits.

## **SUMMARY AND DISCUSSION**

The UK auditing market is dysfunctional, as evidenced by poor quality of audits, lack of competition and choice. Audits are concentrated in comparatively few firms. Reducing the power of the big four is a necessary condition to repairing the market and enabling regulators to take robust action against audit failures. Any restructuring of the audit market will result in some firms losing business and revenues whilst others may gain. There are also formidable barriers to entry arising from size, capital, local/global networks, resources, alumni and political links.

This chapter examined three possibilities. Firstly, it considered restrictions on ownership of auditing firms which restrict the entry of new suppliers to the audit market. It is hard to think of any economic theory which would justify their perpetuation. Such restrictions have not persuaded auditing firms to deliver good independent audits and need to be abolished. The possibility of new entrants would help to attract capital, new technologies, competition and choice to the audit market. All suppliers, whether existing or new, would be robustly regulated to ensure that they meet their social mandate and deliver high quality audits. Subject to safeguards, it does not matter who conducts audit or forces corporations to be accountable. Therefore, there is no reason why the auditing industry should continue to be confined to current providers. After all, the auditing industry routinely enters other markets and sells financial services and consultancy. It could hardly have strong objections if other suppliers wished to enter its traditional jurisdictions. Secondly, the possible sharing of audit technologies developed by the big four firms was considered as a remedy for barriers to entry to the market. However, this will not increase the number of suppliers, competition, choice or audit quality. If anything, it is likely to increase the grip of the big four firms on the mid-tier firms. Thirdly, joint audit were considered. The French experience suggests that such a development has the capacity to reduce concentration of audits and increase choice. Joint audits can also reduce the size of the big four firms and their capacity to hold governments to ransom.

We recommend that all restrictions on the ownership of auditing firms be abolished. We also recommend that all large companies (except in the financial sector) should be required to have a mandatory system of joint audits. In advancing such proposals we are aware that reform is likely to be resisted by the big firms as they have got

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<sup>228</sup> Lamya Kermiche and Charles Piot, *The Audit Market Dynamics in a Mandatory Joint Audit Setting: The French Experience*, *Journal of Accounting, Auditing & Finance* 2018, Vol. 33(4) 463–484.

used to oligopolies and would not wish to surrender profits. The ultimate decision rests with parliament and government and the priority should be to arrest the failures in the audit market rather than continuing appeasement of the big firms.

## **RECOMMENDED REFORMS**

- Remove all restrictions on the ownership of auditing firms in order to attract new entrants, capital, competition and choice and create pressures for improvement in audit quality.
- Joint audits must be made mandatory for large companies, as defined by the Companies Act 2006.

## **CHAPTER 7**

### **AN INDEPENDENT BODY FOR APPOINTMENT OF FINANCIAL AUDITORS**

#### **INTRODUCTION**

Ever since the inception of modern audits there have been concerns about company directors selecting and remunerating auditors and thereby defeating the very concept of an independent audit. Such concerns continue to be amplified by scandals showing close proximity between auditors and company directors. There is also the issue of the domination of the audit market by the big four firms and the related lack of competition and choice at the top-end of the market. Issues about auditor independence, competition and choice can be addressed by the creation of an independent statutory body for the appointment and remuneration of auditors at large companies.

This chapter calls for auditors of large companies to be appointed and remunerated by an independent body. To secure competition and stability in the audit market, this chapter also calls for a cap on the proportion of audit market that can be enjoyed by the big firms

#### **AUDIT IS A PUBLIC CONTRACT**

Audits are a ubiquitous feature of contemporary life and auditors are found in numerous sectors. For example, HMRC audits tax returns and immigration officers check passports at airports to determine the eligibility of persons to enter/leave a country. Health and safety inspectors, environmental inspectors, building inspectors, food hygiene inspectors and fire safety officers perform checks in a variety of situations in accordance with their statutory remit. In each of these instances, the practices of the auditees have consequences for the welfare of others. Therefore, auditees are not permitted to select or remunerate the auditor or hire auditors as consultants even when in recent years governments have permitted some outsourcing of the audit functions. Such auditors are respected and possibly even feared because they are not beholden for their appointment and remuneration to the auditee and can therefore act fearlessly and honestly. No one would seriously suggest that companies should be able to choose their own tax, immigration or health and safety inspectors.

The above social norms are violated by the corporate sector where auditees, effectively company directors or audit committees on behalf of the board, appoint and remunerate the auditors. In practice, shareholders rubber-stamp the board's decision but they exercise little control. The shareholders in listed companies are mostly focused on the short-term returns<sup>229</sup> and have little interest in the long-term invigilation of companies. Andrew Haldane, chief economist at the Bank of England, noted that, for the UK, the "average duration of equity holdings has fallen from around 5 years in the mid-1960s to around 2 years in the 1980s. At the turn of the century, it had reached just over a year. By 2007, it had fallen to around 7½

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<sup>229</sup> John Kay, *The Kay Review of UK Equity Markets and Long-Term Decision Making*, London: UK Department of Business, Innovation and Skills, 2012.

months<sup>230</sup>". The average duration of shareholdings in the US, UK and European banks "fell from around 3 years in 1998 to around 3 months in 2008"<sup>231</sup>. The average shareholding period in listed companies now may well be around one month<sup>232</sup>. With automated computer trading the shareholding duration is likely to shrink further as the average time for which a stock is held before being traded again has been reduced to 22 seconds<sup>233</sup>, a time horizon which is not compatible with any shareholder interest in the long-term wellbeing of companies. It is hard to recall any extensive engagement between auditors and shareholders though some institutional shareholders do their best. In any case, shareholders do not provide most of the risk capital to large companies. For example, at banks they provide less than 10% of total capital and the remainder is provided by other stakeholders. The other stakeholders bear the consequences of audit debacles too as demonstrated by failures at BHS, Carillion and banks which affected taxpayers, suppliers, employees, pension scheme members and economic stability. Yet there is no societal input in the selection, appointment or remuneration of auditors.

The audit was meant to be a mechanism for informing the public and for protecting people from financial malpractices. For example, during the passage of the Companies Act 1948, audits were considered to be "in the interests and protection of the public"<sup>234</sup>. However, the public aspects have increasingly been subverted and the auditing industry and company directors increasingly promote audit as a private contract.

## **WATCHDOGS OR LAPDOGS**

Any auditor selected, appointed and remunerated by the company is always beholden to directors for his/her appointment and for all practical purposes directors are known as 'clients'. This, inevitably, makes auditors dependent upon directors for their fees and profits. Despite periodic restrictions, auditors are still permitted to sell a range of consultancy services to audit clients and thereby increase their fee dependency on directors. Such an auditor cannot be independent of the company board. In this model of auditing, which is prevalent in the UK, one set of entrepreneurs (auditors) invigilates another (company directors) where they measure their success in terms of profits, fees and number of clients, and serving broader society just does not enter the equation. Auditors have little incentive to be robust for fear of losing fees and organisational ethos is focused on private gains.

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<sup>230</sup> Haldane, A.G. Patience and Finance, Speech at Oxford China Business Forum, Beijing, 2 September 2010 (<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech445.pdf>).

<sup>231</sup> Haldane, A.G., Who Owns a Company? Speech given at the University of Edinburgh Corporate Finance Conference, 22 May 2015; <http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech833.pdf>.

<sup>232</sup> The Daily Telegraph, Thatcher's dream for UK investors has become a nightmare, 17 May 2015 (<http://www.telegraph.co.uk/finance/11610490/Thatchers-dream-for-UK-investors-has-become-a-nightmare.html>).

<sup>233</sup> The Daily Telegraph, How long does the average share holding last? Just 22 seconds, 18 January 2012 (<http://www.telegraph.co.uk/finance/personalfinance/investing/9021946/How-long-does-the-average-share-holding-last-Just-22-seconds.html>).

<sup>234</sup> Parliamentary Debates, House of Lords, 18 February 1947, col. 745

Studies of accounting firms have noted that within major accounting firms

“the emphasis is very firmly on being commercial and on performing a service for the customer rather than on being public spirited on behalf of either the public or the state<sup>235</sup>”.

It is hard to think of any auditor being rewarded or promoted for standing up to directors. The appeasement of directors is writ large into audits even when directors do not twist the auditor’ arm. Auditors do not bite the hand that feeds them. A regulatory report on audit failures at BHS noted that:

“During the course of the BHS audit, and prior to issuing the audit reports, the Respondents became aware of the likely sale of BHS. Completion of the audit was brought forward to accommodate the sale. BHS’s financial statements were likely to be subject to increased scrutiny. The financial statements were likely to be of interest to the purchaser and the purchaser’s professional advisors as well as lenders, suppliers, trade creditors and TPR.

The audit reports for BHS and BHS Group were signed by Mr Denison on behalf of PwC on Monday 9 March 2015 (Mr Denison backdated them to Friday 6 March 2015) For the avoidance of doubt, it is not alleged that this was at Taveta’s request. ...Two days later, on 11 March 2015, BHS Group was sold to Retail Acquisitions Limited (“RAL”) for a nominal sum of £1<sup>236</sup>”.

Here is a sample of some other episodes:

- The compliant auditors at Cattles plc did not even bother to corroborate management representations<sup>237</sup>.
- Auditors have been known to appease directors by approving accounting choices even when they know them to be wrong<sup>238</sup>.
- Auditors have willingly acquiesced to unjustified departures from prescribed accounting methodologies<sup>239</sup>.

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<sup>235</sup> Gerald Hanlon, *The Commercialisation of Accountancy: Flexible Accumulation and the Transformation of the Service Class*, London: St. Martin’s Press, 1994.

<sup>236</sup> Financial Reporting Council, *In the matter of: The Executive Counsel To The Financial Reporting Council - and - (1) Stephen John Denison, (2) PricewaterhouseCoopers LLP*, 10 August 2018; <https://www.frc.org.uk/getattachment/433f3df8-d0ef-456b-8a26-aeb55f65489b/BHS-Particulars-of-Fact-and-Acts-of-Misconduct.pdf>

<sup>237</sup> Financial Reporting Council, *The Executive Counsel To The Financial Reporting Council - And -1. Pricewaterhousecoopers LLP, 2. Simon Bradburn*, 31 August 2016; <https://www.frc.org.uk/getattachment/eeb1c057-96d0-4333-ac1c-0fbc18eea775/Particulars-of-Fact-and-Acts-of-Misconduct-PwC-and-Mr-Simon-Bradburn-redacted.pdf>

<sup>238</sup> William C. Powers, Jr., Raymond S. Trough and Herbert S. Winokur, Jr., *Report on Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp.*, Austin: Wilmer, Cutler & Picketing, 2002  
; <http://i.cnn.net/cnn/2002/LAW/02/02/enron.report/powers.report.pdf>.

- Department of Trade Inspectors report on frauds by the late Robert Maxwell concluded that auditors “consistently agreed accounting treatments of transactions that served the interest of RM and not those of the trustees or the beneficiaries of the pension scheme, provided it could be justified by an interpretation of the letter of the relevant standards or regulations<sup>240</sup>”.
- Auditors have helped clients carefully and willfully falsify annual financial reports<sup>241</sup>.
- Even after becoming aware that company directors have included a false audit report in the published accounts, auditors went along with it because “this was a big fee account and that his firm did not want to resign<sup>242</sup>”.
- There is always a possibility that someone at the annual general meeting may ask an awkward question. Evidence shows that auditors have colluded with management and agreed a strategy about how they will or will not answer questions<sup>243</sup>.

The above malpractices have only come to light because of scandals. How many other instances remain hidden because a company continues to survive is not known.

Any suggestion of reducing the board influence on appointment of auditors is resisted by executives who have got used to having compliant auditors. The 100 Group stated that:

“the right to appoint auditors should not be removed from individual company boards, amid suggestions that responsibility for doing so could be handed to an independent body<sup>244</sup>”.

It should be noted that Companies Act 2006 does not permit boards to “appoint auditors” other than under very restricted circumstances (e.g. first auditors, or to fill a casual vacancy) and auditors are generally appointed by shareholders. The

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<sup>239</sup> United States Bankruptcy Court for the District Delaware, “Final Report of Michael J. Missal Bankruptcy Court Examiner: In re: New Century Trs Holdings, Inc., a Delaware corporation, et al.”, 29 February 2008, available at: [graphics8.nytimes.com/packages/pdf/business/Final\\_Report\\_New\\_Century.pdf](http://graphics8.nytimes.com/packages/pdf/business/Final_Report_New_Century.pdf).

<sup>240</sup> UK Department of Trade and Industry, Mirror Group Newspapers plc (two volumes), London: The Stationery Office, 2001.

<sup>241</sup> Financial Services Agency [Japan], Disciplinary Actions against an Audit Firm and Certified Public Accountants, 10 May 2006; <https://www.fsa.go.jp/en/news/2006/20060510.html>

<sup>242</sup> Joint Disciplinary Scheme, Complaints Brought By The Executive Counsel Against Nunn Hayward, JDS: London, 2004.

<sup>243</sup> UK Department of Trade and Industry (1983), Ramor Investments Limited; Derriton Limited, HMSO: London, 1983.

<sup>244</sup> SKY News, Finance chiefs warn against capping big four's audit share, 2 November 2018; <https://news.sky.com/story/finance-chiefs-warn-against-capping-big-fours-audit-share-11543056>

appeasement of directors and independent audits do not go together. There is no logical reason for indulging company boards and it is hard to see why corporate financial audits should be an exception to the well-functioning norms in other sectors.

## **PUBLIC APPOINTMENT OF AUDITORS**

In view of the inherent fault lines, a public body for the appointment, remuneration and oversight of auditors to large companies is needed. Such a proposal was envisaged in the 1930s legislation that created the US Securities Exchange Commission (SEC). In the words of Lynn Turner, former chief accountant of the SEC:

“when the legislation creating the SEC was first drafted in the early 1930s, it included a provision making the SEC the auditor for public companies. Then, at the last minute, the legislation was changed. ...Toward the tail end of the Congressional hearings on the Senate side, the head of the New York State Society of Certified Public Accountants – who was also the head of Haskin and Sells – now Deloitte Touche – went down to Washington and testified and convinced the guys to let the CPA firms to do the auditing. The legislation was revised and hence the external auditing function that we have today<sup>245</sup>.”

The UK has statutory arrangements for independent appointment and remuneration of auditors in specified segments. Following the Local Government Finance Act 1982 the Audit Commission appointed and remunerated auditors<sup>246</sup> for local authorities and a range of local public bodies. They could choose to be audited by district auditors or private sector accounting firms, both were regulated by the Commission. The Commission required councils to have arrangements to secure economy, efficiency and effectiveness in the use of their resources. All auditors appointed by the Commission were generally forbidden from selling non-auditing services to audit clients; exceptions were statutory returns. Big four firms had difficulty in penetrating this market. They lobbied the Conservative Party and made financial contributions<sup>247</sup>. In 2010, the incoming Conservative administration announced its hostility to the Commission and it was formally abolished by the Local Audit and Accountability Act 2014, which came into effect on 31 March 2015. Its successor body, the Public Sector Audit Appointments (PSAA) Limited, a company limited by guarantee and owned by the Local Government Association, is responsible for appointing auditors to principal local authorities, fire and rescue authorities, police authorities, national parks authorities, waste authorities and transport bodies. It also sets audit fees. Contracts are independently awarded to create a portfolio of clients which match a firm's capacity to deliver rather than just the size.

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<sup>245</sup> Lynn Turner Says Unless Big Four Change, Bring on SEC as Public Auditor 21 Corporate Crime Reporter 8, February 14, 2007; available on <http://www.corporatecrimereporter.com/turner021407.htm> (accessed on 24 March 2008).

<sup>246</sup> These were private accounting firms or auditors appointed by the state.

<sup>247</sup> The Guardian, Conservative party donors likely to benefit from axing of Audit Commission, 29 August 2010; <https://www.theguardian.com/politics/2010/aug/29/tory-donors-audit-commission>

In the current concerns about public confidence in audits and a dysfunctional external audit market there is some acceptance that an independent body is needed to manage the market. For example, Grant Thornton<sup>248</sup> has called for auditor selection for large listed companies and other public interest entities to be carried out by a public body such as a newly established commission or a body equivalent to the National Audit Office. According to its senior partner the placing of responsibility for auditor procurement with an independent public body would address the “perennial issue that audit clients select and pay the auditor”. He added that this would help restore trust and integrity in the market at a time when there “seems to have been a loss in impartiality and independence”. An audit partner at BDO said he was initially sceptical about the benefits of a national procurement body for auditor appointments, but said he has “come around to the idea”. Such an arrangement would also counter the big four firm alumni effect where auditor appointment by boards and audit committees of large companies favours the big firms.

### **FITTING THE AUDIT CAP**

It has been suggested that the big four firm acquisition of audits of FTSE 350 audits should be capped to anything from 50% to 80% of FTSE 350 companies and thus meaningful opportunities can be created for challenger firms to enter the market at the top-end. The cap should be overseen by an independent body responsible for appointing and remunerating auditors rather than voluntarily applied by the firms or overseen by any accountancy trade association. The ICAEW has suggested “a market cap of around 65 clients for any single firm<sup>249</sup>” operating in the FTSE 350 market, which effectively means that the big four firms will control 75% of the FTSE 350 market. However, such a narrow ‘cap’ may facilitate distortions. For example, the top 50% of FTSE 350 audits generate about 94% of all FTSE 350 fees. In view of their historical advantages, the big four are likely to colonise that segment of the market and leave others to fight over the rest. This would strengthen the financial position of the big four firms and its manifestations in economic power and regulatory capture would remain unaddressed. Mid-tier firms would have difficulty in penetrating the upper tier of market and generate resources to build an audit infrastructure. However, our proposals for mandatory joint audits (Chapter 6) would ensure that the big firms cannot colonise 94% of the FTSE 350 audits. If they are equally shared between large and medium-size firms, the income from FTSE 350 audits would be dispersed. The purpose of the cap is to prevent domination of the top-end of the market and also create space for expansion of suppliers of audit services. Joint audits would go some way towards that. In addition, we recommend that a cap of 50% be applied to the big four firm share of audit of FTSE 350 companies minus the audit of financial enterprises which would be carried out by the statutory auditor. On competition grounds, the independent body can also adjust the cap, if the circumstances so warrant.

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<sup>248</sup> Financial Times, Grant Thornton calls for independent public body to appoint auditors, 12 September 2018; <https://www.ft.com/content/92050fc4-b5db-11e8-bbc3-ccd7de085ffe>

<sup>249</sup> ICAEW Representation 123/18, Statutory Audit Market, 30 October 2018; <https://www.icaew.com/-/media/corporate/files/technical/icaew-representations/2018/icaew-rep-123-18-statutory-audit-markets-representation.ashx>

The audit firm nominated by the independent body would need to be approved at the company AGM and stakeholders would need the appropriate information. In the case of joint audits, one auditor can be proposed by the Independent Body and another can be selected by the audit committee, subject to approval by the independent body. Stakeholders can reject the firms nominated and thus force the regulator and the audit committee to reconsider the best fit between the company and the eligible auditor. Such negotiations can be conducted by the audit committee with full facts disclosed to the public. The audit committee must not have any alumni of the firm proposed by the independent body.

## **SUMMARY AND DISCUSSION**

This chapter examined the debate for an independent appointment and remuneration of external auditors at large companies. The auditor appeasement of directors and fee dependency on the company has been a major cause of audit debacles. Despite the rhetoric that audit serves the public interest, consideration of the broader societal interest is missing altogether from the auditing arrangements. We recommend that auditors of large companies, as defined by the Companies Act 2006, be appointed and remunerated by an independent body.

Such a body should ensure that the combined big four firm share of the FTSE 350 audit market does not exceed 50% of that market. Directors of some companies will no doubt oppose such recommendations and may rationalise their position by referring to private costs associated with an independent appointment of auditors. Such an argument is one-sided as it also needs to consider social costs associated with perpetuation of the status-quo. Society cannot afford Carillion, BHS, banks and other avoidable audit failures. History will inevitably repeat itself until fault lines of auditing are addressed. The proposals in this chapter are part of a series of steps needed to correct market failures, enhance auditor independence and provide societal steering for improvement of quality of audits.

## **RECOMMENDATIONS**

- An independent body to be created to appoint and remunerate auditors for all non-financial sector large companies, as defined by the Companies Act 2006.
- Big four firm share of the audits of FTSE 350 companies must be capped at 50% of that market.

## CHAPTER 8 AUDIT MARKET AND COMPETITION

### INTRODUCTION

Choice and competition in the UK audit market has long been an issue, especially as the big four firms dominate the lucrative FTSE 350 audits. The issues have been exacerbated as successive governments have permitted firms to merge to form the current big four firms. The abolition of the Audit Commission, by the Local Audit and Accountability Act 2014, has further increased the concentration of audits in the big four firms. One way of increasing auditor choice and competition is by limiting auditor tenure i.e. put a time limit on the period for which a firm can hold the office of the auditor. The compulsory rotation of audit firms can become a catalyst for competition and choice and can encourage mid-tier firms to bid for audits of larger companies. It can also encourage the incumbent auditors to be robust by reducing the incentives to appease directors as the firm will be destined to lose the audit after a fixed period. The compulsory rotation of audit firms can help to break the collusive auditor relationship with company directors and aid auditor independence.

Reforms of the audit market have been grudging and ineffective. They have generally been framed by appeasement of the big four firms and based on faulty economic logics. For example, the 2013 inquiry by the Competition Commission<sup>250</sup> (subsequently replaced by the Competition and Markets Authority) treated audit as a private contract between an auditing firm and the client company. Therefore, only the 'private' costs and benefits were considered. Social costs of appeasing the auditing industry were not considered even though taxpayers had bailed out banks and the social cost of chummy relationships between auditors and directors falls on society at large.

The consequences of lack of choice and the related effects on audit quality have once again been laid bare by the 2018 collapse of Carillion<sup>251</sup>. In this case, KPMG had audited the company for 19 years. Even if Carillion wanted to change its auditors, the choice was limited as the other three major firms were conflicted. Deloitte had run the internal audit function since 2009. Ernst & Young were advising the company on restructuring, cost reduction and cash collection. PwC acted as advisers to Carillion's pension trustees. Carillion has become a catalyst for another look at the audit market. However, there is a danger that once again change will be stifled.

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<sup>250</sup> Competition Commission, Statutory audit services for large companies market investigation, October 2013;  
[http://webarchive.nationalarchives.gov.uk/20140402161735/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/131016\\_final\\_report.pdf](http://webarchive.nationalarchives.gov.uk/20140402161735/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/131016_final_report.pdf)

<sup>251</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, May 2018;  
<https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>

## STIFLING CHANGE

The Department of Trade Industry investigation into the fraud-ridden empire of the late Robert Maxwell called for two principal reforms: Compulsory rotation of partners and Compulsory rotation of firms. Such issues have also been raised after previous audit failures. For example, a 1979 report noted that the auditors of the fraud-ridden Grays Building Society<sup>252</sup> had been in office for nearly 40 years, and called for rotation of auditors. None of this resulted in any tangible reforms.

The main argument raised against compulsory change is private cost and possible higher risks for incoming auditors. Such arguments forget that longevity of auditor term also imposes costs, as BHS, Carillion and the banking crash have shown. The presence of the same firm of auditors over time increases chumminess and with it the likelihood of dubious practices continuing and increases the risks to taxpayers, suppliers, employees, pension schemes and shareholders. Historically, some companies have chosen to change their auditors each year. For example, in the US from 1910 onward Du Pont rotated its external audit firm every year, and later every several years, until the 1950s<sup>253</sup>. The main idea was to encourage auditors to be robust. It also created opportunities for other firms. However, the modest proposal floated in the UK was that the audit firms for major entities should be compulsorily changed every five years<sup>254</sup>. This would require other firms to submit competitive tenders for the audit. Competitive tenders are nothing new and are used in numerous commercial arenas.

Accountancy firms have long used tenders to secure new audit and non-audit business and none of this has been constrained by 'costs' (see above). It was further suggested that audit tenders should be publicly available because an audit is not a private contract. The information contained in the tender would enable stakeholders to make better assessments of auditor capability, quality, independence and accountability<sup>255</sup>. A sight of the successful tender would enable unsuccessful firms to learn and produce better tenders. The calls for disclosure were also driven by the smoke and mirrors practices of the big firms. For example, Price Waterhouse's 1991 audit tender for the audit of Prudential Assurance was leaked to the press (*Accountancy Age*, 12 May 1994, page 1). In it, the firm offered a discount of £900,000 on the proposed audit fee of £2.3 million plus a write-off of £600,000 initial investment. The same document also candidly stated that

“Price Waterhouse has an acknowledged track record in constructive accounting solutions. .... Our experience and expertise in financial reporting will enable us to contribute to your discussions on how best to present your results and balance sheet ...”.

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<sup>252</sup> Registry of Friendly Societies, Grays Building Society, London, HMSO, 1979.

<sup>253</sup> Stephen A Zeff, Du Pont's early policy on the rotation of audit firms, *Journal of Accounting and Public Policy*, Vol. 22, pp 1–18, 2003.

<sup>254</sup> Austin Mitchell, Prem Sikka, Tony Puxty and Hugh Willmott, Discussion Paper No. 7, *Accounting for Change: Proposals for Reform of Audit and Accounting*, Fabian Society, London, August 1991.

<sup>255</sup> Jim Cousins, Austin Mitchell, Prem Sikka and Hugh Willmott *Auditors: Holding the Public to Ransom*, Basildon, Association for Accountancy & Business Affairs, 1998.

In 1991, Price Waterhouse received only £400,000 from non-auditing services to Prudential. In 1993 total fees paid to Price Waterhouse were £5.4 million; £3.7 million of this was for consultancy services. The public availability of audit tenders would provide information about the auditor-client relationships. Needless to say, the auditor rotation and public availability of tender proposals were opposed by the big accounting firms<sup>256</sup> and amplified by the ICAEW, which despite its statutory regulatory role has continued to act as a cheerleader for the big firms.

The Enron scandal of 2001 and WorldCom scandal of 2002 raised questions about auditor tenure, choice and independence, but the big firms remained opposed to audit rotation<sup>257</sup>. In the face of extensive lobbying from the firms, Section 203 of the US Sarbanes-Oxley Act 2002 made it mandatory for the lead audit partner and the reviewing partner to be rotated every five years. Rotation of the audit firm was organised off the political agenda. In 2006 the European Union Directive recommended that only the audit partners need to rotate every seven years<sup>258</sup>. In 2009, the FRC recommended the same<sup>259</sup> for listed companies, a proposal which appeased the big firms but neither aided auditor independence nor encouraged competition or choice. The position was welcomed by the ICAEW<sup>260</sup>.

## APPEASING THE AUDIT INDUSTRY

The 2007-08 banking crash once again raised issues about the silence of auditors and questions about auditor independence, choice and tenure returned. In 2010, the European Commission recommended that:

“the mandatory rotation of audit firms – not just of audit partners – should be considered ... Mandatory rotation can not only enhance the independence of auditors ... it could also operate as a catalyst to introduce more dynamism and capacity into the audit market ... To prevent partners from changing firms to "take along" certain clients with them, rotation rules, if adopted, should ensure that not only firms, but partners are also rotated<sup>261</sup>”.

In 2011, the House of Lords Select Committee on Economic Affairs recommended that

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<sup>256</sup> Accountancy Age, Auditors reject calls for rotation, 9 April 2001; <https://www.accountancyage.com/aa/news/1762746/auditors-reject-calls-rotation>

<sup>257</sup> Accountancy Age, Thumbs down for auditor rotation, 9 January 2003; <https://www.accountancyage.com/aa/feature/1770578/thumbs-auditor-rotation>

<sup>258</sup> DIRECTIVE 2006/43/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 May 2006, on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/

660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC; <https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:157:0087:0107:EN:PDF>

<sup>259</sup> Financial Reporting Council, Ethical Standard 3 (Revised) - Long Association With The Audit Engagement, October 2009; [https://www.frc.org.uk/getattachment/2cc10083-8576-48a5-9b9a-50c9f1c41441/ES-3-\(Revised\)-Long-Association-with-the-Audit-Eng.pdf](https://www.frc.org.uk/getattachment/2cc10083-8576-48a5-9b9a-50c9f1c41441/ES-3-(Revised)-Long-Association-with-the-Audit-Eng.pdf)

<sup>260</sup> <https://www.icaew.com/technical/ethics/auditor-independence/apb-amends-rotation-requirements-for-audit-partners-on-listed-entity-audits>

<sup>261</sup> European Commission, Green Paper - Audit Policy: Lessons from the Crisis, Brussels, 13 October 2010.

“The very long tenure of auditors at large companies is evidence of the lack of competition and choice in the market for the provision of audit services. A regular tender, with a non Big Four auditor invited to participate, should promote greater competition to the benefit of both cost and quality. We recommend that FTSE 350 companies carry out a mandatory tender of their audit contract every 5 years<sup>262</sup>”.

In October 2012, the FRC mentioned audit tender but omitted any reference to rotation and said:

“The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years<sup>263</sup>”

In 2011, the UK Competition Commission (CC) began an investigation into the big four firms’ dominance of the statutory audit services to FTSE 350 companies and found that there were features which resulted in “adverse effect on competition”. These included covenants imposed by banks, requiring companies to appoint big four auditors. In February 2013, an early view from CC was that:

“The CC is now looking at possible ways to encourage greater competition through mandatory tendering and rotation<sup>264</sup>”.

The big firms were not happy and in July 2013 CC’s interim report recommended that:

“FTSE 350 companies should put their statutory audit engagement out to tender at least every five years ... The CC has decided against bringing in measures requiring mandatory switching of auditors<sup>265</sup>”.

The FRC chipped in with the statement that:

“tendering, not mandatory audit firm rotation, is the appropriate way forward<sup>266</sup>”.

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<sup>262</sup> House of Lords Select Committee on Economic Affairs, Auditors: Market concentration and their role, 30 March 2011;

<https://publications.parliament.uk/pa/ld201011/ldselect/ldeconaf/119/119.pdf>

<sup>263</sup> Financial Reporting Council, The UK Corporate Governance Code, September 2012; [https://www.frc.org.uk/getattachment/e322c20a-1181-4ac8-a3d3-1fcfbcea7914/UK-Corporate-Governance-Code-\(September-2012\).pdf](https://www.frc.org.uk/getattachment/e322c20a-1181-4ac8-a3d3-1fcfbcea7914/UK-Corporate-Governance-Code-(September-2012).pdf)

<sup>264</sup> <http://webarchive.nationalarchives.gov.uk/20140402145152/http://www.competition-commission.org.uk/media-centre/latest-news/2013/Feb/audit-market-not-serving-shareholders>

<sup>265</sup> <http://webarchive.nationalarchives.gov.uk/20140402144706/http://www.competition-commission.org.uk/media-centre/latest-news/2013/Jul/cc-outlines-measures-for-audit-market>

<sup>266</sup> Financial Reporting Council, Audit Tenders, July 2013; <https://www.frc.org.uk/getattachment/678f8642-0c7e-45b2-94f7-af9fd2494bc7/Audit-tenders-notes-on-best-practice-July-2013.pdf>

ACCA, another accountancy trade association functioning as an auditing regulator, added that it “is opposed to forced rotation”<sup>267</sup>.

In October 2013, the final CC report<sup>268</sup> opted for audit tenders for listed companies every ten years, double the five-year limit it proposed in July 2013. PwC announced that it was pleased that “Competition Commission has ruled out mandatory firm rotation ... which would be detrimental to competition and audit quality”<sup>269</sup>.

The UK government, in line with the position of the big firms, opposed mandatory rotation of audit firms<sup>270</sup>. Nevertheless, the European Union eventually recommended that:

“PIEs [Public Interest Entities] will be required to change their statutory auditors or their audit firms every 10 years as a maximum ... Member States, however, can establish shorter rotation periods (e.g. a maximum of seven or eight years). In addition, Member States can allow PIEs to extend the audit engagement: i) by an additional 10 years upon tender; or ii) by an additional 14 years in the case of joint audit”<sup>271</sup>

With effect from 2014, the EU banned the use of “Big Four” clauses as a precondition for providing finance by banks, which in principle could help mid-tier firms to secure bigger audits.

Research shows that auditors with shorter tenures are faster to discover financial misreporting because that reduces incentives to develop economic and social bonds with company directors<sup>272</sup>. The EU rotation and tendering rules meant that the same firm could remain in office for up to 20 years. The policy hardly addressed concerns about competition, choice or threats to auditor independence from longevity of appointment. If new players put in a bid, which could have a heavy financial cost, and failed, they would receive no return from that investment and experience because they will have to wait another 20 years before bidding again, and by then the environment would have changed. The policy is not conducive to increasing

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<sup>267</sup> Ian Welch, Head of ACCA Policy, FRC and the audit committee, 2 September 2011; <https://blogs.accaglobal.com/2011/09/02/frc-and-the-audit-committee/>

<sup>268</sup> Competition Commission, Statutory audit services for large companies market investigation, October 2013; [http://webarchive.nationalarchives.gov.uk/20140402161735/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/131016\\_final\\_report.pdf](http://webarchive.nationalarchives.gov.uk/20140402161735/http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/131016_final_report.pdf)

<sup>269</sup> <https://www.pwc.co.uk/who-we-are/competition-commissions-audit-market-investigation.html>

<sup>270</sup> Department of Business Innovation and Skills, UK Government Response to the European Commission’s Green Paper on Audit’0, 8 December 2010; [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/31709/10-1346-uk-government-response-ec-green-paper-on-audit.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/31709/10-1346-uk-government-response-ec-green-paper-on-audit.pdf)

<sup>271</sup> European Commission, Reform of the EU Statutory Audit Market - Frequently Asked Questions. 17 June 2016; [http://europa.eu/rapid/press-release\\_MEMO-16-2244\\_en.htm](http://europa.eu/rapid/press-release_MEMO-16-2244_en.htm)

<sup>272</sup> Zvi Singer and Jing Zhang, Auditor Tenure and the Timeliness of Misstatement Discovery, *The Accounting Review*, Vol. 93, No. 2, pp. 315–338, 2018,

choice and competition. There is always a concern that audit is secured by underhanded and harmful practices, but the rules did not require publication of tenders. Therefore, it is hard to know whether any of the audit contracts have been secured through fair means.

## **INEFFECTIVE AUDIT TENDERING AND ROTATION REGIME**

In 2016, following the EU Directives, the Statutory Auditors and Third Country Auditors Regulations 2016 (SATCAR) required all UK Public Interest Entities (i.e. those listed on a regulated exchange, unlisted banks and unlisted insurers) to conduct a tender at least every 10 years and rotate auditors after at least 20 years. In the UK, the compulsory audit tendering process began with 2012 revisions to the Corporate Governance Code.

By 2017, 213 (61 per cent) of the FTSE 350 had completed a tendering exercise. 74 per cent of those tenders resulted in the appointment of a new audit firm. However, tendering has largely resulted in a redistribution of audit engagements between the big four firms, rather than diversification<sup>273</sup>. In this merry-go-round Ernst & Young won the Royal Dutch Shell audit from PwC; PwC secured the AstraZeneca audit from KPMG; KPMG won Travis Perkins audit from Deloitte; and Deloitte secured the audit of Admiral from KPMG. The choice of even switching from one big four firm to another is illusory as the firms can be conflicted by their prior involvement with the company and are thus ineligible for appointment as auditors.

In May 2018, 78% of the shareholders of buildings group SIG voted to remove Deloitte as auditors. The firm had been implicated in alleged audit failures and was facing an investigation from the FRC<sup>274</sup>. KPMG advised SIG on financial reporting controls and PwC had acted as an IT adviser. Therefore, both firms were conflicted and were not eligible to submit an audit tender. This left Ernst & Young as the only major firm choice and it was appointed auditor in July 2018<sup>275</sup>.

The illusion of choice is present elsewhere too. In June 2017, after an accounting scandal at its Italian business cost BT £530m, the company replaced PwC (had been auditors since 1984) with KPMG<sup>276</sup>. It could not consider Deloitte as the firm was conflicted by consultancy work and that effectively left the choice between KPMG and Ernst & Young. KPMG was possibly selected as it had been hired to investigate accounting failures at the Italian business and revealed “improper accounting practices and a complex set of improper sales, purchase, factoring and leasing

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<sup>273</sup> Financial Reporting Council, Developments In Audit 2018, October 2018; <https://www.frc.org.uk/getattachment/5e1ac2d1-f58c-48bc-bb91-1f4a189df18b/Developments-in-Audit-2018.pdf>

<sup>274</sup> Financial Reporting Council, Investigation into the financial statements of SIG plc, 28 June 2018; <https://www.frc.org.uk/news/june-2018/investigation-into-the-financial-statements-of-sig>

<sup>275</sup> Financial Times, EY wins SIG contract amid weak competition, 3 July 2018; <https://www.ft.com/content/2436030e-7eb8-11e8-8e67-1e1a0846c475>

<sup>276</sup> BBC news, BT drops PwC following Italian accounts scandal; 8 June 2017; <https://www.bbc.co.uk/news/business-40198733>

transactions<sup>277</sup>” which resulted in overstatement of earnings in its Italian business over a number of years.

In October 2017, the US Securities Exchange Commission (SEC) charged the mining company and two former top executives with fraud for inflating the value of coal assets acquired for \$3.7 billion and sold a few years later for \$50 million<sup>278</sup>. At the same time, the FCA fined Rio Tinto £27,385,400 for breaching the Disclosure Rules by failing to carry out an impairment test and to recognize an impairment loss on the value of mining assets based in the Republic of Mozambique which it acquired in August 2011 for US\$3.7 billion when publishing its 2012 interim results<sup>279</sup>. Since 1980, its accounts had been audited by PwC. By a coincidence, in June 2018, Rio Tinto decided to replace PwC with KPMG, with effect from 2020. Ernst & Young audited BHP Billiton, its major competitor and could not be considered. The choice was then between just two firms, KPMG and Deloitte.

In 2015, after an association of nearly 120 years, Barclays Bank switched its £44 million audit from PwC to KPMG<sup>280</sup>. Deloitte was out of the equation as it had a consulting contract with the bank and did not put in a strong bid. Ernst & Young tendered but were already auditors for the rival RBS. The big four firm alumni effect is also worth noting. The chair of Barclays’ audit committee, Mike Ashley, was the former head of quality at KPMG Europe and the bank’s deputy chairman, Sir Michael Rake, was the former chairman of KPMG Europe<sup>281</sup>, though both had not been directly involved with auditor selection.

Scholarly research points to the big four alumni effect as persons formerly connected with the firms gravitate towards them<sup>282</sup>. The influence of the big four firms extends to company boardrooms and could also give them advantage in securing new clients. Some 64% of FTSE100 finance directors are linked to the big four accounting firms and 61 out of the 100 audit committee chair positions at the highest level of UK are held by someone who previously worked for at least one of the Big Four firms – Deloitte, EY, KPMG and PwC – or one of their predecessor firms<sup>283</sup>.

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<sup>277</sup> Financial Times, PwC under audit investigation after BT Italia scandal, 29 June 2017; <https://www.ft.com/content/c633d452-5c99-11e7-b553-e2df1b0c3220>

<sup>278</sup> Securities Exchange Commission, Rio Tinto, Former Top Executives Charged With Fraud, 17 October 2017, <https://www.sec.gov/news/press-release/2017-196>

<sup>279</sup> Financial Conduct Authority, Rio Tinto plc fined £27m for breaching Disclosure and Transparency Rules, 17 October 2017; <https://www.fca.org.uk/news/press-releases/rio-tinto-plc-fined-%C2%A327m-breaching-disclosure-and-transparency-rules>

<sup>280</sup> The Telegraph, Barclays hires KPMG as its auditor after 120 years with PwC, 3 July 2015; <https://www.telegraph.co.uk/finance/newsbysector/epic/barc/11716302/Barclays-hires-KPMG-as-its-auditor-after-120-years-with-PwC.html>

<sup>281</sup> Financial Times, An illusion of choice: the conflicts that mire the audit world, 9 August 2018; <https://www.ft.com/content/2085cab2-9af3-11e8-9702-5946bae86e6d>

<sup>282</sup> Michael Favere-Marchesi and Craig Emby (2018), The Alumni Effect and Professional Skepticism: An Experimental Investigation, *Accounting Horizons*, 32(1) 53-63, 2018.

<sup>283</sup> Accountancy Daily, FTSE 100 alumni survey 2017: Big Four dominate boardrooms and regulator, 4 December 2017; <https://www.accountancydaily.co/ftse-100-alumni-survey-2017-big-four-dominate-boardrooms-and-regulator>

The Prudential Regulation Authority (PRA) says that it is concerned about concentration of audits in the big four firms, especially audit of banks and insurance companies<sup>284</sup>. Yet it sends mixed signals. PwC has audited Goldman Sachs since 1926 and under the current rules it has to step down by 2022. Goldman has non-audit service contracts with KPMG, Deloitte and Ernst & Young and therefore they are conflicted and not eligible for appointment as auditors. So the bank has been forced to look outside the big four firms for its next auditor. It held discussions with Grant Thornton to become its auditor. This prompted the PRA to intervene and query the possible appointment of the firm<sup>285</sup>. The PRA rules require the auditor of a British bank to have the "required skill, resources and experience to perform its function under the regulatory system". Its concerns may have been prompted by the £1 million fine levied by the FRC on Grant Thornton for failures in "fair value hedge accounting and auditing of interest rate swaps and related mortgages at Manchester Building Society<sup>286</sup>". Whether the PRA applies the same scrutiny to the big four firms, fined and sanctioned numerous times is not known. The PRA action elicited a joint letter<sup>287</sup> from chairs of the House of Commons Work and Pensions and Business, Energy and Industrial Strategy Committees on 12 July 2018, and said:

"we would question whether any of the Big Four have sufficiently demonstrated "the required skill, resources and skills to undertake these [bank] audits ... It would be most unfortunate if auditors like Grant Thornton now find that not only is the market working against them, but so too is the financial services regulator ...If the PRA were to block Goldman Sachs from appointing Grant Thornton then you are introducing your own form of Big Four-only clauses".

The PRA reply of 20 July 2018 seems to suggest that it acts as quasi audit regulator:

"we have a significant interest in the quality of the audits of the firms we regulate, not least because our supervisory approach relies in some areas on high quality audit, and we gain value from productive dialogue between each audit team and the relevant supervisor. Given this, we: liaise closely with the FRC; discuss aspects of the audit in a range of bilateral, trilateral and roundtable discussions with regulated firms, audit firms and other regulators; and carry out various activities designed to encourage the delivery of improvements in audit quality ... When we think it necessary we will discuss

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<sup>284</sup> The Times, Prudential Regulation Authority concerned by Big Four dominance, 12 July 2018; <https://www.thetimes.co.uk/article/prudential-regulation-authority-concerned-by-big-four-dominance-ghhqv6vns>

<sup>285</sup> The Times, Bank queries appointment of Grant Thornton as Goldman auditor, 10 July 2018; <https://www.thetimes.co.uk/article/bank-of-england-queries-goldman-auditor-grant-thornton-0rqxwx7dw>

<sup>286</sup> Financial Reporting Council, Outcome of disciplinary case against Grant Thornton UK LLP, Alastair Nuttall and Marcus Swales, 8 July 2015; <https://www.frc.org.uk/news/july-2015/outcome-of-disciplinary-case-against-grant-thornton>

<sup>287</sup> <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/180712-PRA-to-Chairs-audit-Goldman-Sachs.pdf>

aspects of the process with the regulated firm or with one or more of the audit firms that are or might be tendering for the work<sup>288</sup>”

Mid-tier firms face considerable hurdles in bidding for the FTSE 350 audits. There is no guarantee that they will succeed and big four firms have more resources and can be aggressive in securing new business. Outside the big four firms, only BDO and Grant Thornton have any presence in the FTSE 350 market. In 2011, they audited 16 FTSE 350 companies. In 2017, some years after the introduction of compulsory audit tendering, the number declined to just 9. Tendering is costly. BDO, UK’s sixth largest firm, pitches for about eight auditing contracts in the FTSE 350 each year and says that the cost of each tender is a minimum of £250,000<sup>289</sup>.

Grant Thornton, UK’s fifth largest accounting firm, won just two FTSE 350 tenders between 2016 and 2018. Each tender cost the firm about £300,000. In March 2018, it exited the FTSE 350 audit market and said:

“we don’t feel that we’re getting the success and the output for the amount of time and effort that is going in. You’ve only got to look at the stats to see that these jobs going out for tender are simply moving around the Big Four”<sup>290</sup>”.

Since June 2016, the number of registered audit firms offering themselves for audit of Public Interest Entities (PIE) has declined from 50 to 34, and more are expected to deregister. Top 10 firm Smith & Williamson has decided to pull out of the PIE market.

Rather than promoting competition, the present form of audit tendering and rotation has reduced competition and choice. Audit tendering process is not transparent. Tenders are not published and little is publicly known about what each firm has offered.

## **SUMMARY AND DISCUSSION**

Despite the banking crash and accounting scandals at Enron, WorldCom, BHS, Carillion, Tesco, SIG, Rio Tinto and BT, the UK audit market structure has remained unchanged. The CC, the FRC, the RSBs and governments have made noises but done little to encourage competition and choice in the audit market. The much diluted rule changes have failed to address concerns over market concentration of audits. No new firms have been attracted to the FTSE 350 market. The audit merry-go-round seems to stop at one of the big four firms, all implicated in audit failures, offering dubious quality of audits and sanctioned by regulators. Despite incurring heavy costs of tendering, medium-tier firms have little chance of getting a toe-hold in the FTSE 350 market. Indeed, Grant Thornton and BDO, the fifth and sixth largest

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<sup>288</sup><https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/180716-Sam-Woods-to-chair-audit-of-goldman-sachs.pdf>; and <https://www.parliament.uk/business/committees/committees-a-z/commons-select/work-and-pensions-committee/news-parliament-2017/pra-letter-audit-of-goldman-sachs-17-19/>

<sup>289</sup> The Times, Big Four audit rivals priced out of market, 4 June 2018;

<https://www.thetimes.co.uk/article/big-four-s-rivals-priced-out-of-market-qn2jz0d2s>

<sup>290</sup> Economia, Grant Thornton takes a bow from FTSE 350 audit market, 29 March 2018;

<https://economia.icaew.com/news/march-2018/grant-thornton-takes-a-bow-from-audit-market>

firms, have fewer FTSE 350 clients than before the regulatory change. Grant Thornton has pulled out of the market altogether. Inevitably the Competition and Markets Authority had to resume its inquiry into the audit market, as its predecessor the Competition Commission too easily accepted the ineffective proposals advanced by the big firms.

The dysfunctional audit market cannot be reformed without government action and many of the traditional assumptions about the audit industry need to be challenged. It also requires changes to audit firm rotation and tendering. The audit tenure at large non-financial sector companies should be restricted to a maximum period of five years. That would mean a change of the firm and entire audit personnel. The same firm and any of the personnel connected with the audit must not be permitted to return for a period of ten years i.e. there should be a ten year cooling-off period. The rotation would be overseen by the independent body responsible for appointing and remunerating auditors. The same principle would also apply to the joint auditors.

The audit tenders need to be publicly available because secrecy can breed predatory practices. In 2017, the Italian Competition Authority (ICA) levied a fine of €23.7 million on the big four accounting firms for alleged collusion in securing public consultancy work<sup>291</sup>. The public disclosure is needed not just to ensure fair competition but also to inform stakeholders. An audit is not a private contract. It is carried out for the benefit of stakeholders and mandated by law. Therefore, stakeholders should have the right to see audit tenders and make assessments of the audit firm and its claims of the quality of work. The tenders for a portfolio of clients or for a specific client would be submitted to the independent body responsible for appointing and remunerating auditors. The public availability of audit tenders would also enable stakeholders to assess the efficiency of the audit committees, which may have nominated a selected firm for joint audits. If the stakeholders disagree with the choice of audit firm selected by the audit committee, then the matter would need to be renegotiated with the independent body.

We are well aware that major firms and accountancy trade associations would oppose our recommendations. Despite procrastination, the principle of audit firm rotation and audit tendering is now firmly accepted. Despite its previous opposition, even the big four firm friendly FRC now says that “rotation of auditors ... helps improve confidence in audit<sup>292</sup>”. Cases such as BT, Rio Tinto and others show that companies derive benefit from a fresh set of auditors. However, big four firms and large companies oppose more frequent auditor changes by claiming that this will result in higher costs even though they have not published any evidence to support

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<sup>291</sup> The Accountant, ITALIAN ANTITRUST AUTHORITY FINES BIG FOUR TOTAL OF \$26.6M FOR RESTRICTIVE COMPETITION, 16 November 2017, <http://www.theaccountant-online.com/News/italian-antitrust-authority-fines-big-four-total-of-266m-for-restrictive-competition-5973997>; Reuters, Italy Antitrust fines 'big four' accounting firms total of 23 million euros, 7 November 2017, <https://www.reuters.com/article/us-italy-antitrust/italy-antitrust-fines-big-four-accounting-firms-total-of-23-million-euros-idUSKBN1D72DE>; [http://www.rivistacorteconti.it/export/sites/rivistaweb/RepositoryPdf/2017/fascicolo\\_20\\_2017/51-autorit-garante-della-concorrenza-e-del-mercato.pdf](http://www.rivistacorteconti.it/export/sites/rivistaweb/RepositoryPdf/2017/fascicolo_20_2017/51-autorit-garante-della-concorrenza-e-del-mercato.pdf)

<sup>292</sup> Financial Reporting Council, Audit tendering helps improve audit confidence, 7 February 2017; <https://www.frc.org.uk/news/february-2017/audit-tendering-helps-improve-audit-confidence>

such assertions. We are not persuaded by such arguments because the cost of not switching firms earlier than twenty years is considerable, as shown by the costs inflicted upon taxpayers, suppliers, employees and shareholders by the banking crash, BHS, Carillion, Tesco, BT and other episodes. Public policy choices must be based upon consideration of social costs.

The big four firms are not keen on public disclosure of audit tenders. They claim that the tenders contain sensitive information about audit technologies and the approach adopted by the firm. We are not convinced by the arguments. Just because a firm mentions particular audit techniques or audit software, from that it does not follow that competitors can or even want to replicate it. The big firms told us that they oppose disclosures in order to safeguard their audit approach from competitors. These arguments do not carry much weight. Big firms routinely poach staff and partners from each other. Such individuals are well immersed in the firm's audit approaches and technicalities and these indeed are part of the personal capital that they transport from one firm to another. In addition, the audits and related processes should not remain a black-box. Stakeholders should have the right to know about audit processes, sweeteners, discounts, staffing and promises that shape audit quality. The public availability of tenders would deter the firms from engaging in anti-competitive and predatory practices. It would also provide benchmarks for calling them to account. The public availability would also help the less experienced bidders in improving their tender process.

## **RECOMMENDED REFORMS**

- Large companies must be required to change audit firms, partners and entire audit staff at least once every five years.
- This must be accompanied by a ten year cooling-off period i.e. the outgoing firm and audit personnel cannot return for another ten years.
- Audit tenders should be publicly available
- The winning audit tender, in its original form, shall be filed at Companies House.
- Collusion in any part of the audit tendering process in order to secure competitive advantage shall be a criminal offence.
- The Competition and Markets Authority must examine the auditing industry at five yearly intervals; until such time that its structure and practices change to secure a high degree of competition and choice to deliver value for money and high quality audits to protect stakeholders.

## CHAPTER 9 CORROSIVE ORGANISATIONAL CULTURE

### POVERTY OF AUDITS

A rise in the number of firms supplying statutory auditing services at the top-end of the market may increase competition and choice but that alone will not arrest poor quality of audits. There was no golden age of audit quality. Audit quality was poor even when the sector was dominated by five, six, seven or eight big firms. This suggests that failures must be embedded within organisational culture, which is an essential ingredient in the production of audits. This chapter calls for reforms which would exert pressure on the firms to address some parts of their organisational culture.

The secondary banking crash of the mid-1970s highlighted pitiful auditing practices even though the market was dominated by the big eight firms. The mid-tier firms were just as bad. Audit failures at Lonrho, Pergamon Press, Ramor Investments, Pinnock Finance, Vehicle and General, Court Line, London Capital Group, London and Counties, Peachey Property Corporation, Grays Building Society and Milbury, amongst others exposed auditor complicity in corporate frauds. The crisis spread from banks to property and insurance sectors and the government bailed out numerous companies. In the words of a veteran accountancy observer, the crisis was fuelled by

“the ease with which eminent firms of auditors turned a blind eye on the wholesale abuse by client company directors of [legal] provisions. [The directors] operated these public companies for the principal benefit of themselves and their families; and most regrettable of all, on the virtual complicity of their auditors, whose efforts are seen to have amounted to a whitewash at best, and a fatuous charade at worst<sup>293</sup>”.

Then 1980s witnessed audit failures at DeLorean, Johnson Matthey, Cray Electronics, Gilgate, Milbury, Westminster Property, Lloyd's, Alexander Howden, Minet Insurance and elsewhere<sup>294</sup> even though the sector was dominated by six/eight firms. This was followed in the 1990s by Bank of Credit and Commerce International (BCCI), Barlow Clowes, Dunsdale, Atlantic Computers, Ferranti, Homes Assured, Levitt, Eagle Trust, Yamaichi, Sound Diffusion, Barings, Queens Moat Houses, Wickes, Resort Hotels, London United Investments, Maxwell, Polly Peck and others when the market was dominated by six big firms. The failures have continued with the 2007-08 banking crash, BHS, Carillion, Patisserie Valerie and others. None of the audit failures were reported by the firms themselves suggesting that their organisational systems and culture is poor.

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<sup>293</sup> Emile Woolf, Banks: the substance over the form, Accountancy, September 1983, pp. 111-112.

<sup>294</sup> Prem Sikka, “The Corrosive Effects of Neoliberalism on the UK Financial Crises and Auditing Practices: A Dead-End for Reforms”, Accounting Forum, Vol. 39, No. 1, 2015, pp. 1-18; Prem Sikka and Hugh Willmott, Illuminating the State-Profession Relationship: Accountants Acting as Department of Trade and Industry Investigators, Critical Perspectives on Accounting, Vol. 6, No. 4, 1995, pp. 341-369

The concentration of audits in relatively few firms does not provide an adequate explanation of the persistence of poor quality. Many other industries have highly concentrated production yet they do not produce shoddy goods/services at the same scale or regularity. For example, the global aircraft industry is dominated by relatively few companies yet most aircraft are safe and meet the standards of regulators and consumers.

Within the auditing industry, a dominant view is that 'quality' is constructed by using appropriate auditing techniques and having a good set of working papers. This worldview is deeply embedded within institutions and a variety of auditing standards require auditors to evaluate internal controls, conduct analytical reviews and make assessment of whether a business is a going concern. Such strategies equate quality with compliance with techniques and rules and portray auditors as experts who through the use of the right technique can somehow construct an objective state of business affairs. The technician view of audit quality is enforced by regulatory reports which list the failure of auditing firms to use prescribed techniques. No one denies that firms need to focus on systemic and client specific elements, audit management, staff training and related matters, but no amount of sampling, analytical review, or predictive models can persuade auditors to reflect upon the corrosive impact of organisational culture.

Within audit firms individuals are inculcated into the ethos of keeping directors happy. This was typified by instructions given to audit staff by the Coopers & Lybrand (now part of PwC) partner responsible for auditing the fraud-ridden empire of Robert Maxwell (RM). The firm had a long standing commercial relationship with Maxwell and his companies and also provided non-audit services to his companies. Its senior partner famously told the audit team: "The first requirement is to continue to be at the beck and call of RM, his sons and staff, appear when wanted and provide whatever is required<sup>295</sup>". Staff are socialised into such themes and appeasement of directors and prioritisation of firm profits is drilled into them. By any consideration, organisational culture is a key ingredient in the production of audits and can be dysfunctional and incubates failures. As auditors perform public functions, their organisation culture needs to be exposed to public scrutiny so that stakeholders can force auditors to think about their corrosive practices. However, it is not given any visibility. Audit files are secret. Audit contract and management representations are not published. Indeed, resolutions tabled at company AGM to (re)appoint auditors are not accompanied by any meaningful information to enable stakeholders to ask questions about the firm. Consequently, there is no opportunity for the wider public to mould audit firm values, culture and practices.

## **AUDIT QUALITY IS MARGINALISED**

A recurring feature of almost all audit failures is that the firms make a headlong dash for profits. A glimpse of organisational culture is provided by a partner of big firm who said:

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<sup>295</sup> Department of Trade and Industry, Mirror Group Newspapers plc (two volumes) London: The Stationery Office, 2001.

“a firm like ours is a commercial organisation and the bottom line is that ... first of all the individual must contribute to the profitability of the business. In part that is bringing in business but essentially profitability is based upon the ability to serve existing clients well<sup>296</sup>”.

The bottom line has been improved by the sale of more lucrative non-auditing services and neglect of audit quality. The focus can be redirected through staff appraisals and training programmes, but audit quality continues to be marginalised. The 2005-06 FRC audit quality inspection report stated that:

“appraisal forms at some firms, and the manner in which some of the forms had been completed, indicated in our view that the individuals concerned believed that their success in the selling of non-audit services remained an important aspect of their overall evaluation, notwithstanding that the firm’s documented policies state otherwise<sup>297</sup>”.

A 2008 report noted that:

“some firms permit senior specialist personnel from outside the audit function who are involved in audits, including those identified as KAPs [key audit partners] on those audits, to be rewarded for selling non-audit services or for their performance to be evaluated based on their success in selling non-audit services<sup>298</sup>”.

The 2009 report stated that:

“There was some evidence that the term “selling” was being narrowly interpreted and that audit personnel were seeking recognition and reward for their contribution in obtaining non-audit work from their audit clients<sup>299</sup>”.

The above tensions have continued and seemingly firms are unable or unwilling to address them. A 2011/12 report concluded:

“Our review of partner and staff appraisal documentation continued to find that insufficient emphasis is given to audit quality and that there was an absence of specific audit quality objectives against which performance could be assessed<sup>300</sup>”.

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<sup>296</sup> Hanlon, 1994; op cit.

<sup>297</sup> Financial Reporting Council, 2005/6 Audit Quality Inspections Report, July 2006.

<sup>298</sup> Financial Reporting Council, 2007/08 Audit Quality Inspections Report, 8 December 2008; <https://www.frc.org.uk/getattachment/a87f9858-3153-4130-9b3d-f0fb0f3938b6/Overview-report-2008-FINAL-VERSION-051208-for-web.pdf>

<sup>299</sup> Financial Reporting Council, Report to The Secretary Of State For Business, Innovation and Skills- Year to 31 March 2009, [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/248178/0875.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/248178/0875.pdf)

<sup>300</sup> Financial Reporting Council, Audit Quality Inspections 2011/12, 13 June 2012; <https://www.frc.org.uk/getattachment/6de6e86c-b028-41fc-a8ed-fd898a22b4c2/Audit-Quality-annual-report-2011-2012.pdf>

The 2012 report on audit quality at PwC noted:

“We reviewed the self-appraisal forms and objectives for a sample of audit directors and managers. Approximately half of the appraisal forms in the sample had little or no comments on audit quality or from the appraiser<sup>301</sup>”.

The 2012 report on Deloitte noted that

“nearly all of the staff appraisal forms we reviewed did not include specific objectives and commentary relating to audit quality<sup>302</sup>”

The 2012 report on Ernst & Young noted:

“The current annual staff appraisal process does not require an individual’s performance in relation to audit quality to be separately rated<sup>303</sup>”.

The 2012 report on KPMG noted:

“The existing system does not ensure the specific consideration or assessment of audit quality as an objective against which staff should be appraised<sup>304</sup>”

The above extracts suggest that big four firms have consistently failed to attach much weight to audit quality in making decisions about staff, promotion and rewards. After a decade of reminders from the regulators, matters do not appear to have changed possibly because the extant arrangements resonate with organisation ethos. For example, the 2017 report on Ernst & Young said:

“In the sample of staff appraisals we reviewed, audit quality did not appear to have a direct impact on the staff appraisal process<sup>305</sup>”.

The downgrading of audit quality is not just confined to the big four firms, it is also prevalent in other firms. For example, the 2018 audit quality inspection report on Moore Stephens, a top-ten firm, noted:

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<sup>301</sup> Financial Reporting Council, Public Report on the 2011/12 inspection of PricewaterhouseCoopers LLP, 15 June 2012; [https://www.frc.org.uk/getattachment/3d6933d6-050f-4ff4-a7c7-5396a8a38891/PwC-Public-Report-2011-12-\(Clean\).pdf](https://www.frc.org.uk/getattachment/3d6933d6-050f-4ff4-a7c7-5396a8a38891/PwC-Public-Report-2011-12-(Clean).pdf)

<sup>302</sup> Financial Reporting Council, Public Report on the 2011/12 inspection of Deloitte LLP, 15 June 2012; [https://www.frc.org.uk/getattachment/6744e699-21f0-4940-b5d4-d2885a5d4fdc/Deloitte-Public-Report-2011-12-\(Clean\).pdf](https://www.frc.org.uk/getattachment/6744e699-21f0-4940-b5d4-d2885a5d4fdc/Deloitte-Public-Report-2011-12-(Clean).pdf)

<sup>303</sup> Financial Reporting Council, Public Report on the 2011/12 inspection of Ernst & Young LLP, 15 June 2012; [https://www.frc.org.uk/getattachment/fd177f0a-c58d-489d-90ac-453974ebb641/Ernst-Young-Public-Report-2011-12-\(Clean\).pdf](https://www.frc.org.uk/getattachment/fd177f0a-c58d-489d-90ac-453974ebb641/Ernst-Young-Public-Report-2011-12-(Clean).pdf)

<sup>304</sup> Financial Reporting Council, Public Report on the 2011/12 inspection of KPMG LLP and KPMG Audit Plc, 15 June 2012; [https://www.frc.org.uk/getattachment/f2e45299-1e88-4ec6-b8fb-ad94c1a15541/KPMG-Public-Report-2011-12-\(Clean\).pdf](https://www.frc.org.uk/getattachment/f2e45299-1e88-4ec6-b8fb-ad94c1a15541/KPMG-Public-Report-2011-12-(Clean).pdf)

<sup>305</sup> Financial Reporting Council, Ernst & Young LLP Audit Quality Inspection, June 2017; <https://www.frc.org.uk/getattachment/87fed5be-634e-43ed-8d66-824262dccc2d/EY-LLP-Audit-Quality-Inspection-16-17.pdf>

“In the sample of staff appraisals reviewed, it was disappointing to note that audit quality did not appear to have a direct impact on appraisal gradings<sup>306</sup>”.

## OFFSHORING AUDITS

Audits are labour intensive and auditing firms are constantly searching for ways of either reducing the labour content, or audit time budgets or substituting skilled and semi-skilled labour with cheaper labour. As part of their strategy for increasing profits, the big firms offshore some part of the audits to work centres in other countries (e.g. India, Sri Lanka, and Eastern Europe) and/or remote centres within the UK. Within firms, all kinds of exotic and impressive titles are given to endeavours to enhance audit quality, but when scrutinised they turn out to be efforts to reduce time budgets and increase profits. Here is the FRC’s take on PwC:

“During the year, the firm launched its Audit Transformation programme, the stated objective of which is to enable audit teams to focus on key judgment areas, standardise the firm’s approach and improve audit quality. However, the guides issued to date under the programme appear to focus on improving audit efficiency by reducing audit hours. The programme also includes increasing the use of the firm’s off-shoring capability, now through two overseas centres, one in India and the other in Poland. Work performed in 2011 by these centres accounted for about 4% of the firm’s core audit hours and is expected to increase to 6% in 2012<sup>307</sup>”.

Ernst & Young uses “offshore centres based in India and in 2014 that accounted for about 6% of its total audit hours. The UK audit teams say that they are “unaware of offshore staff performance ratings and capabilities<sup>308</sup>”. Deloitte also offshores work to India through a joint venture between the US and Indian firms. In 2014, it involved 2% of audit hours but offshore staff is also involved in what the FRC calls “areas of significant risk and those involving audit judgment<sup>309</sup>”.

Any form of offshoring or outsourcing requires a subdivision of audits into convenient parts so that they can be parcelled off to remote locations. PwC<sup>310</sup> uses the services

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<sup>306</sup> Financial Reporting Council, Moore Stephens LLP Audit Quality Inspection, June 2018; <https://www.frc.org.uk/getattachment/634c3f5b-b048-4811-a357-93c9bb5252db/Moore-Stephens-LLP-Public-Report-2017-18.pdf>

<sup>307</sup> Financial Reporting Council, Public Report on the 2011/12 inspection of PricewaterhouseCoopers LLP, 15 June 2012; [https://www.frc.org.uk/getattachment/3d6933d6-050f-4ff4-a7c7-5396a8a38891/PwC-Public-Report-2011-12-\(Clean\).pdf](https://www.frc.org.uk/getattachment/3d6933d6-050f-4ff4-a7c7-5396a8a38891/PwC-Public-Report-2011-12-(Clean).pdf)

<sup>308</sup> Financial Reporting Council, Ernst & Young LLP Audit Quality Inspection 2015; <https://www.frc.org.uk/getattachment/3148015e-4025-44b6-ace2-0dec6e01831d/Ernst-Young-LLP-Public-Report-2014-15.pdf>

<sup>309</sup> Financial Reporting Council, Deloitte LLP Audit Quality Inspection 2015; <https://www.frc.org.uk/getattachment/9e7b6253-e56e-4d4e-bfea-a7596cae0daa/Deloitte-LLP-Public-Report-2014-15.pdf>

<sup>310</sup> PricewaterhouseCoopers, Transparency Report Year Ended 30 June 2017; <https://www.pwc.co.uk/annualreport/assets/2017/pdf/annual-report-2017-transparency-report.pdf>

of PwC Network delivery centres in Katowice (Poland), Bangalore and Kolkata (India) to perform a variety of procedures. This includes:

- casting, cross-referencing, internal consistency and quality review of financial statements;
- assisting audit teams with tests of details by setting up templates and the audit tests, including vouching to supporting documentation;
- managing the preparation of requests for, and subsequent receipt of, external confirmations;
- assistance with data extraction and transformation for use in the audit of journals; and
- related parties searches and other client knowledge management. To maintain confidentiality and security of information, we have implemented strict data security controls, and work is performed solely by PwC employees in these locations. The centres are also subject to annual quality reviews

The performance of audits at remote locations requires coordination, supervision and oversight. Audit reports accompanying corporate financial statements do not say the proportion of audit work or audit tasks performed at offshore centres, most likely by staff without professional qualifications and without day-to-day awareness of the UK legal, economic and social environment. The firms are effectively placing reliance on audit work performed by staff not under their direct control or supervision. The full extent of offshoring is not known but some expect it to account for about 20% of the work of major auditing firms<sup>311</sup>. During its audit quality inspections, the FRC examines evidence on the files of audit firms, which may be prepared at offshore centres, to reach conclusions about the audit processes and procedures. However, neither the FRC, nor any of the RSBs conduct inspections of staff, facilities or control on audit work performed in offshore centres. The regulators may not be able to discipline staff at offshore centres. The impact of offshoring on audit quality at BHS, Carillion, banks or elsewhere is not known, but the labour of the persons performing work offshore are included in the calculation of total audit hours and are billed to companies. Stakeholders are unable to ask any questions because the details of audit work carried out at offshore centres is not disclosed.

## **RELIANCE ON THE WORK OF OTHER AUDITORS**

The audit report of a large multinational company may be signed by a UK firm, but the entire audit work is not necessarily performed by the primary auditor. Some part of the work, especially that relating to foreign subsidiaries, is likely to have been performed by firms located in the same network, but located abroad. It may be argued that the big firms are globally integrated and have common standards, but there is little empirical evidence to support that contention. All too often the firms claim that they are network of national firms. If so, they may have different standards due to local laws, standards, education, economic and political and regulatory environment. Despite auditing standards, the firms flout the rules if it suits them. The 2013 audit quality inspection report for PwC noted:

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<sup>311</sup> Financial Times, Watchdogs probe 'offshoring' of audit work, 26 July 2011; <https://www.ft.com/content/9da91fd0-b6a8-11e0-ae1f-00144feabdc0>

“We identified that in one case, the firm instructed another PwC network firm, as component auditor, to carry out the audit of the whole of the entity, including the audit of the consolidation process. The UK firm was fully involved in the identification of significant and elevated audit risks, in determining the planned response to them by the component auditor and reviewed the component auditor’s work on the consolidation. However, under Auditing Standards, a group auditor cannot delegate responsibility for performing the audit as a whole, including the audit of the consolidation process, to a component auditor<sup>312</sup>”

The point remains that the audit work forming the basis of the audit opinion has been performed by individuals not under the direct control and supervision of the firm signing the audit report. It is also doubtful that the FRC or any of the RSBs can discipline any of the foreign staff for poor quality of audit work even though they work for another firm in the network. The public is not told about the proportion of work performed by foreign auditors and when malpractices are exposed, the firms try to wriggle away from responsibility and liability.

Price Waterhouse (UK) were auditors of the fraud-infested Bank of Credit and Commerce International (BCCI) and were subpoenaed by the US Foreign Affairs Committee for documents. The firm refused to comply and said:

“Price Waterhouse firms are separate and independent legal entities whose activities are subject to the laws and professional obligations of the country in which they practice ... each firm elects its own senior partners; neither firm controls the other; each firm separately determines to hire and terminate its own professional and administrative staff.... each firm has its own clients; the firms do not share in each other’s revenues or assets; and each separately maintains possession, custody and control over its own books and records, including work papers<sup>313</sup>”.

After the Parmalat accounting scandal in Italy, Grant Thornton International was quick to emphasise that “The member firms in the Grant Thornton International network are entirely independent legal, financial and administrative entities<sup>314</sup>”

Grant Thornton International "do not share profits with, or liabilities for the actions of other member firms ... Consequently, we do not have any financial, legal or regulatory exposure as a result of the work done at Grant Thornton SpA<sup>315</sup>".

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<sup>312</sup> [https://www.frc.org.uk/getattachment/f89ee075-3e22-471a-8403-9034a3050d04/PwC-Public-Report-Final-for-web-\(21-May-2013\).pdf](https://www.frc.org.uk/getattachment/f89ee075-3e22-471a-8403-9034a3050d04/PwC-Public-Report-Final-for-web-(21-May-2013).pdf)

<sup>313</sup> US Senate Committee on Foreign Relations, The BCCI Affair (A Report by Senator John Kerry and Senator Hank Brown), Washington DC: USGPO, 1992.

<sup>314</sup> New York Times, Parmalat Sues 2 Auditors, Saying They Failed to Catch Fraud, 19 August 2004; <https://www.nytimes.com/2004/08/19/business/parmalat-sues-2-auditors-saying-they-failed-to-catch-fraud.html>

<sup>315</sup> Irish Independent, Grant Thornton Ireland 'not affected' by Parmalat, 6 January 2004; <https://www.independent.ie/business/irish/grant-thornton-ireland-not-affected-by-parmalat-26019199.html>

In the face of liabilities and responsibilities, the claims of global networks disintegrate. Firms are not willing to accept liability or responsibilities arising out of the work carried out by their international affiliates. Once again, the labour of the persons carrying out the work is included in the calculation of the total hours charged out by the firms to their audit clients.

## **TIME BUDGETS**

A number of submissions made to us by members of audit teams have referred to the relentless pursuit of profit, often by reducing time budgets for audits. This they argued reduces the quality of audits. There is also a strongly held view that liability shields have persuaded the firms to be very cavalier about audit time budgets. The time budgets for audits are dependent on the size of the company, extent of audit work/tests and the ability to bill the client. Last year's audit experience or equivalent experience elsewhere often forms the basis of an estimated time budget.

In auditing firms, non-auditing services are highly valued because of high profit margins. This leaves those confined to audits in a predicament about how to flag-up their contribution to the firm's bottom line. One of the ways is to acquiesce, under pressure, to tighter time budgets i.e. agree that the audit can be performed in less time even though tighter time budgets may result in incomplete or botched audits<sup>316</sup>. Everyone connected with the audit knows that the tasks cannot be performed in less time, but for reasons for job security, promotion, salary increments and study leave, staff go along with tighter/lower time budgets. Time budgets act both as a control mechanism and also as a performance measurement tool and can have dysfunctional effects. Tighter budgets enable the firm to squeeze more from its labour and generate extra revenues by making a more productive use of the time saved. Tighter time budgets are also dysfunctional because they impair the ability of audit team to collect and evaluate evidence, and some crucial areas might receive little or no attention. If somehow the audit is completed within the time budget then it becomes a benchmark for the next year and further reduction in the time.

Audit work is labour intensive and repetitive but senior managers expect audit teams to work evening and week-ends, for no extra pay, to come in under or on budget. This disrupts family and social life and is resented by many though some audit trainees put in the hours in the hope getting study leave to complete their professional studies. Contrary to the official firm policies, audit staff feel that they are under pressure to underreport or self-absorb the hours and the phrase "eating time" is commonly used to denote a situation where work is done but the time is not recorded on time sheets or is not charged to the client. Such practices also make partners and audit manager look good as they can claim credit for delivering audit in less time. Staff mediate time pressures by adopting irregular auditing practices. For example, they circumvent recommended sampling criteria and ignore unusual or suspicious items which might require a lot of time consuming investigation. They do not always follow-up inquiries. No one wants to be rebuked by their line manager for only clearing a small proportion of the allocated tasks as this can damage possibilities of career advancement. Audit staff also avoid approaching

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<sup>316</sup> Department of Trade and Industry, James Ferguson Holdings plc; Barlow Clowes Gilt Managers Limited (3 Volumes), London: HMSO, 1995.

uncooperative personnel at client companies as dealing with them also eats up a substantial part of the audit time budget. In auditing firms, a good file is measured by its contents of checklists and ticks in right boxes.

An auditor told us:

“audit departments are subsidised by other areas of the firm. Profit margins are wafer thin, with our clients seeing audits as a compliance exercise. As a consequence our biggest audits are understaffed. All Big 4 auditors have horror stories of work not being properly completed. This puts increasing pressure on auditors to complete work as quickly as possible- protracted debates with management and extended work on high risk areas are simply not cost effective and ultimately discouraged.

...pressure is most felt by audit middle-managers, who likely have no engagement with the board, but will take the majority of judgemental decisions on high risk areas. It's their job to make sure we remain 'management's choice', and as such controversial issues are often not escalated but quietly swept under the carpet. I believe that the biggest audit scandals have come from pressure on middle managers to produce 'results' which protect the firm while keeping the client happy”.

Another correspondent said

“We also go through an internal progress, which mirrors the FRCs work. These processes invariably mean going through our files, assessing if we have identified the right risks and understanding if we have tested these risks correctly. ... If a valuation [of investments] was contentious it would be a lot easier to not test it and keep the client's valuation paper off the audit file. You might get negatively scored for not having tested it, but you would not be penalised for the asset valuation being materially wrong. The current obsession with audit file review has resulted in a focus on documentation rather than ensuring risks have been appropriately tested. I think the real risk of auditor malpractice is middle management cutting corners to keep both partners and the client happy- only re-performance of audit procedures by AQR teams would limit this risk”.

Research<sup>317</sup> shows that in the face of time pressures, a large proportion of audit staff adopt irregular practices, including falsification of audit schedules and files i.e. they create false schedules to show that work has been done. Before reaching a conclusion and signing the audit report, audit partners are required to review the audit files and schedules for completeness and satisfy themselves that the required tasks have been carried out. However, audit schedules (or spreadsheets) based on

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<sup>317</sup>Otley, D. T. & Pierce, B. J., Audit Time Budget Pressure: Consequences and Antecedents. *Accounting, Auditing and Accountability Journal*, 9 (1), 31-58, 1996; Consequences and Antecedents', *Accounting, Auditing & Accountability Journal*, pp. 31-38; Shaun M. McNamara and Gregory A. Liyanarachchi, Time budget pressure and auditor dysfunctional behaviour within an occupational stress model, *Accountancy Business and the Public Interest*, 7(1): 1-43, 2008.

false work or irregular auditing practices do not look any different from the ones based on genuine work. Audit partners may be able to identify irregular or false practices by re-performing some of the audit tasks, but due to time constraints that is not feasible. So the dysfunctional aspects of time budgets remain embedded in the system and form the basis of audit opinions.

The irregular practices are carried out by senior and junior members of the audit teams<sup>318</sup>. Most of the research has produced outcomes similar to the table below.

<b>Reasons for speeding up testing</b>		
	<i>Have you been under so much pressure that you were tempted to speed up testing by</i>	<i>Have you encountered colleagues who have speeded up testing by</i>
	<i>%</i>	<i>%</i>
Rejecting awkward looking items from a sample	53.7	62.5
Not testing all items in a reported sample	26.8	45.5
Accepting doubtful audit evidence	24.1	41.1
Other	16.1	4.4.
<b>Reasons for being tempted to speed up testing by irregular methods</b>		
	<b>%</b>	
Budget Pressures	60.5	
Boring Work	30.3	
Unimportant work	41.1	
Other	9.8	

**Source:** Willett and Page<sup>319</sup> (1996).

The persistence of the above practices means that many of the senior personnel in auditing firms reached that position after using irregular practices and neglect of audit quality. They are now the supposed role models for the rest.

## **COMPOSITION AUDIT TEAMS**

A number of the audit staff from large and mid-tier firms told us that they were concerned about the composition of audit teams. They claim to have little regular

<sup>318</sup> Prem Sikka, "Some questions about the governance of auditing firms", International Journal of Disclosure and Governance, Vol. 1, No. 2, 2004, pp. 186-200.

<sup>319</sup> Willett, C and Page, M, A Survey of Time Budget Pressure and Irregular Auditing Practices amongst Newly Qualified UK Chartered Accountants, British Accounting Review, Vol. 28, No. 2, pp. 101-120, 1996

contact with the partner in-charge of audits. Some said that partners were there to win business, have dinners/lunches with clients, sell non-auditing services and were mainly focused on strategic issues arising from audits. Some trainees said that they were more knowledgeable about current developments than their seniors who were not always familiar with recent development in finance or development of exotic accounting practices. Some said that audit teams mainly consisted of trainees and had minimal supervision or were supervised by inexperienced seniors. Some attributed this to high staff turnover whilst others thought that this has been normalised. All agreed that their firms gave them technical support and training and how to present themselves to clients, but most struggled to engage with the question - "how do you question your firm's ethos or value system and how do you know that it is the best"? Indeed this should be a major issue for the firms in that they expend considerable resources to train and nurture their personnel, yet audits continue to fail. Even the regulators, such as the FRC, are openly saying that audit quality has worsened. This requires attention to everything that is embedded within the firm's organisational culture and taken for granted.

Whichever way anyone looks at it, the composition of audit teams has a significant impact on the quality of audit evidence, its interpretation and analysis. Its success or failures are a commentary on the organisational culture.

## **SUMMARY AND DISCUSSION**

This chapter argued that increased auditor competition and choice will not on its own arrest poor quality of audits. Audit quality was just as bad when the industry was dominated by more than four firms. The organisational culture of auditing firms is a key ingredient in the production of audits and requires individuals to increase profits through downgrading of concerns about audit quality. Firms cut costs through offshoring audit work which can adversely affect audit quality. The UK auditors also rely upon audit work performed by staff at other firms affiliated to the network, but not under the direct control of the UK firm. The third-party locations may or may not have standards appropriate for UK audits. In pursuit of profits, audit time budgets are squeezed with the consequence that audit opinions may be premature. The staff facing relentless time pressures resort to using irregular work practices and some also falsify audit schedules. Audit teams may have inappropriate mix of staff and poor supervision. The above practices are nurtured by organisational culture and have severe consequences for audit quality and the appropriateness of audit opinion. Some of the pressures would be mitigated by the reforms recommended in this report – such as the formation of 'audit only' firms. Therefore, pressures on staff to sell non-auditing services to audit clients would be reduced and force the firms to pay attention to audit quality. However, the firm culture needs to be exposed to public scrutiny so that exposure can become a catalyst for change. This can be difficult as audit effort cannot easily be observed by outsiders. Nevertheless, various windows and pressure points can be created.

Auditor files should be available for stakeholder scrutiny so they can form a view about the extent, quality, efficiency and value for money provided by auditors. Currently, virtually nothing is known about the work performed by auditors and the standardised audit reports provide little/no indication of the work carried out. No doubt, any proposal for transparency and public accountability would be opposed by

the auditing industry and its sponsors as they fear public scrutiny, but would build their opposition on the grounds of cost and confidentiality. Audit files do not contain information about secret formulas and commercial processes which any competitor can replicate. They may contain some information about corporate contracts and agreements and there is every reason for stakeholders affected by them to become aware of them. Arguably, if markets had been aware of the worthless contracts in Carillion's balance sheet, many stakeholders would have been able to reduce their losses. If 'confidentiality' obstructs public accountability, Parliament can enact legislation to override it or enable auditors to redact some selected items. But confidentiality per se should not obstruct a public evaluation of the conduct of audits, especially as the quality of audits affects a variety of stakeholders who bear the cost of audit failures. In the absence of public access to audit files, auditing firms would continue to make the usual high sounding claims about the quality of audit work, but they cannot be corroborated. It is also worth bearing in mind that anyone hiring a lawyer is entitled to see most letters and documents and even keep most of the file at the end of the assignment. Yet stakeholders do not have the right to see auditor files. A revised Companies Act should facilitate this change. Some invoke the court judgement in the case of *Chantrey Martin & Co v Martin* [1953] 2 QB 286, which stated that documents brought into existence by auditors were the property of the auditors, to resist change. However, the standards of public accountability have moved on since then and there is no reason to exempt auditors.

Companies appoint and reappoint auditors at AGMs, but the resolutions are not accompanied by any information about the firm and its capacities. Audit reports are not accompanied by any meaningful information either. This should be addressed by revising the Companies Act and requiring that each audit report and AGM resolution to appoint or reappoint auditors must be accompanied by a copy of the audit contract (commonly known as the letter of engagement); a list containing composition of the audit staff, the time spent on audit by each grade of labour, their qualification and the rate of charge for each grade of labour; proportion of audit work offshored and/or performed by staff not under the control of the firm; the main questions that auditors raised with the directors and replies received from the directors (known as management representations); a list of regulatory action taken against the auditing firm during the previous five years and the firm's response; and any shortcomings in the firm's audit procedures identified by the regulator (e.g. in the audit inspection reports) during the previous five years and the firm's response and commitment for dealing with them. Such disclosures would enhance public accountability of auditors and exert pressure on auditors to improve the quality of audit work. There should also be disclosures about the audit work performed by staff not directly under the control of the audit firm.

It should be noted that the enabling legislation for publication of the audit contract already exists in Section 493 of the Companies Act 2006. Under the Insolvency (England and Wales) Rules 2016, insolvency practitioners (e.g. liquidators) are already required to provide information about the hourly charges for each grade of labour. As the principle of disclosure already exists, it can easily be translated into a change to the Companies Act. New legislation must be enacted to turn the rest of the above recommendation to reality and generate pressure pressures on auditors to change their organisational culture.

In the case of BHS, the suggested disclosure would have shown that the audit partner and audit manager only spent two and nine hours respectively on the audit. This in itself would have sent alarm bells ringing and possibly dissuaded the audit firm from engaging in such practices in the first place. The knowledge that the auditing firm has been prosecuted or fined by the regulator, and that the regulator considers the firm's work to be poor and that the firm has to publicly explain the reasons for the persistence of poor quality work would exert pressure on the audit firms to clean-up their act.

## **RECOMMENDED REFORMS**

- Auditor files should be available for stakeholder scrutiny
- Each resolution to appoint or reappoint an auditor, and each audit report must be accompanied by the following:
  - A copy of the audit contract.
  - A list containing composition of the audit team, the time spent by each member on the job, their qualifications and the hourly rate charged for each grade of staff.
  - Details of the audit work performed by staff not under the control and direct supervision of the entity signing the audit report, together with the names of the entities where the work is performed.
  - Percentage and significance of the audit work carried out by staff not under the control and direct supervision of the entity signing the audit report.
  - A statement that the auditor accepts full responsibility and liability for the quality of work carried out by staff not under the control and direct supervision of the entity signing the audit report.
  - A statement that the audit firm has arrangements in place to ensure that all files and staff related to the audit work, whether at the firm or at third party location, shall be made available to regulators.
  - A list of materially significant questions asked by auditors and directors' replies.
  - A list of regulatory action taken against the firm during the five previous years and the firm's response to each action.
  - A list of the shortcomings in the firm's audit procedures identified by the regulator during the previous five years and the firm's response and commitment for dealing with each of them.
- The provision of false or misleading information would be a criminal offence.

## CHAPTER 10 REFORMING AUDITOR LIABILITY

### INTRODUCTION

People increasingly transact with faceless corporations for goods and services. There is always a danger that in pursuit of private and through negligence profits producers/providers may sell goods/services which fail to deliver the promised benefits, or injure/damage not only consumers but also citizens and society at large. Therefore markets are policed and at the very least the state sets minimum standards, enforcement programmes and liability laws to deter predatory practices. The legal framework exerts pressure on the producers/providers to ensure that their products/services are fit-for-purpose and in the event of breach of standards or negligence they are required to compensate the injured parties. There can be criminal and civil penalties for those habitually selling shoddy goods and services. Such pressures points are weak for the auditing industry and require reforms.

The incidence of liability should act as a pressure point and persuade auditors to take greater care in the production of audits. However, current liability laws do not exert sufficient pressure on auditors to be diligent or even exercise reasonable care and skill. In this environment, some audit partners cannot even be bothered to spend enough time on the job, or supervise audit staff. More generally, this state of affairs engenders a culture of ineffectiveness and poor quality audit work. It is salutary to note that the PwC audit partner spent just two hours on the final audit of BHS and its parent company; while the Audit Senior Manager recorded only seven hours and was not involved in the final stages of the BHS audit<sup>320</sup>. Supervision and control of audit was left to an Audit Manager with only one year post-qualification experience. At Quindell, auditors KPMG failed to “obtain reasonable assurance that the financial statements as a whole were free from material misstatement, failure to obtain sufficient appropriate audit evidence and failure to exercise sufficient professional scepticism<sup>321</sup>”. At Farepak<sup>322</sup>, Ernst & Young failed to perform adequate procedures to obtain sufficient appropriate audit evidence that all material subsequent events up to the date of their audit report which required adjustment of, or disclosure in, the financial statements had been identified and properly reflected therein. The firm did not corroborate management representations and also failed to consider Farepak’s ability to continue as a going concern.

The shortcomings have been documented for decades<sup>323</sup>. Stringent liability laws applicable to firms and audit partners would give the auditors some food for thought,

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<sup>320</sup> Financial Reporting Council, In the matter of: The Executive Counsel To The Financial Reporting Council - AND - (1) Stephen John Denison, (2) Pricewaterhousecoopers LLP, 10 August 2018; <https://www.frc.org.uk/getattachment/433f3df8-d0ef-456b-8a26-aeb55f65489b/BHS-Particulars-of-Fact-and-Acts-of-Misconduct.pdf>

<sup>321</sup> Financial Reporting Council, Sanctions in relation to the audit of Quindell plc, 11 June 2018; <https://www.frc.org.uk/news/june-2018/sanctions-in-relation-to-the-audit-of-quindell-plc>

<sup>322</sup> Financial Reporting Council, Outcome of disciplinary case against Ernst & Young LLP, Member Firm of the ICAEW and Alan Flitcroft, Member of the ICAEW, 19 December 2013; <https://www.frc.org.uk/news/december-2013/outcome-of-disciplinary-case-against-ernst-young>

<sup>323</sup> For example see, Prem Sikka, “The Corrosive Effects of Neoliberalism on the UK Financial Crises and Auditing Practices: A Dead-End for Reforms”, Accounting Forum, Vol.

but for the last forty years there has been a one-way traffic. Successive governments have indulged auditors by granting them more liability shields without any quid pro quo. It is difficult to think of any economic theory or evidence which suggests that weakening of producer liability and weakening of consumer or societal recourse incentivises producers to improve quality of goods and services. This is even less so in a state guaranteed market reserved for an occupational group accompanied by weak public accountability and liability laws. Lax liability laws have weakened incentives for diligent audits. The cost of such indulgence is borne by investors, taxpayers, suppliers, employees or any other stakeholders. According to Joseph Stiglitz, former chief economist and senior Vice-President of the World Bank:

“there are plenty of carrots encouraging accounting firms to look the other way ... there had been one big stick discouraging them. If things went awry, they could be sued ... In 1995, Congress adopted legislation intended to limit securities litigation ... in doing so, they provided substantial [liability] protection for the auditors. But we may have gone too far: insulated from suits, the accountants are now willing to take more “gambles”<sup>324</sup>”.

The US is not alone in showering gifts upon auditing firms. Successive UK governments have indulged giant auditing firms and granted liability concessions.

## INDULGENCE OF AUDITORS

Ever since the inception of modern audits, auditors have mostly traded as partnerships and had ‘joint and several’ liability. Partners shared the profits/losses generated by each and had incentives to police each other and the firm’s standards because they were liable for each other’s failures. Auditors were forbidden from contracting with companies for their liability to be restricted<sup>325</sup>. On the back of ‘joint and several’ liability of partnerships, auditing firms became global businesses. The mid-1970s secondary banking crash and the 1980s crashes and frauds exposed audit failures<sup>326</sup>. The response of the auditing firms, with the full support of accountancy trade associations, such as the ICAEW, was to demand liability concessions to protect them from the consequences of their own shortcomings<sup>327</sup>.

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39, No. 1, 2015, pp. 1-18; Prem Sikka and Hugh Willmott, *Illuminating the State-Profession Relationship: Accountants Acting as Department of Trade and Industry Investigators*, *Critical Perspectives on Accounting*, Vol. 6, No. 4, 1995, pp. 341-369; with Austin Mitchell, Prem Sikka, Tony Puxty and Hugh Willmott, *Discussion Paper No. 7, Accounting for Change: Proposals for Reform of Audit and Accounting*, London: Fabian Society, August 1991.

<sup>324</sup> Joseph Stiglitz, *The Roaring Nineties: Seeds of Destruction*, Penguin, London: 2003, p. 136.

<sup>325</sup> Christopher Napier, *Intersections of law and accountancy: Unlimited auditor liability in the United Kingdom*, *Accounting, Organizations and Society*, 23(1): 105-128, 1998.

<sup>326</sup> Prem Sikka, “The Corrosive Effects of Neoliberalism on the UK Financial Crises and Auditing Practices: A Dead-End for Reforms”, *Accounting Forum*, Vol. 39, No. 1, 2015, pp. 1-18; Prem Sikka and Hugh Willmott, *Illuminating the State-Profession Relationship: Accountants Acting as Department of Trade and Industry Investigators*, *Critical Perspectives on Accounting*, Vol. 6, No. 4, 1995, pp. 341-369

<sup>327</sup> For further information see, Jim Cousins, Austin Mitchell and Prem Sikka, “Auditor Liability: The Other Side of the Debate”, *Critical Perspectives on Accounting*, Vol. 10, No. 3, 1999, pp. 283-312; Prem Sikka, “Globalization and its Discontents: Accounting Firms Buy

Rather than improving audit quality, firms portrayed themselves as unfair victims of lawsuits and demanded protection even though lawsuits against them were rare<sup>328</sup>.

### **Limited Liability Companies**

The auditing firms wanted to trade as limited liability companies and demanded that the law be changed to permit them to do that so that their partners could limit their liability and protect their personal property. The firms also argued that partnership structures are unwieldy (with some firms, including of course the biggest ones, having hundreds of partners) and did not easily enable them to raise finance from capital markets. This, they claimed, hindered their development and placed them in an unfair competition with other forms of consultancy and advisory businesses. In response, the Companies Act 1989 granted the auditing firms the right to trade as limited liability companies. The right of incorporation conferred upon the auditing industry the same advantages and obligations placed upon numerous other organisations. Yet in practice most firms continued to trade as partnerships.

There were two reasons for this lack of enthusiasm about trading through limited liability companies. Firstly, accountancy firms were not keen to publish audited information about their affairs. According to the ICAEW,

“the obligation on [auditing firms trading as] companies to publish their accounts is perceived as a considerable drawback<sup>329</sup>”; and “firms have always stood out against revealing any financial information except their annual fee income<sup>330</sup>”.

Amongst major firms, only KPMG chose to incorporate and even this was confined to its auditing business. The second reason was tax. The firms were not keen to abandon the comparatively favourable tax regime for partnerships. For example, firms were taxed on a ‘cash basis’ rather than the ‘accrual basis’ and thus had greater scope for shunting tax liabilities. There were also capital gains tax and expense deductibility advantages. In sum, the firms campaigned for the right to trade through limited liability companies and after it was given they rowed back because they wanted to hang on to the partnership tax perks and were not keen to make public disclosures about their affairs either.

### **No Duty of Care to Individual Stakeholders**

Developments in UK case law further diluted liability pressures on the auditor. During the early 1980s, court cases, such as *JEB Fasteners Ltd v Marks Bloom & Co. [1983] 1 All ER 583* and *Twomax Ltd v Dickson, McFarlane and Robinson [1983] SLT 98* indicated the possibility that under some highly restrictive circumstances

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Limited Liability Partnership Legislation in Jersey”, *Accounting, Auditing and Accountability Journal*. Vol. 21, No. 3, 2008, pp. 398-426.

<sup>328</sup> David Gwilliam, Making Mountains out of Mole Hills, *Accountancy*, March 1998, pp. 22-23.

<sup>329</sup> *The Accountant*, September 1991, p. 2

<sup>330</sup> *Accountancy*, April 1994, p. 26

auditors may be held liable to third parties. Subsequent court judgements, however, in cases such as *Caparo Industries plc v Dickman & Others* [1990] 1 All ER HL 568 and *Al-Saudi Banque v Clark Pixley* [1990] 1 Ch. 313 held that in general auditors only owe a 'duty of care' to the company (as a legal entity) rather than to any individual current/potential shareholder, creditor, or any other stakeholder

The *Caparo* law lords said:

"I see no grounds for believing that, in enacting the statutory provisions [requiring publication of audited company accounts] Parliament had in mind the provision of information for the assistance of purchasers of shares or debentures in the market, whether they be already the holders of shares or other securities or persons having no previous proprietary interest in the company ..... For my part, however, I can see nothing in the statutory duties of a company's auditor to suggest that they were intended by Parliament to protect the interests of investors."

"I therefore conclude that the purpose of annual accounts, so far as members [shareholders] are concerned is to enable them to question the past management of the company, to exercise their voting rights, if so advised, and to influence future policy and management. Advice to individual shareholders in relation to present or future investment in the company is no part of the statutory purpose of the preparation and distribution of the accounts".

"As a purchaser of additional shares in reliance on the auditor's report, he [the shareholder] stands no different from any other investing member of the public to who the auditor owes no duty".

The *Caparo* judgement effectively overturned the emerging consensus from previous case law suggesting that auditors had some responsibility to individual shareholders and the general public and therefore had to ensure that company accounts could be relied upon. The key element in the judgement is that the auditors enter into a contract with the company and not with shareholders.

Despite enjoying statutory monopolies, auditors thus have no duty of care, in general, to any individual stakeholder. The duty of care is mainly only to the company being audited though a duty of care to third parties, such as current/potential shareholders and creditors, may arise in very exceptional circumstances. Company directors can be held personally liable for publishing false and misleading accounts. Yet the law applicable to auditors is lax. Auditors have been considered to be at fault in auditing financial statements (for example, see *McNaughton (James) Paper Group Limited v Hicks Anderson & Co.* [1991 1 All ER 134 and [1990] BCC 891; *Berg Sons & Co. Limited & Others v Adams & Others* [1992] BCC 661) but have escaped any damages on the ground that they did not owe a 'duty of care' to third parties. Following the case of *Barings plc and another v Coopers & Lybrand* [1997] BCLC 427, auditors of subsidiary companies could owe a 'duty of care' to the parent company (as a legal person) but not to any human stakeholder. The *Caparo* judgment was incorporated into the Companies Act 2006.

## Proportional Liability

The early 1990s provided further evidence of audit failures at Polly Peck, Maxwell, Bank of Commerce and Credit International (BCCI), Levitt Group of Companies, Barlow Clowes, Sock Shop, Coloroll, Parkfield, British and Commonwealth, Sound Diffusion. Rush and Tompkins and elsewhere made the headlines. The auditing industry demanded even more liability concessions by claiming that it was an unfair victim of lawsuits because of the deep-pocket syndrome, but rarely provided any information about its insurance cost, the number of lawsuits or actual settlements. Most of the lawsuits against auditors have tended to be from other accountancy firms acting in their capacity as liquidators. For example, Touche Ross (now part of Deloitte) sued Price Waterhouse over the audit of BCCI; Price Waterhouse sued Deloitte over the collapse of Barings and KPMG sued Coopers & Lybrand (now part of PwC) for alleged audit failures at Wallace Smith Trust. Lawsuits prolong the completion of liquidations and generate fees for the liquidators which diminish the amounts available to unsecured creditors. The headline amounts may be large and the actual settlements tended to be small, but it all provided fodder for the campaigns to secure liability concessions.

In 1996, following an inquiry by the Law Commission, the government rejected the industry's demand for full proportional liability. The Law Commission concluded that "we regard the policy objections to joint and several liability to be at worst unproven and, at best, insufficiently convincing to merit a departure from the principle<sup>331</sup>". Meanwhile, however, the Law Commission advanced the concept of 'contributory negligence' which is a form of 'modified proportional liability'. This permits auditors to defend themselves by arguing that others (e.g. directors) contributed to their negligence and the damages suffered by the plaintiffs.

The principle of 'contributory negligence' was demonstrated by the UK House of Lords judgement in the case (not involving accountants) of *Banque Bruxelles Lambert S.A. v Eagle Star Insurance co. Ltd* [1997] AC 191. It established that a wrongdoer will be responsible for all of the consequences of his/her wrongful act, but only for those consequences attributable to the wrongful feature or characteristic of the act – that which made the act wrongful. Where liability arises for negligently providing inaccurate information, this means that liability will extend only to that information being inaccurate. The informed legal opinion of the time was that the ruling will act as a check on the range of losses which clients can claim from their professional advisers when things go wrong, and that the House of Lords has moved significantly towards proportionality of responsibility for professional advisers. A spokesperson for the ICAEW accepted that the ruling will have a "dramatic effect on limiting the consequences of negligence<sup>332</sup>". Cases such as *MAN Nutzfahrzeuge AG & Anor v Freightliner Ltd & Anor* [2007] EWCA Civ 910) show that auditors can be negligent yet escape liability. However, the ICAEW and the auditing industry wanted more. Deloitte & Touche were found guilty of negligence in the case of *Barings Plc & Anor v Coopers & Lybrand (a firm) & Ors, Court of Appeal - Chancery Division, June*

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<sup>331</sup> Department of Trade and Industry, Feasibility Investigation of Joint and Several Liability, London, HMSO, 1996, p. 35.

<sup>332</sup> The Accountant, August 1996, p. 11.

11, 2003, [2003] EWHC 1319 (Ch), and paid a penalty of around £1.5 million, instead of the £130 million sought, on the ground that Barings directors failed to create effective internal controls.

### Cap Does Not Fit

Imagine hiring the services of a professional person, such as a doctor, dentist or a pensions-broker, with the full expectation that s/he is a professional and competent person. Subsequently, it is discovered that the person was negligent, your life has been blighted and your savings have been wiped out. A reasonable principle of law is that the damages secured should have regard to the circumstances of the case and should be based upon the loss directly attributable to the alleged negligence. Yet the auditing industry wanted to be treated as an exception. It argued that regardless of the extent of damages suffered by the stakeholders, auditor liability should be 'capped'; with the 'cap' being a multiple of the audit fee. The Law Commission said that "We can find no principled arguments for a 'capping' system<sup>333</sup>".

The Companies Act 2006 contains a general prohibition against the company exempting or indemnifying an auditor from liability arising from negligence, default, breach of duty or breach of trust in relation to the company during the course of an audit, but a form of 'cap' or limitation of liability is permitted. Sections 532 to 538 of the Companies Act 2006, which came into effect on 6 April 2008, permit companies to limit the liability of their auditors by contract, subject to the agreement of shareholders. The arrangements must be fair and reasonable, having regard to the particular circumstances<sup>334</sup>. If matters are disputed, the Court can override any contractual limits agreed between the company and the auditors if it considers that they are less than "fair and reasonable". This EU Directives also permit Member States to enable auditors to limit their liability except in cases of intentional breach of their duties. The UK liability concession was also accompanied by Sections 507 to 509 of the Companies Act 2006 which introduced criminal penalties for 'knowingly or recklessly' giving a misleading audit opinion

The above arrangements do not consider any broader societal or stakeholder concerns arising from audit failures and the limitations on liability as everything is left to approval by shareholders. This again poses the question whether an audit is a private or a public contract. If it is a public contract then what mandate do shareholders have to agree liability limits for others? There may also be international ramifications of liability limit agreements for companies with global subsidiaries as not all countries permit this type of liability cap. The full extent of liability limitation agreements is not known but a survey of the top 100 auditing firms reported that 17% had managed to agree a contract with a client to limit their liability for damages

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<sup>333</sup> Department of Trade and Industry, 1996, op cit.

<sup>334</sup> Financial Reporting Council, Guidance on Auditor Liability Limitation Agreements, June 2008; <https://www.frc.org.uk/getattachment/ec02c8ea-4c14-4349-9333-d655a5dd52f7/FRC-ALLA-Guidance-June-2008-final5.pdf>

in the event of the company collapsing<sup>335</sup>. This liability concession was granted because of the concerns that the demise of a major auditing firm could reduce supply of audits and deter other suppliers from entering the market. It was accompanied by an implicit understanding that the auditing industry would improve quality of audits. There are inevitably recurring moral hazard issues and the spate of accounting scandals do not suggest that the industry has delivered its part of the bargain.

### **Companies Buy Insurance for Auditors**

Undeterred, the ICAEW and the auditing industry sought other ways of limiting liability expenditure by firms. It called for reform to Section 310 of the Companies Act 1985 which prohibited auditors from limiting liability in respect of statutory audits. The industry wanted such restrictions lifted to enable auditors to negotiate the limits on their liability with company directors. This presupposes that audit is just a private contract between the company and the auditing firm. If not, then directors do not have any mandate from other stakeholders to negotiate a limit on auditor liability. One can imagine a situation where auditors are sitting around a table with crooked directors granting liability concessions to each other. But when the next audit failure comes around auditors will hide behind the liability limits, while innocent third parties will bear the consequences of auditor negligence. With fees and insurance cover provided by third parties, auditor incentives to deliver good audits would be severely eroded.

The cap was not secured but the government replaced Section 310 of the Companies Act 1985 with Section 137 of the Companies Act 1989 to enable companies to buy insurance for its Directors and Officers (which includes auditors). Yes, companies would pay auditors fees for conducting audits and then also buy their insurance to protect them. This would need to be approved by shareholders. The enactment of legislation drew hostile public comments and hardly any company has bought insurance for its auditors.

Subsequently, the industry called for compulsory insurance for Directors and Officers (D&O), which included auditors. Its demands would have forced companies to incur additional economic costs, but without any public benefit. The government refused to yield as anything introduced to appease the auditing industry would also apply to numerous state officials (e.g. in local authorities, public bodies etc.) and increase public expenditure and levels of taxation. In any case, what incentives would auditors have to deliver good audits?

### **Limited Liability Partnerships**

When the UK government was not seen to be bending to demands from big firms they decided to discipline it through offshore strategies. By 1994, some auditing firms began to consider the possibility of forming “offshore” Limited Liability Partnerships (LLPs). The general rule for LLPs was that the liability claims would be met by the

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<sup>335</sup> Accountancy Age, Auditors struggle to agree liability limits with clients, 28 May 2009; <https://www.accountancyage.com/aa/analysis/1789375/auditors-struggle-agree-liability-limits-clients>

assets of the firm and any applicable liability insurance, followed by the assets of the partner responsible for the action/inaction creating the liability. Thus, the assets of the other partners were protected, even though they shared in the profits generated by all partners. It would be recalled that the firms wanted to trade through limited liability companies because they considered a partnership structure to be unwieldy and not conducive to raising finance for expansion, but now they wanted to push for LLPs which would be an amalgam of the partnership and limited liability forms.

In late 1995, just before the UK Law Commission rejected the firms' demands for full proportional liability and a cap, Price Waterhouse and Ernst & Young spent more than a million pounds in preparing an initial draft of a Jersey LLP Bill. In this Bill, the firms gave themselves virtually all the concessions they had been looking for - secrecy, limited liability, proportional liability, with no regulator, tax or public accountability. Jersey's leading politicians agreed to 'fast track' the legislation and On 21 May 1996 a sixty-two page draft Bill (Limited Liability Partnerships (Jersey) Law 199) was published. Its publication led to "one of the most turbulent political debates in living memory"<sup>336</sup> and held up the parliamentary passage of the Bill which was finally passed on 19 May 1998.

The big firms, supported by the ICAEW, kept up pressure on the UK government with threats that unless the government yields they will relocate to Jersey and cause considerable economic turmoil. Of course, the firms had no intention abandoning their lucrative UK niches and the threat was therefore empty. The intention was to use Jersey as a lever to squeeze liability concessions from the UK government. Nevertheless, the orchestrated media coverage embarrassed the government and problematized its claims of being business-friendly. The UK government capitulated and in 1997 published a consultation paper<sup>337</sup> on facilitating LLPs, followed by the Limited Liability Partnerships Act 2000 which came into force on 6 April 2001. No big firm registered in Jersey.

### **Disclaimer of Responsibility**

Auditors also limit their liability by inserting disclaimer of liability clauses in audit contracts (letter of engagement) and audit reports. This way they are able to restrict liability to the company only. A typical disclaimer statement might say:

"This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed"<sup>338</sup>.

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<sup>336</sup> Financial Times, 26 September 1996, p. 7

<sup>337</sup> UK Department of Trade and Industry, Limited Liability Partnership - A New Form of Business Association for Professions, HMSO, London, 1997.

<sup>338</sup> Institute of Chartered Accountants in England & Wales, Audit And Assurance Faculty Technical Release 01/03AAF (Revised): The Audit Report and Auditors' Duty of Care to

Disclaimers are also found in audit reports. The case of *Barclays Bank Plc v Grant Thornton UK LLP*[2015] EWHC320 considered disclaimers inserted into non-statutory reports prepared by Grant Thornton for a client company with the full knowledge that the documents would be sent to a bank. The client company went out of business and Barclays sued Grant Thornton for negligence. The bank argued that the non-statutory reports failed to identify frauds by two employees of the client company. The High Court concluded that disclaimers included in the reports were sufficient to preclude Grant Thornton owing a duty of care to Barclays.

## **SUMMARY AND DISCUSSION**

The incidence of liability acts as a pressure point for improvement of quality. However, successive governments have indulged accounting firms and auditors now enjoy too many liability concessions. The weak liability laws exert little pressure upon auditors to improve the quality of audits. Anyone selling potato crisps or toffees has to ensure that the product is fit for purpose and will not injure current or potential consumers or harm societal interests. Airlines have to ensure that aircrafts are fit for purpose and passengers are compensated for poor quality of service. Producers must also recall faulty products and the producers often pledge that the same faults will not occur again. In the case of serious and persistent failures, their directors are also fired.

None of these considerations apply to auditors and the auditing industry has shown no inclination to embrace responsibility routinely accepted in most other fields. Individual stakeholders are not empowered to sue negligent auditors and rarely have the resources to call them to account even when they suffer damage. Audit failures are complicit in the demise of Carillion, BHS, and HBOS and have inflicted losses on employees, suppliers, pensions scheme members, shareholders and taxpayers, but stakeholders have no redress against auditors. Throughout the debate about statutory audits there is tension between whether it is a public contract or a private contract. There are also time limits within which any action can be taken. Under the Limitation Act 1980, any case has to be brought within six years of the plaintiff discovering fraud, and concealment giving rise to the legal claim. However, the FRC rarely produces timely reports on audit failures and auditor files are not publicly available, which in turn imposes impossible burdens on ordinary stakeholders to prove auditor negligence even if citizens were empowered to sue negligent auditors.

Big law firms have told us that they will not take a case against any of the big four firms because of their business links. When acting as liquidators, big accounting firms invite major law firms to act as legal advisors and none wants to jeopardise their source of lucrative revenues.

The liability policies pursued by successive governments have failed. They were often driven by the claim that liability shields will somehow invite new providers of audit and improve auditor competition and choice. That has not been the case and

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Third Parties, May 2018; <https://www.icaew.com/-/media/corporate/files/technical/technical-releases/audit/tech01-03aaf-the-audit-report-and-auditors-duty-of-care-to-third-parties---revised.ashx>

the market is even more dominated by the big four firms. The implicit bargain behind numerous liability concessions has been that they will somehow spur the industry to improve the quality of audits. That has not been the case either. The FRC reported that:

“The Big Four audit practices must act swiftly to reverse the decline in this year’s audit inspection results if they are to achieve the targets for audit quality set by the Financial Reporting Council (FRC). Overall results from the most recent inspections of eight firms by the FRC show that in 2017/18 72% of audits required no more than limited improvements compared with 78% in 2016/17. Among FTSE 350 company audits, 73% required no more than limited improvements against 81% in the prior year.

Across the Big 4, the fall in quality is due to a number of factors, including a failure to challenge management and show appropriate scepticism across their audits, poorer results for audits of banks. There has been an unacceptable deterioration in quality at one firm, KPMG. 50% of KPMG’s FTSE 350 audits required more than just limited improvements, compared to 35% in the previous year<sup>339</sup>.

Other countries have also indulged auditing firms and given them numerous liability concessions, with similar outcomes. A report by the International Forum of Independent Audit Regulators (IFIAR) covered the results of 918 audits performed by 120 firms across 33 different jurisdictions and reported that in 2017 around 40% of the audits were deficient. The common problem was auditor failure to corroborate management assertions, expressed as a "failure to assess the reasonableness of assumptions, including consideration of contrary or inconsistent evidence<sup>340</sup>". Other common shortcomings were "the failure to obtain sufficient persuasive evidence to support reliance on manual internal controls" and "the failure to sufficiently test controls over, or the accuracy and completeness of, data or reports produced by management". In the absence of a stringent liability laws, the auditing industry has failed to address even such basic problems.

With joint and several liability regimes partners had incentives to monitor each other as they were liable for each other’s debts and negligence awards. Such incentives are diluted in LLPs because partners are no longer liable for each other’s errors and omissions. The UK office of PwC has around 953 auditors; Deloitte, 696; Ernst & Young, 685 and KPMG around 623; it is doubtful that partners even know each other or regularly meet. Most have no interest in audit which is increasingly a smaller part of a firm’s revenue stream. The aggressive strategies prevalent for maximisation of consultancy revenues are not conducive to building sustained audit quality. Lax auditor liability laws are at the heart of the recurring auditing crisis with the result that:

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<sup>339</sup> Financial Reporting Council, Big Four Audit Quality Review results decline, 18 June 2018; <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline>

<sup>340</sup> The International Forum of Independent Audit Regulators, Survey of Inspection Findings 2017, 8 March 2018; <https://www.ifiar.org/?wpdmdl=7970>

“we have (i) a legal framework that effectively protects “partners” against personal liability; (ii) aggressive commercialisation of audit work; and (iii) blatant lapses in audit quality, evidenced by caseloads of palpably defective financial reports of public companies carrying unqualified audit opinions<sup>341</sup>”.

It may be challenging to roll-back the availability of limited liability companies and LLPs to auditing firms. Yet without personal liability auditor incentives to improve quality would remain deficient. Individuals and society must be empowered to sue negligent auditors. Auditors should owe a duty of care to individual stakeholders and the effect of the Caparo judgment must be rolled back. Key reforms must include pinning personal liability on audit partners and their firms for delivery of poor audits. An audit is manufactured within the organisational context of the firm, which provides training, personnel, commitment, communicative and operational competence, technology, client recruitment and infrastructure necessary for the production of all audits. The firm receives the fee and its name appears on the audit report. The firm is central to the production of audits and must be held liable for any shortcomings. Any liability agreement enabling auditors to escape liability must be null and void.

The veil of incorporation upon LLPs must be lifted and the Companies Act should be amended to state that where a partner of the audit firm acts negligently, fraudulently or colludes with directors then civil and criminal liability shall fall upon the partners concerned and upon the firm jointly and severally. Such a proposal does not penalise honest and diligent auditors and reminds them their negligence and collusion will have consequences for themselves and their firms. Here is an interesting extract from Section 147(5) of India’s Companies Act 2013 (Companies (Amendment) Act 2017).

"Where, in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally”.

## **RECOMMENDED REFORMS**

- Auditors must owe a ‘duty of care’ to individual stakeholders who have a reasonable justification for placing reliance upon auditors.
- The incidence of liability must act as a pressure point for improvement of audit quality. Individuals and society must be empowered to seek redress from negligent auditors
- There must be personal liability for audit failures upon partners responsible for audits.
- Where a partner of the audit firm acts negligently, fraudulently or has colluded in the perpetration of fraud and material irregularities, civil and criminal liability

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<sup>341</sup> Emile Woolf, Time to make LLP partners accountable, Accountancy, April 2018; [https://library.croneri.co.uk/acmag\\_193509](https://library.croneri.co.uk/acmag_193509)

must fall upon the partner or partners concerned and upon the firm jointly and severally.

- Class lawsuits must be permitted to empower stakeholders as many stakeholders are not always in a position to seek redress from negligent auditors.
- In the event of negligent and fraudulent practices, audit fees for the relevant years shall be returned to the audited entity.

## **CHAPTER 11**

### **ACCOUNTING FOR AUDITING FIRMS**

Auditing firms vary in size and significance from big four firms to small local firms. Almost all of them trade as limited liability partnerships and enjoy limits on liability and lucrative revenues from the state guaranteed monopoly of the external audit market. The bigger firms also advise government departments and local authorities; receive public contracts and deplete the public purse through tax avoidance. Their activities affect society and diverse stakeholders, but their financial reports provide little information about their operations or justification for many of their predatory practices. A major reason for this vacuum is that the firms are permitted to write their own rules about what they will or will not publish in their audited annual financial reports. Even worse, through the FRC, the accounting firms collude with their auditors to write the rules on accounting and auditing and commentators are saying that their accounts often fall “far short of the disclosure the law demands from their clients<sup>342</sup>”. The poor state of financial reporting by the big firms of their own affairs is further evidence of their indulgence by the regulators. It must end.

#### **ACCOUNTING FOR LLPs**

Limited liability partnerships (LLPs), with minor exceptions, are required by the Limited Liability Partnerships Act 2000 to publish audited financial statements. These should enable stakeholders to make sense of their operations, resources and public accountability, but all is not what it seems. The legislation itself is the outcome of the big firm’s disdain for public disclosures.

In response to demands from the accounting industry, the Companies Act 1989, permitted accountancy firms to trade as limited liability companies and secure liability protection for their members/partners. Limited liability status is usually accompanied by disclosure requirements i.e. publish audited financial statements and related information. As legal persons, companies are also taxed on their profits. However, big accountancy firms did not welcome disclosures or the possible loss of lucrative tax arrangements available to partnerships. They therefore campaigned to form limited liability partnerships (LLPs) which enabled them to secure liability protection for their partners and retain the tax advantages available to partnerships.

The Limited Liability Partnership Act 2000 and regulations made thereunder specified the broad financial reporting framework (for example see Limited Liability Partnerships Regulations 2001 (SI 2001/1090) which came into force on 6th April 2001<sup>343</sup>). However, the details were left to the Accounting Standards Board (ASB). At that time, the ASB was a subsidiary of the FRC and was responsible for developing accounting standards<sup>344</sup>. On 2 March 2000, the ASB invited the Consultative Committee of Accountancy Bodies (CCAB) to formulate what eventually became known as the Statement of Recommended Practice (SORP).

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<sup>342</sup> Financial Times, ‘Fab Four’ accountancy groups are too few to fail, 22 September 2017; <https://www.ft.com/content/e2b8a51c-9ee3-11e7-8b50-0b9f565a23e1>

<sup>343</sup> [http://www.legislation.gov.uk/ukxi/2001/1090/pdfs/ukxi\\_20011090\\_en.pdf](http://www.legislation.gov.uk/ukxi/2001/1090/pdfs/ukxi_20011090_en.pdf)

<sup>344</sup> On 2 July 2012, however, the FRC Board assumed responsibility for setting accounting standards

## ACCOUNTING CARTEL SETS THE RULES

### Financial Reporting

The Consultative Committee of Accountancy Bodies (CCAB) is a vehicle for promoting the joint interests of the UK accountancy trade associations. Since 1984, it has operated as a limited liability company (CCAB Limited) with total issued share capital of £1,000. The ICAEW is its majority shareholder. Other shareholders are the ACCA, ICAS, ICAI and CIPFA. In 2011, CIMA withdrew from CCAB over wrangling about the benefits from its financial contributions to the FRC<sup>345</sup>.

From the very beginning, the control of LLP accounting policymaking was predominantly in the hands of big accounting (and law) firms and their trade associations (Table 11.1<sup>346</sup>).

**TABLE 11.1**  
**Control of LLP Accounting SORP**

<b>Steering Committee</b>	
<b>Name</b>	<b>Links</b>
Graham Ward (Chairman)	The Institute of Chartered Accountants in England and Wales; PricewaterhouseCoopers partner
Michael Foulds	The Association of Chartered Certified Accountants (former President)
James Gemmell	The Institute of Chartered Accountants of Scotland; chairman of Horwath Clark Whitehill, previously partner at Deloitte
Peter Graham	The Law Society
Nigel Llewellyn	Association of Partnership Practitioners
Andrew Nairn	Construction Industry Council
Frances Paterson	Construction Industry Council
Richard Turnor	Association of Partnership Practitioners Observer
David Dean	Department of Trade and Industry
<b>Working Party</b>	
Nigel Llewellyn (Chairman)	Deloitte & Touche
Jeremy Boadle	Smith & Williamson
James Carty	RSM Robson Rhodes
Kathryn Cearns	Herbert Smith
Fiona Crozier	
Ian Dinwiddie	Allen & Overy
John Oliver	Bacon & Woodrow
John Robinson	Barclays Bank plc
Michael Roden	KPMG
Peter Saunders	Deloitte & Touche
Desmond Wright	CCAB

<sup>345</sup> <https://www.cimaglobal.com/Press/Press-releases/2011/CIMA-withdraws-from-the-CCAB/>

<sup>346</sup> Adapted from CCAB, Statement of Recommended Practice – Accounting by Limited Liability Partnerships, May 2002.

The domination by big accountancy firms has continued in all subsequent revisions of the SORPs. The 2014 working party consisted solely of partners from Deloitte, PwC, KPMG and Clark Whitehill<sup>347</sup>. The 2017 working party consisted solely of partners from Deloitte, PwC, KPMG, Clark Whitehill and BDO<sup>348</sup>. It should be noted that there are a number of sector specific SORPs e.g. for insurance industry. However, LLPs are not sector specific: they are found in numerous businesses, such as law, accounting, surveying, architects, engineering and numerous other lines of business. The case for handing over the formulation of accounting rules to the accountants and lawyers is correspondingly weak. Accounting firms also audit LLPs. For example PwC's 2017 financial statements are audited by Crowe Clark Whitehill<sup>349</sup>, a firm that sat with PwC to write the accounting rules. The auditor cannot be considered to be independent.

### Transparency Reporting

The Statutory Audit Directive, which came into force in 2006, introduced a mandatory requirement for annual transparency reporting by auditors of UK companies with securities admitted to trading on a UK regulated market. In the UK, effect was given to this through the Statutory Auditors (Transparency) Instrument 2008 and applies in respect of any financial year of a relevant audit firm starting on or after 6 April 2008. The rules have subsequently been revised by Regulation (EU) No 537/2014<sup>350</sup> which requires the publication of the following information:

- (a) a description of the legal structure and ownership of the audit firm;
- (b) where the statutory auditor or the audit firm is a member of a network:
  - (i) a description of the network and the legal and structural arrangements in the network;
  - (ii) the name of each statutory auditor operating as a sole practitioner or audit firm that is a member of the network;
  - (iii) the countries in which each statutory auditor operating as a sole practitioner or audit firm that is a member of the network is qualified as a statutory auditor or has his, her or its registered office, central administration or principal place of business;
  - (iv) the total turnover achieved by the statutory auditors operating as sole practitioners and audit firms that are members of the network, resulting from the statutory audit of annual and consolidated financial statements;
- (c) a description of the governance structure of the audit firm;
- (d) a description of the internal quality control system of the statutory auditor or of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;

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<sup>347</sup> CCAB, Statement of Recommended Practice - Accounting by Limited Liability Partnerships, 15 July 2014; <http://www.ccab.org.uk/documents/LLPSORPFinal.pdf>

<sup>348</sup> CCAB, Statement of Recommended Practice - Accounting by Limited Liability Partnerships, 26 January 2017; <http://www.ccab.org.uk/documents/FinalSORP26012017.pdf>

<sup>349</sup> As per <https://www.pwc.co.uk/annualreport/assets/2017/pdf/annual-report-2017-financial-statements.pdf>

<sup>350</sup> <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>

- (e) an indication of when the last quality assurance review referred to in Article 26 was carried out;
- (f) a list of public-interest entities for which the statutory auditor or the audit firm carried out statutory audits during the preceding financial year;
- (g) a statement concerning the statutory auditor's or the audit firm's independence practices which also confirms that an internal review of independence compliance has been conducted;
- (h) a statement on the policy followed by the statutory auditor or the audit firm concerning the continuing education of statutory auditors referred to in Article 13 of Directive 2006/43/EC;
- (i) information concerning the basis for the partners' remuneration in audit firms;
- (j) a description of the statutory auditor's or the audit firm's policy concerning the rotation of key audit partners and staff in accordance with Article 17(7);
- (k) where not disclosed in its financial statements within the meaning of Article 4(2) of Directive 2013/34/EU, information about the total turnover of the statutory auditor or the audit firm, divided into the following categories:
  - (i) revenues from the statutory audit of annual and consolidated financial statements of public-interest entities and entities belonging to a group of undertakings whose parent undertaking is a public-interest entity;
  - (ii) revenues from the statutory audit of annual and consolidated financial statements of other entities;
  - (iii) revenues from permitted non-audit services to entities that are audited by the statutory auditor or the audit firm; and
  - (iv) revenues from non-audit services to other entities.

The statutory auditor or the audit firm may, in exceptional circumstances, decide not to disclose the information required in point (f) of the first subparagraph to the extent necessary to mitigate an imminent and significant threat to the personal security of any person. The statutory auditor or the audit firm shall be able to demonstrate to the competent authority the existence of such threat.

The transparency report shall be signed by the statutory auditor or the audit firm.

The EU reporting requirements are also the outcome of lobbying and agenda shaping by the big firms, which is rarely studied.

## **FIRMS ARE ECONOMICAL WITH INFORMATION**

### **Poor Financial Reports**

The financial reports published by the auditing firms are described as 'true and fair' which in its broadest is taken to mean that all material information for appreciation of financial statements is provided. However, that is rarely the case. The firms, or their network, have links with numerous offshore entities<sup>351</sup> through which they market tax

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<sup>351</sup>Moran Harari, Markus Meinzer and Richard Murphy, Financial Secrecy, Banks and the Big 4 Firms of Accountants, Tax Justice Network, 2012, [https://www.taxjustice.net/cms/upload/pdf/FSI2012\\_BanksBig4.pdf](https://www.taxjustice.net/cms/upload/pdf/FSI2012_BanksBig4.pdf); Chris Jones, Yama

avoidance schemes. Those links have been highlighted by parliamentary committees<sup>352</sup> and whistleblowers (for example, see Panama Papers<sup>353</sup>, Luxembourg leaks<sup>354</sup>, Swiss leaks<sup>355</sup> and the Paradise Papers<sup>356</sup>). Yet the firms do not provide any list of their offshore links though equivalent limited liability companies are required to provide information about group structure, subsidiaries and affiliates. The firms do not provide information about lawsuits i.e. contingent liabilities, fines or regulatory action, all of which are of interest to a wide variety of stakeholders interested in making assessments of the quality of services or even viability of the firms. There is no mention of how much of the fines have been paid through insurance or by partners themselves or deferred onto to future entrants to the partnerships. Auditing firms have insurance arrangements with captive insurance companies i.e. the companies controlled by the firms and/or their partners, but no information is available<sup>357</sup>.

Some firms separately disclose fees from major business segments, such as accounting and auditing, but many do not, and that deficiency makes it difficult to know the marginalisation of audits within the firms. The LLP accounts show the total profits attributable to partners but the amounts received by each partner (equivalent to executive pay in companies) are not shown, though as part of a beauty parade some firms identify the highest paid partner. Some partners receive incentives and bonuses and these are not identified. No data is provided about profits from tax avoidance schemes, the number of court cases won/lost or pending, or action by regulators.

### **Poor Transparency Reports**

The Transparency Reports are also deficient. PwC's 2016, 88 page Transparency Report provided information which is already publicly available. It said:

"We have four open investigations (FY15: five) in respect of certain audits of the financial statements of BHS Limited, Tesco PLC, RSM Tenon Group plc and our reporting on Barclays' compliance with the FSA client asset rules. The FRC has served formal complaints, following its investigation of our 2010 audit work on Connaught plc and a tribunal hearing is due to start in November 2016, involving the firm and the former engagement partner. A settlement has been reached following the FRC's investigation of our 2007

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Temouri and Alex Cobham, Tax haven networks and the role of the Big 4 accountancy firms, *Journal of World Business*, Vol 53, Issue 2, February 2018, pages 177-193.

<sup>352</sup> House of Commons Committee of Public Accounts, Tax avoidance: the role of large accountancy firms (follow-up), 28 January 2015;

<https://publications.parliament.uk/pa/cm201415/cmselect/cmpublic/1057/1057.pdf>

<sup>353</sup> <https://www.icij.org/investigations/panama-papers/>

<sup>354</sup> <https://www.icij.org/investigations/luxembourg-leaks/>

<sup>355</sup> <https://www.icij.org/investigations/swiss-leaks/>

<sup>356</sup> <https://www.icij.org/investigations/paradise-papers/>

<sup>357</sup> Arthur Andersen (now defunct) had professional liability cover with a captive insurance company. When faced with claims, it was found that the insurance company was insolvent - <https://www.insurancejournal.com/magazines/mag-features/2002/05/13/21740.htm>

audit of Cattles plc. Further details of the FRC's investigations and proceedings can be found within the Conduct section of the FRC website<sup>358</sup>

The 2017 report<sup>359</sup> did not contain any information about the progress or the outcome of the cases relating to BHS, Tesco, RSM Tenon or Barclays. The 2018 Transparency Report<sup>360</sup> contained six mentions, mainly defensive, of "BHS", an audit failure discussed in the earlier parts of this report. However, PwC did not provide any information about the penalties imposed by regulators or the social consequences of the firm's failure e.g. impact on employees, pension scheme members, suppliers, SMEs, taxpayers or why after over a century in business it is unable to deliver robust audits though there are plenty of apple-pie and motherhood statements in the reports.

On 5 August 2015, the FRC announced that it will investigate the past audits of Quindell Plc<sup>361</sup> conducted by KPMG. On 11 June 2018, KPMG was by the FRC<sup>362</sup>. It is not too unreasonable to expect that KPMG's 2016<sup>363</sup> and 2017<sup>364</sup> transparency reports would make some reference to the case, but they do not. This is the only mention of Quindell Plc in KPMG's 2018 transparency report: "following a settlement with the FRC in relation to the audit of the financial statements of Quindell plc for the period ended 31 December 2013, KPMG and the engagement Partner each received a reprimand and fines of £3.1 million and £84,000 respectively; and KPMG paid £146,000 towards the FRC's costs<sup>365</sup>". No information is provided about the matters are stake, the consequences or whether KPMG is a repeat offender, is provided. Seemingly, the transparency reports are just another marketing vehicle for the firms.

The transparency reports are silent about the business tactics of the firms. The firms hire potential and former ministers, advise government departments and have colonised public bodies to advance their business interests. They fund political parties, support individual legislators and lobby policymakers. Yet such matters are rarely disclosed in any annual report or the transparency report. The big four firms are ranked among the worst offenders for not disclosing how they engage with politicians. A report by Transparency International<sup>366</sup> awarded grade F, the lowest possible, to Ernst & Young for disclosing information about political engagements. Deloitte and PwC showed "fairly poor standards" and received D grade and KPMG secured a C.

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<sup>358</sup> <https://www.pwc.co.uk/annualreport/assets/2016/pdf/annual-report-2016-transparency-report.pdf>

<sup>359</sup> <https://www.pwc.co.uk/annualreport/assets/2017/pdf/annual-report-2017-transparency-report.pdf>

<sup>360</sup> <https://www.pwc.co.uk/annualreport/assets/2018/pdf/uk-transparency-report-18.pdf>

<sup>361</sup> <https://www.frc.org.uk/news/august-2015/quindell-plc>

<sup>362</sup> <https://www.frc.org.uk/news/june-2018/sanctions-in-relation-to-the-audit-of-quindell-plc>

<sup>363</sup> <https://home.kpmg.com/content/dam/kpmg/be/pdf/kpmg-transparency-report-2016.pdf>

<sup>364</sup> <https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/12/transparency-report-2017.pdf>

<sup>365</sup> <https://assets.kpmg.com/content/dam/kpmg/uk/pdf/2018/12/annual-report-2018-transparency-report.pdf>

<sup>366</sup> Transparency International, Corporate Political Engagement Index 2018, London: TI, November 2018; <https://www.transparency.org.uk/publications/cpei2018/>

The transparency reports provide information about the composition of the firm boards, the number of UK partners, offices and related entities. PwC provides a list of the members of the network carrying out statutory audits in EU and members countries. The names of the PIEs audited by the firm are provided. However, no information is provided about the offshore entities connected with the firms. PwC's 2018 transparency report lists individuals who are members of the "global board" and makes extensive references to 'global network, creating the impression that is a global entity. Then it helpfully adds that "The PwC network is not a global partnership, a single firm, or a multinational corporation ... PwC network consists of firms which are separate legal entities. The firms that make up the network are committed to working together to provide quality service offerings for clients throughout the world. Firms in the PwC network are members in, or have other connections to, PricewaterhouseCoopers International Limited (PwCIL), an English private company limited by guarantee<sup>367</sup>". This is helpful but poses more questions. Who owns the name "PricewaterhouseCoopers"? Do all the firms in the network have common standards? If a firm in the network passes audit business to another member of the network, why are the stakeholders of that business not told? What happens when regulators arrive and want to examine files held by the other firm in the network? For example, Price Waterhouse (now part of PwC) secured the audit of the Bank of Credit and Commerce International (BCCI) with the claim that it was a global firm, but such a claim dissolved when the US regulators asked for files and papers.<sup>368</sup>. A US Senate Committee investigating audit failures at BCCI noted that

"The main audit of BCCI was done by Price Waterhouse UK. They are not permitted, under English law, to disclose, at least they say that, to disclose the results of that audit, without authorization from the Bank of England. The Bank of England, so far -- and we've met with them here and over there -- have not given that permission. The audit of BCCI, financial statement, profit and loss balance sheet that was filed in the State of New York was certified by Price Waterhouse Luxembourg. When we asked Price Waterhouse US for the records to support that, they said, oh, we don't have those, that's Price Waterhouse UK. We said, can you get them for us? They said, oh, no that's a separate entity owned by Price Waterhouse Worldwide, based in Bermuda<sup>369</sup>".

Price Waterhouse (UK) refused to comply with US Senate subpoenas for documents with the claims that "the British partnership of Price Waterhouse did not do business in the United States and could not be reached by subpoena".

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<sup>367</sup> <https://www.pwc.co.uk/annualreport/assets/2018/pdf/uk-transparency-report-18.pdf>

<sup>368</sup> Patricia Arnold and Prem Sikka, Globalization and the State-Profession Relationship: The case of the Bank of Credit and Commerce International, Accounting, Organizations and Society, Vol. 26, No. 6, 2001, pp. 475-499.

<sup>369</sup> US Senate Committee on Foreign Relations, The BCCI Affair (A Report by Senator John Kerry and Senator Hank Brown), Washington DC: USGPO, 1992.

After the Parmalat accounting scandal in Italy, Grant Thornton said that “the Italian practice - one of Parmalat's auditors - was merely a member firm of an international network. It was independently owned and operated<sup>370</sup>”.

The firms' structure enables them to secure business with the claim that they are 'global', but escape liability and regulatory action by claiming to be local entities. Regulators might believe that an audit report signed by a local firm signifies that the audit was produced locally and might later learn that part of the work was carried out by a foreign affiliate, but would not be able to force the foreign affiliate to cooperate because it is subject to the laws of another country. The transparency reports did not provide any information about the circumstances under which the affiliated firms would cooperate with foreign regulators, or otherwise.

It is commonly understood that the firms are owned by their partners, but partners' interests may well be routed through obscure offshore arrangements as shown by the quotes above. Such information is not provided in the annual financial or the transparency reports. The absence of information about ownership, control and conflicting loyalties disrupts investigation of audit failures. As part of its inquiry into the collapse of Barings Bank, the Bank of England (BoE) focused on the audit work performed in Singapore, the principal site of frauds at the bank. I sought access to the Singapore audit files and staff of Coopers & Lybrand (C&L) and Deloitte & Touche (D&T) but the audit firms did not cooperate<sup>371</sup>. The transparency reports provide some information about ownership but it is not complete. The firms are also silent

## **SUMMARY AND DISCUSSION**

Auditing firms trade as LLPs and enjoy the benefits of limited liability. Their audit and consultancy practices have consequences for stakeholders and society. The financial and transparency reports published by auditing firms are very economical with information though one might have expected the guardians of corporate accountability to publish meaningful information about their affairs. A major reason for the failure is the capture of the FRC by the big firms. Consequently, they are permitted to write their own accounting rules and fail to provide vital information. At the FRC forums auditors and auditees collude to produce rules for accounting and auditing though a charade of independence is maintained. Unsurprisingly, most of the information which might enable stakeholders to make assessments about the firms' performance is not published. The firms must not be permitted to write the rules for their own accountability. The very fact that such privileges are enjoyed by the big firms shows that the FRC is unfit to be a regulator.

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<sup>370</sup> Accountancy Daily, Special Reports - Parmalat - Myth, reality and the global firm, 1 February 2004, <https://www.accountancydaily.co/special-reports-parmalat-myth-reality-and-global-firm>

<sup>371</sup> Bank of England, Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings, London: HMSO, 1995.

## RECOMMENDED REFORMS

- Auditing firms must not be permitted to write their own accounting, auditing and financial reporting rules.
- Auditors and auditees must not collude and fix financial reporting and auditing rules for LLPs.
- Accounting trade associations must not be permitted to write accounting rules for businesses controlled by their members.
- Auditing firms must provide socially useful information about their operations, including information about their offshore links, captive insurance companies, political links, audit failures, cooperation with regulators, regulatory action, lawsuits and profits from predatory practices.
- The contents of financial and transparency reports must form part of a revised Companies Act, or equivalent legislation, so that the requirements can be enforced to secure consistency and empowerment of stakeholders.

## **CHAPTER 12 REGULATORY STRUCTURES**

The previous chapters drew attention to numerous failures in the audit industry. The responsibility of that must rest with the regulators for presiding over a failed system that delivers so little. How should the effectiveness of a regulatory system be assessed? Our response is that it needs to meet the objectives of a good regulatory system. There are broadly two objectives of a regulatory system: to protect consumers, taxpayers and the public in general from harmful practices; and promote stability, predictability and confidence in the system by addressing systemic factors which transcend the concerns of individual consumers and producers of audit opinions. Auditing regulators have failed to meet the above objectives.

The objectives of a good system need to be translated into principles of regulation to guide the regulators in their daily practices and actions. The key principles are that the regulators' must protect the interests of the people, and not promote the interests of the industry. Regulators must be independent of those who are to be regulated. The same organisation should not be both responsible for lobbying and representing the sectoral interests of an industry and provide supervision and enforcement actions over that sector. People should be able to exercise strategic oversight on regulators. Regulators must be publicly accountable for the efficiency and effectiveness of their action and activities, while remaining independent in the decisions they take. Regulators must operate with transparency especially as regards decisions involving enforcement and settlement of complaints and charges. Regulators must investigate shortcomings on a timely, efficient and effective basis and take remedial action. Regulators must be proactive, anticipate emerging issues and ensure that the system is capable of dealing with them. All regulations should be written so that they are easily understood, easily implemented, and easily enforced, and societal stakeholders, not just the industry, should be consulted when they are being drafted. The audit firms that persistently deliver substandard audits should be identified quickly and face proportionate and robust sanctions. Financial sanctions, fines and other penalties imposed by regulatory bodies should be used in priority to compensate victims of abuses or where appropriate to contribute to the overall costs of regulation; sanctions by way of criminal prosecution should where possible be focused on the punishment of responsible individuals and the recovery of ill-gotten personal gains.

The auditing regulators have failed to meet the above principles and objectives of good regulation. They are aligned with the interests of the auditing industry. The RSBs and the FRC do not meet the above tests and need to be replaced. Under their watch, the quality of financial reporting and audit quality has remained poor, and possibly deteriorated. Failures are not investigated on a timely basis. There is little effective action against firms consistently delivering poor audits and people have not been protected from predatory practices.

## NO STATUTORY REGULATORY POWERS FOR THE ACCOUNTANCY TRADE ASSOCIATIONS

The accountancy trade associations in their capacity as Recognised Supervisory Bodies (RSBs) act as statutory regulators for the auditing industry. These are currently the ICAEW, ACCA, ICAS and CAI (see chapter 2). They licence auditors, assess audit quality; make rules about ethics, standards of accounting and auditing, albeit through the FRC which they fund, and discipline auditors not connected to PIEs. The RSBs do not have any independence from their members and were indeed formed to advance the collective interests of their members. They promote the auditing industry. The earlier parts of this report documented that the RSBs have opposed reforms, such as compulsory rotation of audit firms and restraints on auditor ability to sell non-auditing services to audit clients though eventually they grudgingly accepted some constraints. When the charade of ethical codes is exposed by dubious practices of the firms, they tweak them to ensure that profit-making by the firms takes priority<sup>372</sup>. They have failed to develop mechanisms for public accountability of auditing firms or exposure of audit quality. The ICAEW has played a major role in the big firm campaigns to secure liability concessions for big firms, which has weakened the pressure points upon auditors for delivery of good audits<sup>373</sup>. It was key player in enabling the firms to hold the UK government to ransom and demand that firms be given LLPs or they will cause economic chaos<sup>374</sup>.

Numerous court judgements have shown that big firms of auditors have sold unlawful tax avoidance schemes to their audit clients and then audit the very transactions resulting from their schemes. Yet no big firm has ever been disciplined or fined<sup>375</sup>. One accountancy body, ACCA, even had the temerity to inform a court that it was somehow above the law and that the public courts did not have the authority to hear complaints from its own students and members<sup>376</sup>. After interventions by the Lord Chancellor, the body sent a grovelling apology to the Lord Chancellor, but neither its in-house magazine nor any of its annual reports ever mentioned this unique case in the UK regulatory history.

The UK economy has suffered from a series of bank collapses for the last fifty years and each has exposed regulatory shortcomings. Successive governments have sought to shore up the system by tweaking auditor duties and requiring financial sector auditors to report irregularities to the regulators. Such obligations were

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<sup>372</sup> Austin Mitchell, Tony Puxty, Prem Sikka and Hugh Willmott "Ethical Statements as Smokescreens for Sectional Interests: The Case of the UK Accountancy Profession", *Journal of Business Ethics*, Vol. 13, No. 1, 1994, pages 39-51.

<sup>373</sup> Jim Cousins, Austin Mitchell and Prem Sikka, "Auditor Liability: The Other Side of the Debate", *Critical Perspectives on Accounting*, Vol. 10, No. 3, 1999, pp. 283-312;

<sup>374</sup> Prem Sikka, "Globalization and its Discontents: Accounting Firms Buy Limited Liability Partnership Legislation in Jersey", *Accounting, Auditing and Accountability Journal*. Vol. 21, No. 3, 2008, pp. 398-426.

<sup>375</sup> Austin Mitchell and Prem Sikka, "The Pin-Stripe Mafia: How Accountancy Firms Destroy Societies", Basildon: Association for Accountancy & Business Affairs, 2011

<sup>376</sup> Austin Mitchell and Prem Sikka, "Accountability of the Accountancy Bodies: The Peculiarities of a British Accountancy Body", *British Accounting Review*, Vol. 36, No. 4, 2004, pp. 395-414.

opposed by the accountancy bodies<sup>377</sup>. Even after mega frauds at BCCI, the ICAEW opposed the imposition of a statutory audit upon bank auditors to report frauds to the regulators<sup>378</sup>. This was in line with the policies advanced by the big firms in their evidence to parliamentary committees<sup>379</sup>. As the government sought to impose a statutory duty, the FRC published a draft auditing standard stating that auditors "have no responsibility to carry out procedures to search out the information relevant to the regulator<sup>380</sup>) and more specifically, auditors were being urged not to "undertake work specifically designed to search for reportable items<sup>381</sup>". Eventually, in the teeth of opposition, the government imposed a statutory duty upon auditors to report irregularities to regulators though it failed to impose a statutory duty to look for them.

In keeping with its trade association traditions, the accountancy bodies have a long history of opposing reforms and often align themselves with the corporate lobby. For example, the ICAEW opposed the obligation upon companies to publish fees paid to auditors for the sale of non-auditing services to audit clients<sup>382</sup>. It claimed that disclosure is not particularly useful<sup>383</sup> and will give "ammunition to those who want to use it for the detriment of the profession<sup>384</sup>". This is not an isolated case of opposition to disclosures. The ICAEW has opposed the legislation requiring companies to publish profit and loss account, group and consolidated accounts, replacement costs of assets, movements on their reserves, and turnover, just to mention a few items<sup>385</sup>. It is hard to see much evidence of thought leadership or any concern with advancing social accountability and welfare through disclosures which can enable the public to call powerful corporations to account. It is also rare for the accountancy bodies to advance reforms which make big auditing firms accountable to the public.

Despite being statutory regulators, the accountancy bodies have routinely acted purely as self-interested parties in their representations to the state, concerned only to protect the economic interests of their economically powerful constituents, the audit firms. It is impossible to reconcile their consistent opposition to reforms with any notion of a public regulator.

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<sup>377</sup> Prem Sikka, Anthony Puxty, Hugh Willmott and Christine Cooper, "The Impossibility of Eliminating the Expectations Gap: Some Theory and Evidence", *Critical Perspectives on Accounting*, Vol. 9, No. 3, 1998, pp. 299-330.

<sup>378</sup> Bingham, Lord Justice, (1992). 'Inquiry into the Supervision of The Bank of Credit and Commerce International', London, HMSO

<sup>379</sup> House of Commons Treasury and Civil Service Committee, *Banking Supervision and BCCI: International and National Regulation*, London: HMSO, 1992.

<sup>380</sup> Auditing Practices Board, *Proposed Statement of Auditing Standards - Exposure Draft: The Auditors' right and Duty to Report to Regulators in the Financial Sector*, London: Auditing Practices Board, 1993, para 3.

<sup>381</sup> *Accountancy Age*, 29 July 1993, page 9.

<sup>382</sup> Austin Mitchell and Prem Sikka, "Accounting for Change: The Institutions of Accountancy", *Critical Perspectives on Accounting*, 1993, Vol. 4, No. 1, pages 29-52.

<sup>383</sup> *Financial Times*, 28th September 1991, page 4; *The Independent on Sunday*, 6th October 1991, page 11

<sup>384</sup> *Financial Times*, 19th June 1991, page 14

<sup>385</sup> Tony Puxty, Prem Sikka and Hugh Willmott, (Re)Forming the Circle: Education, Ethics and Accountancy Practices, *Accounting Education*, Vol. 3, No. 1, 1994, pp. 77-92.

## THE FINANCIAL REPORTING COUNCIL HAS FAILED

Chapter 2 provided some background to the FRC and its colonisation by big firms and corporations. As a result, it has acted more as a cheerleader rather than a regulator of the accounting industry. The FRC was established after Sir Ron Dearing's report of 1988 'The Making of Accounting Standards' which called for the formation of the Accounting Standards Board to set accounting standards (ASB). The ASB was accompanied by the Auditing Practices Board (APB), responsible for setting auditing standards, and Financial Reporting Review Panel (FRRP), with powers to force company directors to correct defective accounts. The ASB, APB and the FRRP were to be subsidiaries of the FRC. The FRC's main role was to generate financial support for its subsidiaries. Following the enactment of the Companies Act 1989, the new apparatus became operational in 1990. Gradually more tasks were grafted on to the FRC, including responsibility for promulgation of codes of corporate governance, codes of ethics, stewardship code; regulator of actuaries, money laundering and disciplining of FTSE 350 auditors. The FRC has no power to enforce codes of corporate governance or take action against any accounting firm involved in money laundering or tax avoidance. It never had any real distance from the accountancy trade associations who fund it though some of the funding also comes from levies on corporations and in the recent past it also received some public money. The FRC legitimised its existence by claiming that it is a public body and formally secured that status in 2004<sup>386</sup>. However, it has shunned the public accountability practices that accompany such a status and successive governments did not check the contradictions. It has remained a vehicle for private interests.

The FRC showed little urgency in addressing accounting and audit failures or taking remedial action. The Enron and WorldCom scandals exposed poor accounting and auditing practices. The 2007-08 banking crash exposed weakness of the accounting/auditing standards and audit quality regime overseen by the FRC. It failed to investigate audit failures leading to the financial crash. The FRC's response was to push International Financial Reporting Standards (IFRS), which were also promoted by the European Union. The poverty of the IFRSs was exposed by the 2007-08 crash and little of substance changed on the auditing front. It shows no urgency and many of its disciplinary reports take years to appear. In some cases, the FRC soothed public anxieties by announcing investigation of headline audit failures, but some time later quietly abandoned the investigations. Under its watch, poor audit quality has continued. Even when it became aware of poor audit quality at big firms, it took little/no action. It was urged by the Banking Standards Commission and various parliamentary committees to embrace reforms which necessarily would have required it to put some distance between itself and corporate interests, but it took little action. The BHS and Carillion audit failures were the final straws and persuaded the House of Commons Work and Pensions Committee and the Business, Energy

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<sup>386</sup> Hansard, House of Lords Written Question HL8896, 25 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-06-25/HL8896/>

and Industrial Strategy Committee (BEIS) to describe the FRC as “useless” and “toothless<sup>387</sup>”.

## Faulty Standards

The BHS, Carillion and bank audits have raised the familiar question – was the business a going concern? This requires good awareness of the business models of the companies. There were visible danger signals, but auditors did not mention anything in the audit reports. All too often auditors seek refuge in auditing standards issued by the FRC. The UK auditing standard on going concern advises auditors:

“when there is a history of profitable operations and a ready access to financial resources, management may make its [going concern] assessment without detailed analysis. In this case, the auditor’s evaluation of the appropriateness of management’s assessment may be made without performing detailed evaluation procedures if the auditor’s other audit procedures are sufficient to enable the auditor to conclude whether management’s use of the going concern basis of accounting in the preparation of the financial statements is appropriate in the circumstances<sup>388</sup>”.

The above passiveness may help auditors to economise on audit effort but does not lead to good audits. The FRC has consistently promoted passive approaches to going concern evaluations<sup>389</sup> and little has been learnt from past audit failures. The encouragement to attach undue weight to management representations on going concern matters at BHS was one of the reasons for audit failures

## No Urgency

The FRC has been described as “an extraordinarily useless body even by the standards of UK regulators<sup>390</sup>” and “it has been far too close to the industry it purports to regulate, and its instincts are to delay and conceal<sup>391</sup>”. A parliamentary report on the collapse of Carillion added that “we have little faith in the ability of the FRC to

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<sup>387</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018, <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>.

<sup>388</sup> Financial Reporting Council, International Standard on Auditing (UK) 570 (Revised June 2016): Going Concern, June 2016; [https://www.frc.org.uk/getattachment/8eab510c-17a7-4ac5-a91a-fc590bb3d7dd/ISA-\(UK\)-570.pdf](https://www.frc.org.uk/getattachment/8eab510c-17a7-4ac5-a91a-fc590bb3d7dd/ISA-(UK)-570.pdf)

<sup>389</sup> Prem Sikka, "Audit Policy-making in the UK: The Case of "The auditor's considerations in respect of going concern", *European Accounting Review*, Vol. 1, No. 2, 1992, pp. 349-392.

<sup>390</sup> Ruth Sunderland. The bean counters deserve a roasting - it's time for the 'big four' accountants to be held to account, *Mail on Sunday*, 15 April 2018; <http://www.thisismoney.co.uk/money/article-5616377/lts-time-big-four-accountants-finally-held-account.html>

<sup>391</sup> Ruth Sunderland, How to start an audit of the Big Four accountancy giants... break them up, *Mail on Sunday*, 17 June 2018; <http://www.thisismoney.co.uk/money/comment/article-5851857/RUTH-SUNDERLAND-start-audit-Big-Four-break-up.html>.

complete important investigations in a timely manner ...<sup>392</sup>. Baroness Sharon Bowles, a former Member of the European Parliament added that

“The FRC is fatally flawed in the way it was set up and has been operating, and distance needs to be put between that culture and the future regulator. This is most likely to be effective if the FRC is wound up and a comprehensive, fully accountable companies regulator set up that is not based on trade association relationships and which follows fully all the principles of public life<sup>393</sup>”.

Almost all distressed banks received an unqualified audit report on their accounts, immediately before their collapse. In some cases, the banks collapsed within days/weeks of receiving unqualified audit reports<sup>394</sup>. The FRC did not investigate the systemic failures and has taken no action against the auditors. Under pressure from parliamentary committees to investigate the 2007-08 audit failures at HBOS, the FRC finally moved but abandoned the investigation in 2017. The FRC has offered no evidence to support its conclusions. Following criticisms from the Treasury Committee, FRC admitted that it “should have adopted a more proactive role and acted more quickly<sup>395</sup>”.

The FRC announced its investigation of the BHS audits on 27 June 2016 and announced its findings on 12 June 2018. In the two year period, it only investigated the 2014 audit even though the problems, as noted in the parliamentary report, went back to earlier years. On 12 September 2018, the chairs of the House of Commons Work and Pensions Committee and the BEIS Committee inquired about the reasons for the omissions. The FRC chief executive replied (on 16 October 2018) to say that “we do not, as a matter of course, open new investigations into previous audit years where steps have already been taken to safeguard the public interest and sanctions have been imposed on those who fall within the scope of our regulatory remit<sup>396</sup>”. It is hard to see how any remedial policies or standards can be developed without a comprehensive investigation of the failures. Another reason given by the FRC chief executive was that the organisation has “finite resource”. This sits uneasily with the

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<sup>392</sup> House of Commons Business, Energy and Industrial Strategy and Work and Pensions Committees, Carillion, London: House of Commons, May 2018, <https://publications.parliament.uk/pa/cm201719/cmselect/cmworpen/769/769.pdf>.

<sup>393</sup> Investment Pensions Europe, Former MEP says ‘fatally flawed’ FRC should be shut down, 15 June 2018; <https://www.ipe.com/pensions/pensions/pensions-accounting/former-mep-says-fatally-flawed-frc-should-be-shut-down/10025209.article>

<sup>394</sup> Prem Sikka, “Financial Crisis and the Silence of the Auditors”, *Accounting, Organizations and Society*, Vol. 34, No. 6-7, 2009, pp. 868-873.

<sup>395</sup> Financial Reporting Council, The FRC’s enquiries and investigation of KPMG’s 2007 and 2008 audits of HBOS, November 2017; <https://www.frc.org.uk/getattachment/646bb35a-f39f-4d75-a12e-6d2480e0b2a7/HBOS-Report-Nov-2017-FINAL.pdf>

<sup>396</sup> Letter from the FRC chief executive to the chairs of the House of Commons Work and Pensions Committee and the BEIS Committee, 16 October 2018; [https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/SH\\_to\\_FF\\_FRC\\_BHS\\_Taveta\\_161018.pdf](https://www.parliament.uk/documents/commons-committees/work-and-pensions/Correspondence/SH_to_FF_FRC_BHS_Taveta_161018.pdf)

FRC's official statement is that "We will spend £2.2m less than we budgeted for in 2016/17<sup>397</sup>" and "We have spent less than we budgeted for in 2017/18<sup>398</sup>".

The FRC has a poor record in conducting robust and timely investigations. Its investigation of audit failures at MG Rover, audited by Deloitte & Touche, was announced in August 2005. The outcome was not finalised until April 2015. On appeal, the fine on auditors was reduced to £3 million, the derisory nature of which is evident when it is appreciated that between 2000 and 2005 Deloitte received £30.7m in audit and non-audit fees.

An investigation into the financial statements of iSoft Group Plc for the years 2003-2005 was announced in October 2006. Interim reports appeared in 2010 and 2011 and the matter being finalised in August 2013. An investigation of the 2007 and 2008 audits of Aero Inventory Plc by Deloitte began in March 2011 and the report was only published in November 2016<sup>399</sup>. In the case of Cattles Plc, the FRC announced an investigation into the role of PricewaterhouseCoopers in the company's accounts for 2007 and 2008. A report was published in August 2016. In November 2010, FRC announced an investigation of the 2009 audit of Connaught Plc conducted by PwC. The final report appeared on 31 May 2017. In August 2015, an investigation into the Grant Thornton audits of Quindell Plc<sup>400</sup> for the years 2011, 2013 and 2014 was launched and a report appeared nearly three years later in June 2018.

In May 2018, a former senior executive at the UK software firm Autonomy was convicted of fraud in the US<sup>401</sup>. The executive had artificially inflated the firm's financial position before its sale to Hewlett Packard in 2011 for £7.1 billion. Prosecutors argued that some of the irregularities went back to 2009. Upon discovering the irregularities, Hewlett Packard was forced to write-off most of the value of Autonomy. Attention focused on Deloitte, Autonomy's auditors. On 11 February 2013, the FRC announced an investigation of the published financial reports of Autonomy for the period between 1 January 2009 and 30 June 2011. It claimed that the investigation had been held up by the court case. On 31 May 2018, it announced possible disciplinary action against Deloitte<sup>402</sup>. A report is still awaited.

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<sup>397</sup> Financial Reporting Council, Plan & Budget and Levies 2017/18, March 2017; <https://www.frc.org.uk/getattachment/960b13a7-84b7-400e-92bd-21cc379570a8/Plan-and-budget-and-levies-2017-18.pdf>

<sup>398</sup> Financial Reporting Council, Strategy 2018/21 - Budget and Levies 2018/19, March 2018; [https://www.frc.org.uk/getattachment/644a8555-41b3-45c8-8f09-51114f2183ff/FRC-Strategy-2018-21-\(March-2018\).pdf](https://www.frc.org.uk/getattachment/644a8555-41b3-45c8-8f09-51114f2183ff/FRC-Strategy-2018-21-(March-2018).pdf)

<sup>399</sup> Financial Reporting Council, Deloitte LLP and John Clennett fined for Misconduct in relation to Aero Inventory Plc; <https://www.frc.org.uk/news-and-events/frc-press/press/2016/november/deloitte-llp-and-john-clennett-fined-for-misconduct.aspx>

<sup>400</sup> Financial Reporting Council, Sanctions in relation to the audit of Quindell plc, 11 June 2018; <https://www.frc.org.uk/news/june-2018/sanctions-in-relation-to-the-audit-of-quindell-plc>

<sup>401</sup> BBC News, Autonomy ex-executive guilty of fraud, 1 May 2018; <https://www.bbc.co.uk/news/business-43959468>

<sup>402</sup> Financial Reporting Council, Disciplinary action in relation to Autonomy Corporation plc, 31 May 2018; <https://www.frc.org.uk/news/may-2018/disciplinary-action-in-relation-to-autonomy-corporation>

In early 2018, Carillion collapsed but there is no sight of the report on audit failures. In June 2016, an investigation of the 2011 and 2012 audits of Serco<sup>403</sup> by Deloitte began, but no report has been published. . In June 2015, FRC announced that it will investigate the conduct of KPMG in relation to its reports to the financial sector regulator on BNY Mellon's compliance with the client asset rules for the years 2007 to 2011<sup>404</sup>. A report is yet to be published. The FRC's inertia can't be blamed on lack of resources because it continues to underspend its budget.

## Abandoned Investigations

The FRC has soothed public anxieties by announcing investigations, but has subsequently abandoned them. For example, 26 October 2008 and 7 October 2009 the FRC announced that it will investigate aspect of the audits of the Equitable Life Assurance Society, a high profile case in its time. Then on 17 August 2012, it announced that it was abandoning its investigation of the role of Ernst & Young there was "no realistic prospect that a Tribunal would make an adverse finding"<sup>405</sup>.

Following concerns about accounting practices at Lehman Brothers, on 15 March 2010 the FRC announced that it is "ascertaining the facts on how the "Repo" transactions were accounted for and audited in the UK in order to determine any implications"<sup>406</sup>. A press release on 22 June 2012 said that "no action should be taken against Ernst & Young LLP or any individuals in connection with their conduct in this matter"<sup>407</sup>. There was no report on what evidence had been examined and how the conclusions had been reached.

On 29 August 2014, Tesco announced that it expected trading profit for the six months ending 23 August 2014 to be in the region of £1.1bn. On 22 September 2014, it announced that it had identified an overstatement of its expected profit for the half year, principally due to the accelerated recognition of commercial income and delayed accrual of costs. In December 2014, the FRC announced that it will investigate the 2012, 2013 and 2014 audits of Tesco, but on 5 June 2017 the investigation was abandoned with a statement that "there is not a realistic prospect that a Tribunal would make an Adverse Finding against PwC LLP and certain Members in respect of the matters within the scope of the investigation"<sup>408</sup>. In March 2017, it had been announced that Tesco is to pay out £235 million to settle investigations by the Serious Fraud Office and Financial Conduct Authority into the

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<sup>403</sup> Financial Reporting Council, Investigation into the preparation, approval and audit of the financial statements of companies within the Serco group, 8 June 2016;

<https://www.frc.org.uk/news/june-2016/investigation-into-the-preparation,-approval-and-a>

<sup>404</sup> Financial Reporting Council, Investigation into KPMG in connection with The Bank of New York Mellon's compliance with the FSA's client asset rules, 23 June 2015;

<https://www.frc.org.uk/news/june-2015/investigation-into-kpmg-in-connection-with-the-ban>

<sup>405</sup> <https://www.frc.org.uk/news/august-2012/equitable-life-assurance-society>

<sup>406</sup> <https://www.frc.org.uk/news/march-2010/frc-statement-on-issues-raised-in-report-on-lehman>

<sup>407</sup> [https://www.frc.org.uk/news/june-2012/lehman-brothers-international-\(europe\)](https://www.frc.org.uk/news/june-2012/lehman-brothers-international-(europe))

<sup>408</sup> <https://www.frc.org.uk/news/june-2017/closure-of-investigation-into-the-conduct-of-membe>

2014 accounting scandal<sup>409</sup>. The company's accounting practices are central and raise questions about the quality of audits but the FRC had abandoned its investigation. Of course, the FRC itself had decided the scope of its investigation and did not publish any report to explain how its initial inquiries developed.

## **Puny Sanctions**

The most common sanction for audit failures is a fine though occasionally some auditors have been suspended from professional membership. In the case of BHS the penalty was for the audit partner "to remove his name from the register of statutory auditors and not to apply to have his name re-entered on the register for a period of 15 year<sup>410</sup>".

A lot has been made about the fines of millions of pounds on auditing firms, but surface appearances can be deceptive. The FRC is under intense public scrutiny and has said that from June 2018, big auditing firms will face potential fines of £10m or more for serious breaches of rules<sup>411</sup>. How appropriate are the fines and how do they compare to the position taken by other regulators?

Why do the firms deliver poor audits? There are many reasons but most point to pursuit of profits, appeasement of directors and short- changing the stakeholders, all classic signs of pursuit of competitive advantage. Perhaps, the nearest comparison is to penalties imposed by the EU for infringement of competition law. The EU guidance notes<sup>412</sup> state that the fines fulfil two objectives: to punish and to deter. The EU fines are based on a percentage of the company's annual sales of the products involved in the infringement. The EU adds that the "amount of fine is limited to 10% of the overall annual turnover of the company. The 10% limit may be based on the turnover of the group to which the company belongs if the parent of that group exercised decisive influence over the operations of the subsidiary during the infringement period". A sliding scale of discounts may be given where the offender co-operates. This then provides a benchmark for assessment of the FRC's recent fines for audit failures. The FRC also gives discounts.

Table 12.1 is a modified version of a table published by Oxera<sup>413</sup>, a consultancy company that conducted previous probes into audit market competition for the UK Competition Commission.

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<sup>409</sup> The Guardian, Tesco to pay £129m fine over accounting scandal, 28 March 2017; <https://www.theguardian.com/business/2017/mar/28/tesco-agrees-fine-serious-fraud-office-accounting-scandal>; <https://www.fca.org.uk/news/press-releases/tesco-pay-redress-market-abuse>

<sup>410</sup> Financial Reporting Council, Sanctions against PwC and former audit partner in relation to BHS, 12 June 2018; <https://www.frc.org.uk/news/june-2018/sanctions-against-pwc-and-former-audit-partner-in>

<sup>411</sup> The Independent, World's 'big four' accounting firms face £10m fines for serious breaches, 9 April 2018; <https://www.independent.co.uk/news/business/news/big-four-accounting-firms-fine-frc-pwc-kpmg-deloitte-ey-a8295696.html>

<sup>412</sup> European Commission, Fines for breaking EU Competition Law, November 2011, [http://ec.europa.eu/competition/cartels/overview/factsheet\\_fines\\_en.pdf](http://ec.europa.eu/competition/cartels/overview/factsheet_fines_en.pdf)

<sup>413</sup> Oxera, Four-ever? Competition remedies in the audit market, June 2018; <https://www.oxera.com/agenda/competition-remedies-audit-market/>

A number of things should be noted. The sample of cases in the table relate to some of the highest fines levied by the FRC. The average fine is about 0.016% of a big four firm's annual global turnover and 0.13% of the firm's UK turnover. In contrast, Oxera notes that the average European Commission fine is 2.40% of turnover and these fines are about 150 times larger (2.40% divided by 0.016%) than FRC audit fines when measured as a proportion of the global turnover of the firms. From the perspective of the UK data, the EU fines are 18 times large compared to the fines levied by the FRC on big firms for audit failures. Even if the fines for audit failures were fixed at a modest 0.5%, the amounts would be significantly higher than those levied by the FRC.

**Table 12.1  
Puny FRC Fines**

<b>Audit Failure</b>	<b>Audit Firm</b>	<b>FRC fine £m</b>	<b>Audit Firm UK Fees £m</b>	<b>Audit Firm Global Fees £m</b>	<b>Fine as % of UK Fees</b>	<b>Fine as % of Global Fees</b>	<b>If fine set at 0.5% of UK fees £m</b>	<b>If fine set at 0.5% of Global fees £m</b>
BHS	PwC	6.5	3,598	28,927	0.18%	0.022%	18	144.6
RSM Tenon	PwC	5.1	3,598	28,927	0.14%	0.018%	18	144.6
Connaught	PwC	5	3,598	28,927	0.14%	0.017%	18	144.6
Tech Data	EY	1.8	2,348	24,093	0.07%	0.007%	12	120.5
Aero Inventory	Deloitte	4	3,380	29,771	0.12%	0.013%	17	148.9
Average					0.13%	0.016%		

Regulators on other countries have been more forceful. For example, the US Federal Deposit Insurance Corporation (FDIC) brought a court case and secured damages of \$625 million from PwC for deficient audits of Colonial BancGroup Inc. The judge said that PwC had failed in its audits of the bank from 2003 to 2005 and for 2008 as it did not design its audits to detect fraud or gather enough evidence of its funding to sign reports for those years<sup>414</sup>. The FDIC also took legal action and secured \$24 million in damages from Grant Thornton for deficient audit of another bank.<sup>415</sup>

Compared to other countries, the UK fines are puny and are unlikely to act as a significant deterrent or pressure point for improvement of audit quality. The firms current partners need not necessarily bear the entire sum of the fines either. Some may be recoverable through insurance; and contributions from future partners may also be required i.e. future partners may have a pay a higher premium to attain

<sup>414</sup> [http://online.wsj.com/public/resources/documents/PWC\\_rulingpdf.pdf?mod=article\\_inline](http://online.wsj.com/public/resources/documents/PWC_rulingpdf.pdf?mod=article_inline)

<sup>415</sup> Grant Thornton, LLP v. FDIC, No. 1:2000cv00655 - Document 645 (S.D.W. Va. 2010); <https://cases.justia.com/federal/district-courts/west-virginia/wvsdce/1:2000cv00655/136/645/0.pdf?ts=1428387676>; also see <https://www.courtlistener.com/opinion/219065/grant-thornton-llp-v-fdic/>

partner status. Despite a regular parade of scandals, no criminal proceedings have been brought against auditors. Such an option is available to the FRC under Sections 507-509 of the Companies Act 2006 but has not been exercised.

In discussions with us, some firms argued that fines should be related to audit fees. This presupposes that there are no spillover effects from faulty audits e.g. a firm secures the audit of company and then that is used to cement its credentials and secure more clients and enhance the firm's turnover, market share and profits. The logic advanced by the auditing industry would suggest that the regulatory fines upon train and flight operators, and dentists and surgeons should be based upon a predetermined multiple of fares/fees rather than the seriousness of the matter or the damage done to innocent bystanders. That would be a poor basis for public policy and we do not support such an approach. Of course, the firm could avoid financial penalties altogether by delivering robust audits.

The FRC sanctions are also one-dimensional. The offending firms are not barred from securing any new business for a fixed period or until such time that they have provided evidence of higher audit quality. They could be barred from selling audits in selected industries for a specified period. Some firms (or some of their offices) could also be shut-down. However, the FRC has not imposed such penalties.

### **Destination of Fines**

The outcome of the FRC disciplinary hearings are negotiated with the firms in question and the RSB which licensed the firm or the auditor. The firm/partner can appeal against the findings though no such opportunity is available to any complainant or party suffering from audit failures. The fines eventually levied are not used to soften the financial blow on stakeholders affected by audit failures. What happens to the fines? The Minister stated that

“Fines imposed on accountancy firms by the Financial Reporting Council as part of an audit enforcement action must be paid by the Financial Reporting Council to the Secretary of State. Any costs awarded to the Financial Reporting Council in recognition of the enforcement costs funded by the recognised audit supervisory bodies must be paid to those bodies. This arrangement applies only in respect of fines paid under the Statutory Auditors and Third Country Auditors Regulations 2016<sup>416</sup>”.

The Business Secretary explained that:

“The Financial Reporting Council (FRC) agreed a disciplinary scheme with the accountancy professional bodies in 2004 meeting requirements in company law for it to have in place arrangements with the recognised supervisory bodies for the purposes of disciplining auditors. The funding basis for the scheme was that the professional bodies would fund the costs of disciplinary

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<sup>416</sup> Hansard, House of Lords, Written question - HL4543, 9 January 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-01-09/HL4543/>

actions and that any costs and fines ordered against the members of their bodies would be paid to those bodies.

New statutory powers for the FRC to impose fines on auditing firms were introduced in the Statutory Auditors and Third Country Auditors Regulations 2016. The Regulations require that fines imposed under the powers must be transferred by the FRC to the Secretary of State.

The FRC continues to maintain a disciplinary scheme for non-statutory audit matters: for fines recovered under those arrangements, the fines continue to be paid over to the relevant accountancy professional bodies<sup>417</sup>.

The 2004-2016 arrangements are likely to have generated considerable windfalls for the accountancy bodies. A Minister informed Parliament<sup>418</sup> that the following fines (Table 12.2) were imposed under the FRC's accountancy scheme from 2012 to 2016 and passed to the participating body which met the related case costs. (The table does not include the costs that were awarded to the bodies in relation to specific cases or the contributions to case costs by the participating bodies overall).

**Table 12.2**  
**FRC Fines and Their Destination**

Year	Total fines Received	Fines passed to the accountancy bodies		
		ICAEW	CIMA	CAI
2012	NIL	-	-	-
2013	£815k	£815k	-	-
2014	£1,038k	£1,025k	£13k	-
2015	£4,688k	£4,688k	-	-
2016	£6,712k	£6,552k	-	£160k

On 3 September 2018, in accordance with the FOI law, the FRC was asked to provide data missing from the above table i.e. from year 2004 onwards. The request was accompanied by a paraphrasing of the ministerial statement (see above)

“My understanding is that FRC agreed a disciplinary scheme with the accountancy professional bodies in 2004. This was to enable it to meet requirements in company law for it to have in place arrangements with the recognised supervisory bodies for the purposes of disciplining auditors. The funding basis for the scheme was that the professional bodies would fund the costs of disciplinary actions and that any costs and fines ordered against the members of their bodies would be paid to those bodies”

<sup>417</sup> Hansard, House of Commons, Written question – 105196, 14 September 2017; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105196/>

<sup>418</sup> Hansard, House of Lords, Written question – HL5096, 25 January 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-01-25/HL5096/>

On 20th September 2018, FRC declined to provide the requested information and also contradicted the ministerial information by saying that “This understanding is not quite correct; the company law requirement for the RSBs to have in place independent disciplinary arrangements was a requirement placed on the RSBs, not on the FRC. Please see s1217 and Schedule 10 Companies Act 2006 (pre – 2016 amendments)”.

Why was the FRC withholding information? Was it confidential? A member of parliament subsequently requested the same information in a parliamentary question and the Minister stated that “the following fines were imposed under the FRC’s Accountancy Scheme from 2004 to 2011 and passed to the participating body which met the related case costs<sup>419</sup>” (see Table 12.3).

**Table 12.3**  
**FRC Fines and Their Destination for the Period 2004-2011**

<b>Year</b>	<b>Total Fines received</b>	<b>Fines passed to the accounting bodies</b>
2004	NIL	
2005	NIL	
2006	NIL	
2007	NIL	
2008	£12,000	CAI
2009	NIL	
2010	NIL	
2011	£1,640,000	ICAEW

The FRC fines have generated additional resources for the accountancy bodies to reduce the rate of increase in membership/licensing fees (which also benefits big accounting firms) and engage in campaigns to defend the auditing industry.

### **Public’s Right To Know Is Not Valued**

Regulators need to be accountable to the general public but that is not the case with the regulators of the auditing industry. Their board/council meetings, minutes of

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<sup>419</sup> Hansard, House of Lords, Written question – HL10459, 9 October 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Lords/2018-10-09/HL10459/>

meetings are not open to the people. Their background papers for policy formation are publicly available. As part of a framework of accountability, people must be able to request information and make their own assessment of the effectiveness of regulators. But that is not case in the world of accounting. The RSBs are named as statutory regulatory bodies in the Companies Act 2006, but they are excluded from the freedom of information law. The Business Secretary informed parliament that

“They are independent private bodies and are not subject to the Freedom of Information Act<sup>420</sup>”

Since 2004, the FRC has enjoyed the status of a ‘public body’ and should therefore have been subjected to the full application of the freedom of information (FOI) law, but the Business Secretary informed parliament that

“All our regulatory bodies are subject to the Freedom of Information Act 2000 with the exception of the Financial Reporting Council which is subject to the Act for some but not all of its functions<sup>421</sup>”.

Between 2013 and 2018, the FRC received 56 FOI requests for information. It gave a meaningful reply to only six<sup>422</sup>. It rejected requests for information on topics including whether any of its staff have been seconded to the “big four” accounting firms and vice versa and its investigation into the role of KPMG in the collapse of the defunct lender HBOS.

For the purpose of this report, on 30th May 2018 the FRC was asked to provide the following information:

- a) The number of complaints and requests for investigations that the FRC has received from the Recognised Supervisory Bodies (RSBs), other organisations and individuals about the conduct of PwC, Deloitte, EY, KPMG, Grant Thornton and BDO;
- b) the number of such requests rejected by the FRC;
- c) the number referred by the FRC to other professional or regulatory bodies;
- d) the number of instances where the FRC advised the complainant to refer the matter to another RSB or regulator
- e) the number where the FRC subsequently sought to discover the action taken by the bodies referred in c) and d) above.

On 22 June 2018, the FRC declined to provide the information on the basis that “The information you have requested relates to the FRC’s enforcement activities, which do not fall within the Delegated Functions ... We are not therefore required by the Act to provide such information”. The auditing industry’s regulators portray themselves as

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<sup>420</sup> Hansard, House of Commons, Written question – 105224, 14 September 2017; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2017-09-14/105224/>

<sup>421</sup> Hansard, House of Commons, Written Question 156310, 21 June 2018; <https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2018-06-21/156310/>

<sup>422</sup> Financial Times, UK accounting regulator rejected 90% of FOI requests, 12 April 2018; <https://www.ft.com/content/a4659b5e-3d93-11e8-b7e0-52972418fec4>

guardians of the public interest but do not value the public's right to know. Their preferred mode is to publish carefully selected annual reports.

### **Silence is not Golden**

The FRC conducts audit quality inspections and published reports. These supposedly highlight weaknesses, but the FRC does not require the firms to give any binding undertakings to eradicate or resolve the problems. For example, the accounting treatment of goodwill at Carillion was a major issue. Through its audit quality inspection reports, the FRC was aware of that the auditing practices of KPMG, auditors of Carillion, in relation to goodwill were persistently deficient. It did not demand eradication of the shortcomings. The 2016-17 audit inspection report by the FRC based on a sample of KPMG<sup>423</sup> audits, published in June 2017, identified a number of weaknesses in the firm's approach to auditing goodwill. The FRC said that there were:

“Weaknesses in the audit approach adopted for goodwill impairment, including insufficient professional scepticism and challenge of management's assessment; and insufficient evidence of involvement by the group team in the component auditor's work relating to a material acquisition.

Insufficient challenge of management's assumptions in relation to the impairment of goodwill and other intangibles, with undue reliance placed on evidence which supported management's assumptions/ position

We continue to identify a number of concerns in relation to the audit of valuations, loan loss provisions and impairment reviews of goodwill and other intangibles”.

The FRC's 2015/16 audit inspection report<sup>424</sup> on KPMG noted the following about the firm's procedures for auditing goodwill and intangibles:

“We identified a number of concerns in relation to the audit of valuations, impairment reviews of goodwill and other intangibles, tax provisions and loan loss provisions. For example:

Insufficient challenge of management regarding, in one case, the consistency of the financial projections which formed the basis for the recognition of deferred tax assets.

For an audit where business combinations were identified as a significant risk, there was insufficient testing relating to key estimates and judgements used in the valuation of acquired intangible assets.

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<sup>423</sup><https://www.frc.org.uk/getattachment/84251a1d-be78-4590-b284-ea47d6c8cc75/KPMG-LLP-Audit-Quality-Inspection-16-17.pdf>

<sup>424</sup> <https://www.frc.org.uk/getattachment/93494442-a287-4ac4-a23c-96fdcd3edca1/KPMG-LLP-Public-Report-2015-16.pdf>

there was insufficient evidence of challenge of management's judgments relating to impairment of stores. In one case the audit team did not sufficiently challenge management's identification of cash generating units. In the other audit there was insufficient evidence of challenge of management as to whether certain stores should have been assessed for impairment."

The 2014/15 Audit Inspection Report reached the following conclusions:

"We reviewed the audit of goodwill and other intangible assets on eleven audits. In four audits there was insufficient testing of the reliability of forecast cash flows used within the impairment assessment of goodwill or the capitalisation of development costs. In one of those audits and one further audit, we identified related financial statement disclosures that were erroneous or potentially misleading. In another audit, we considered the level of challenge regarding the allocation of brand assets to cash generating units to be insufficient.

In one of those audits, there was also insufficient challenge of the assumptions used by management in the impairment assessment of investment property, including insufficient involvement of the firm's property specialists in assessing the appropriateness of the land valuation. In another audit there was insufficient evidence of scepticism in the assessment of whether a loan receivable was recoverable."

For at least three consecutive years before the Carillion collapse, FRC was aware that KPMG's audit of goodwill was deficient, but did not set the firm any targets for improving its practices or alert other regulators and stakeholders about relying upon the quality of KPMG's audits.

After the collapse of BHS, the FRC found PwC's audit to be deficient, particularly for failure to consider whether BHS was a going concern. The audit work in relation to verification of fixed assets, investments, loans, income and other matters was also considered to be deficient. Yet, the FRC had been aware of weaknesses in PwC's audits even before the BHS crash, but chose to do nothing.

The 2011/12 FRC audit inspection report based upon a sample of for PwC stated:

"We identified weaknesses in the audit of property, plant and equipment (PP&E) in three audits. In one of them, a high street retailer, management's sensitivity testing comprised increasing sales only. Given the changing commercial environment in the high street, the audit team should have requested management to perform some downside testing on sales. In this respect, it did not demonstrate sufficient scepticism regarding the sensitivity testing of PP&E.

The audit team's evaluation of the entity's 5-year business plan was fundamental to the impairment review of goodwill and PP&E and the recognition of a deferred tax asset. It also contributed to its evaluation of going concern. However, given the significance of the plan to important areas of the audit, there was insufficient evidence to support the audit team's conclusion that the key assumptions underpinning the plan were reasonable.

In addition, in its evaluation of going concern, the audit team did not give sufficient consideration to the need for going concern disclosures in the financial statements and the implications for the firm's audit report<sup>425</sup>.

The 2013, audit inspection report noted that

"The audit team did not obtain sufficient audit evidence in respect of the entity's investment accounting records or the general ledger which were maintained by service providers. Furthermore, insufficient audit evidence was obtained to confirm the valuation of the entity's significant portfolio of investments. We also identified weaknesses relating to financial statement disclosures which we report below under that heading.

the group audit team was not sufficiently involved in the planning and conduct of the audit of revenue in a significant component. In this case, the component audit team did not test the IT general controls of the entity's key systems, by means of which the accounting entries for revenue were initiated and processed, and performed insufficient procedures to test the accuracy and reliability of reported revenue. As a consequence, the component audit team obtained insufficient audit evidence in relation to the entity's reported revenue<sup>426</sup>.

The 2014, audit inspection report noted that

"In one audit, we identified a number of weaknesses in relation to group audit considerations as follows:

- Risk categorisation at group level: There was insufficient justification for not treating going concern as an area of significant risk at group level given the financial position of the entity; and insufficient evidence that the audit team had applied appropriate sensitivities to management's base cash flow forecast and considered the feasibility of potential mitigating action<sup>427</sup>.

The above is only a small sample of evidence to show that even when the FRC is aware of poor audit quality, it did not require a commitment from the firms to eradicate the shortcomings.

## **FINANCIAL REPORTING FAILURES**

### **Banks**

The 2007-08 banking crash should have been a wake-up call for the poor state of financial reporting. In the 2000-2007 boom period preceding the crash, the market value of equity, debt and derivatives rose and fair value accounting enabled banks to

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<sup>425</sup> [https://www.frc.org.uk/getattachment/3d6933d6-050f-4ff4-a7c7-5396a8a38891/PwC-Public-Report-2011-12-\(Clean\).pdf](https://www.frc.org.uk/getattachment/3d6933d6-050f-4ff4-a7c7-5396a8a38891/PwC-Public-Report-2011-12-(Clean).pdf)

<sup>426</sup> [https://www.frc.org.uk/getattachment/f89ee075-3e22-471a-8403-9034a3050d04/PwC-Public-Report-Final-for-web-\(21-May-2013\).pdf](https://www.frc.org.uk/getattachment/f89ee075-3e22-471a-8403-9034a3050d04/PwC-Public-Report-Final-for-web-(21-May-2013).pdf)

<sup>427</sup> <https://www.frc.org.uk/getattachment/c08154db-06b1-45e1-b4d1-6688f7712998/PwC-Public-Report-May-2014.pdf>

record gains of over £200 billion<sup>428</sup> to create illusions of liquidity, solvency and profits. Executives on performance related pay also did nicely. Northern Rock, HBOS, RBS, Bradford & Bingley all came tumbling down despite publishing healthy accounts. Almost all banks had toxic assets and worthless loans on their books which markets would not touch and government had to bail them out. The FRC rules did not require banks to make a provision for the foreseeable losses at the earliest possible opportunity. They only had to make a provision when the loss was actually incurred, which could easily be shifted to future periods. After the crash, the market price of equity, debt and derivatives tumbled and under the principles of fair value accounting, banks would have been forced to show huge losses, but the IASB/FRC changed the accounting rules. Banks were allowed to reclassify financial instruments from trading to holding to avoid recording mark-to market losses, which suppressed losses and boosted profits and executive pay. The banking crash showed that fair value accounting over-emphasised the returns in boom years and thus mispriced risks and investment in the economy. In the bust years, risks are under-emphasised and investments were still mispriced. The FRC is empowered to force companies to publish revised accounts if they are considered to be defective. No bank has been forced to publish revised accounts because they complied with the standards, even though they were defective.

The mispricing of risk/return arising from accounting rules is not just confined to banks and financial institutions; it infects the whole financial system and the entire economy. The financial regulators use the accounting data to make assessment of bank liquidity, solvency, risks and the stability of the financial system, but it cannot identify systemic risks. The 2013 Banking Standards Commission report said that IFRSs are “not fit for regulators’ purposes<sup>429</sup>”. The Commission called for the development of alternative accounts, but the FRC has continued to promote its model of financial reporting which is divorced from the legal requirements and a common sense approach to accounting.

## **Carillion**

Carillion complied with accounting standards issued by the FRC, but its accounts were not worth the paper they were written. It had worthless contracts in its balance sheet. The company had £1,571m of goodwill, its biggest asset, in its balance sheet and it had only ever impaired £134 million of it. The conventional accounting claim is that goodwill represents the possibility of earning above average returns, but one of the company’s largest acquisitions had negative assets of £200 million and was only surviving because of financial support from the parent company. Still, it passed the tests specified by the FRC and goodwill remained unamortised.

Since goodwill or the economic advantage in an acquired entity is embedded in the entire set of its assets, it cannot easily be severed from the business or sold as a separable asset. Thus, there is no way of ascertaining a reliable measure of its

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<sup>428</sup> Andrew Haldane, Accounting for bank uncertainty, 19 December 2011; <https://www.bankofengland.co.uk/-/media/boe/files/speech/2012/accounting-for-bank-uncertainty>

<sup>429</sup> UK House of Lords and House of Commons Parliamentary Commission on Banking Standards: Changing banking for good, June 2013.

value. However, such factors did not worry the FRC. Instead, it required directors to build a valuation model and show that despite the effluxion of time and usage, the value of goodwill has not been impaired. The resulting amounts carried in company balance sheets could not be corroborated with any market event because goodwill is very rarely traded as a separable asset (land, buildings, cars, plant and machinery, trademarks, copyrights can be severed from the business and can be sold separately, but that is not easily possible for goodwill). As a result, Carillion routinely overstated its assets, profits and understated leverage (had reverse factoring) and all that was permitted by the accounting standards. The accounting rules enabled it to recognise profits recognising profits on contracts which were actually making losses.

Some sanity would have ruled if the FRC required companies to adopt prudent policies, recognise losses to be written-off at the earliest possible opportunity. It did not do so.

## **BHS**

BHS had been technically insolvent for years before its collapse. Its poor state of liquidity and solvency could have been gauged by suppliers, employees and investors from its cash flow statement, but this crucial information was not published. Financial Reporting Standard 1 (FRS1) does not require wholly-owned subsidiaries to publish such a statement even though the information is routinely produced for internal a management purposes and the cost of publishing it is negligible. According to the FRC, anyone chasing cash flow details needed to look at the accounts of Taveta Investments, BHS's the parent company. The problem is that at the parent company level, the financial information of all subsidiaries is aggregated and cash flows of a specific subsidiary cannot be identified. The net result of the FRC imposed opacity was that interested stakeholders could not learn about BHS's solvency and liquidity. Many innocent suppliers kept providing goods and services, throwing good money after bad.

Increasingly, companies shift profits through intragroup transactions to subsidiaries, affiliates and controllers. A sensible idea is to demand disclosure of transactions with related parties, but once again FRC added a layer of opacity. A note on page 25 of BHS's 2014 accounts stated that

“The company has taken advantage of the exemption under the terms of the Financial Reporting Standard 8 from disclosing related party transactions with entities that are part of the Taveta Investments Limited group or investees of Taveta Investments Limited”.

Once again, in an exercise in futility, people had to chase the accounts of Taveta Investments Limited.

## **Illegal Dividends**

A key purpose of financial statements is to report on the maintenance of capital i.e. the amounts which could be made available to creditors and other stakeholders in the event of bankruptcy. This is required by Part 23 of the Companies Act 2006 and forms the basis of any assessment of profit, solvency and the ability of a business to

remain a going concern. The Companies Act 2006 also provides the rules for payment of dividends. In short, a company must have *sufficient* distributable reserves to enable it to pay dividends<sup>430</sup>. The payment of dividends must not deplete its capital which is seen as a kind of reserve fund for protection of its creditors.

The 'sufficiency' of distributable reserves and maintenance of capital depend on accounting standards and rules issued by the FRC. It is hard to discern any recognisable or measurable concept of capital maintenance in IFRSs advanced by the FRC. The Local Authority Pension Fund Forum (LAPFF) has argued that the FRC's interpretation of company law is faulty and consequently companies may have paid illegal dividends<sup>431</sup>. Some companies, including Domino's Pizza, Dunelm and stockbroker Hargreaves Lansdown<sup>432</sup>, have acknowledged making dividend payments in contravention of the requirements of the Companies Act.

### **Stability and Viability of Companies**

The above examples have only provided a glimpse of the chaos resulting from inappropriate accounting rules. The shift to fair value accounting and recognition of unrealised profits in company income statements has legitimised a process of 'financialization' whereby companies are able to exploit loopholes in company law that erode capital maintenance; whilst the adoption of Fair value Accounting (FVA) imports speculative capital market valuations into both earnings and a variety of asset classes held on company balance sheets.

This 'financialization' of accounting brings onto the financial statements considerable real and potential financial instability and volatility. These financial disturbances can undermine the viability of companies and compromise the interests of stakeholders involved in the consolidated activities carried out by companies. FTSE 100 companies distributed £756bn of dividends and an extra £203bn in the form of share buy-backs to shareholders over the period 2000-2017. Glaxo Smith Kline (GSK) has paid out £56bn in dividends and £22bn in share buybacks since the year 2000. In 2017 its shareholder equity was negative £68 million.

A revaluation reserve created under fair value accounting can be used to issue bonus shares even though these capital reserves are not distributable. The 2016 accounts of Anglian Water PLC show that the company converted its revaluation reserve into bonus shares which were then cancelled and funds transferred into retained earnings thereby inflating distributable reserves by £2.6bn.

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<sup>430</sup> For example, see The Institute of Chartered Accountants in England & Wales, *Guidance on Realised and Distributable Profits under the Companies Act 2006*, London: ICAEW, April 2007.

<sup>431</sup> Reuters, UK pension funds urge firms to disregard certain regulator guidance, 3 December 2015; <https://uk.reuters.com/article/uk-britain-accounting/uk-pension-funds-urge-firms-to-disregard-certain-regulator-guidance-idUKKBN0TM1N020151203>.

<sup>432</sup> Accountancy Daily, Two more PLCs pay out dividends breaking Companies Act rules, 16 February 2017, <https://www.accountancydaily.co/two-more-plcs-pay-out-dividends-breaking-companies-act-rules>; Financial Times, Hargreaves Lansdown breaks company law over dividend payments, 8 February 2017, <https://www.ft.com/content/44b97ab8-edda-11e6-ba01-119a44939bb6>.

These accounting finagles take place in a regulatory vacuum and poor accounting standards. There is considerable confusion about what distributable profits are both in the Companies Act and common law and the problems are further exacerbated by the FRC standards. Distributions are made by individual companies and not by groups. The group accounts may therefore not be relevant for the purpose of determining a company's profits available for distribution<sup>433</sup>. Thus the aggregate earnings that might be available in the parent company consolidated accounts for distribution may not align with the actual distributions made because these could be set by wholly owned subsidiaries that are in their own right separate legal entities with limited liability. Further, the ICAEW technical note<sup>434</sup> states that:

“There is no requirement under law or accounting standards for financial statements to distinguish between realised profits and unrealised profits or between distributable profits and non-distributable profits. Paragraph 2.16 above draws attention to the need for companies to maintain sufficient records to enable them to distinguish between those profits that are available for distribution and those which are not”.

The confusion between what are realised and unrealised earnings available for distribution is compounded by Fair Value Accounting (FVA) which recalibrates asset valuations to market value and shows these as gains or losses in the comprehensive income statement and movements in shareholder equity reserves. Thus surplus earnings from trading activity are blended with holding gains from asset revaluations and it is not clear what the distributable earnings are in these circumstances.

The use of FVA affects financial stability of companies and the related signals that it sends to markets, stakeholders and regulators about leverage, risks and solvency. Here is an example from audited accounts of Tesco for the year ending February 2018 where retained earnings jump from £332 million to £4529 million (Table 12.4). Out of this increase, roughly 80 percent was accounted for by a favourable change in the value of Tesco's defined benefit pension funds (estimated future asset values moving ahead of future liabilities). In the previous year a fair value adjustment to these pension funds more or less wiped out all operating profits from trading. In 2015 Tesco had to write down the value of its property, plant and equipment and investments by £5bn.

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<sup>433</sup> Institute of Chartered Accountants in England and Wales, TECH 02/10: GUIDANCE ON THE DETERMINATION OF REALISED PROFITS AND LOSSES IN THE CONTEXT OF DISTRIBUTIONS UNDER THE COMPANIES ACT 2006, <https://www.icaew.com/~media/corporate/files/technical/technical%20releases/legal%20and%20regulatory/tech%2002%2010%20guidance%20on%20realised%20and%20distributable%20profits%20under%20the%20companies%20act%202006.ashx>

<sup>434</sup> Institute of Chartered Accountants in England and Wales, TECH 02/10: GUIDANCE ON THE DETERMINATION OF REALISED PROFITS AND LOSSES IN THE CONTEXT OF DISTRIBUTIONS UNDER THE COMPANIES ACT 2006, <https://www.icaew.com/~media/corporate/files/technical/technical%20releases/legal%20and%20regulatory/tech%2002%2010%20guidance%20on%20realised%20and%20distributable%20profits%20under%20the%20companies%20act%202006.ashx>

**Table 12.4**

Tesco Retained Earnings in Shareholder Equity		
	£mill	
Retained Earnings	Feb-17	Feb-16
Opening Profit	332	3265
Trading profit	1206	-40
Change in value of financial assets		80
Revaluation of defined pension funds	3265	-3567
Taxes relating to components of comprehensive income	-544	564
Other Share transactions		30
Year ended	Feb-18	Feb-17
<b>Total</b>	<b>4259</b>	<b>332</b>

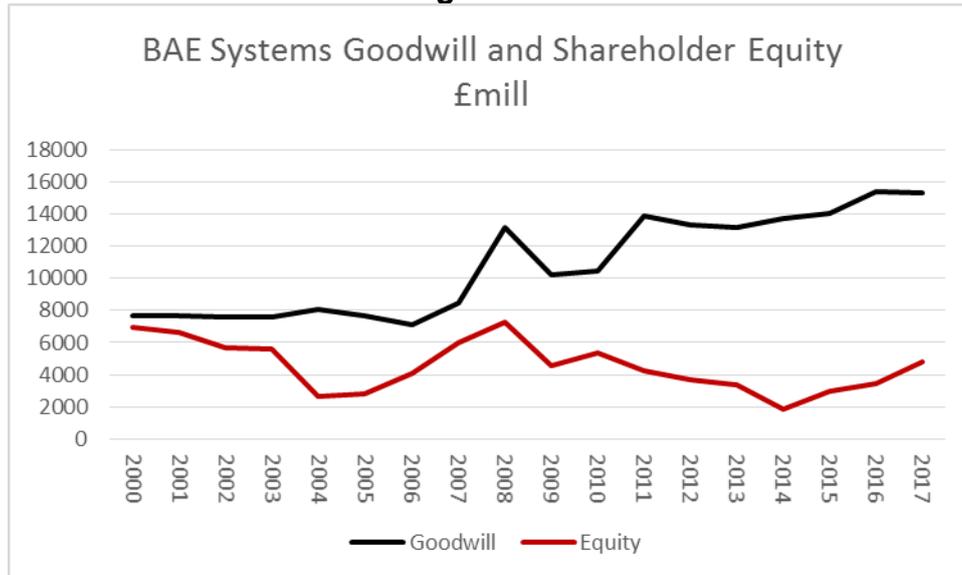
The FVA adjustments to asset valuations can be large and volatile. Assets such as property, financial instruments, biological assets and intangible assets can be adjusted to their market values. A significant 'asset' now held and accumulating on balance sheet is that relating to goodwill which measures the difference between the market value of companies acquired and the book value of their net assets. In the FTSE 100 companies, the most recent accounts show that the goodwill asset to shareholder equity ratio averages 45% but that 34 out of the FTSE 100 are operating with goodwill that now exceeds shareholder equity (Table 12.5).

**Table 12.5**  
**Impact of Goodwill**

	Shareholder Equity to Total Assets as at 2016-17	Goodwill to Total Assets as at 2016-17	Ratio of Goodwill to Shareholder Equity as at 2016-17
	%	%	Factor
Serco	20.2	36.4	1.8
Capita	6.8	38.9	5.7
Carillion	15.8	35.4	2.2
G4S	15.7	39.8	2.5

Carillion operated with a goodwill to shareholder equity ratio of over 2:1. All of the major companies servicing UK central and local government contracts have goodwill that exceeds their equity and if impaired would send confusing signals to markets about solvency and liquidity, which may then have real effects. The threat is that accounting rules centred on adjusting asset valuations to their market value might not only compromise reported earnings but also wipe out shareholder equity reserves forcing perceptions of insolvency. There is a major moral hazard to society arising out of accounting practises because companies like Capita and BAE systems (Figure 12.1) provide essential foundational services to the household and defence resources to for the nation.

**Figure 12.1**



The FRC has been complacent about the consequences of the standards for the stability and viability of companies.

### **Neglect of Stakeholders**

The financial reporting practices promoted by the FRC have neglected the interests of societal stakeholders. It has been almost exclusively focused on the interests of shareholders. But who are the shareholders? The Bank of England's chief economist noted that:

“the average duration of equity holdings has fallen from around 5 years in the mid-1960s to around 2 years in the 1980s. At the turn of the century, it had reached just over a year. By 2007, it had fallen to around 7½ months<sup>435</sup>”.

The average duration of shareholdings in the US, UK and European banks “fell from around 3 years in 1998 to around 3 months in 2008”<sup>436</sup>. The average shareholding period in listed companies may well be around one month<sup>437</sup>. With automated computer trading the shareholding duration is likely to shrink further as the average time for which a stock is held before being traded again has been reduced to 22

<sup>435</sup> Haldane, A.G. Patience and Finance, Speech at Oxford China Business Forum, Beijing, 2 September 2010 (<http://www.bankofengland.co.uk/archive/Documents/historicpubs/speeches/2010/speech445.pdf>).

<sup>436</sup> Haldane, A.G., Who Owns a Company? Speech given at the University of Edinburgh Corporate Finance Conference, 22 May 2015; <http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech833.pdf>.

<sup>437</sup> The Daily Telegraph, Thatcher's dream for UK investors has become a nightmare, 17 May 2015 (<http://www.telegraph.co.uk/finance/11610490/Thatchers-dream-for-UK-investors-has-become-a-nightmare.html>).

seconds<sup>438</sup>. Haldane has also reported that “among UK companies, share buybacks have consistently exceeded share issuance over the past decade ... In other words; over the past decade the equity market no longer appears to have been a source of net new financing to the UK corporate sector”<sup>439</sup>.

The above data shows that many large listed companies are now ownerless. Most shareholders are akin to traders and speculators and do not have a long-term interest in companies. They rarely provide new or productive finance capital and mostly trade in “fictitious capital”. At major corporations, such as banks, shareholders provide less than 10% of total capital. The capital structure of Bernard Matthews<sup>440</sup>, Maplin<sup>441</sup>, Caffè Nero<sup>442</sup>, Toys R Us<sup>443</sup> and other companies shows that shareholders have developed strategies to eliminate the residual risks i.e. they do not rank as unsecured creditors at the end of the queue but through financial engineering have become secured creditors and rank above all others. Shareholders have always been able to manage risks by diversifying their portfolio of investments and through a combination of call and put options, as options pricing theory has pointed out<sup>444</sup>. This means that most of the risks fall on employees, taxpayers, pension scheme members and supply chain creditors. Many of the assumptions and much of the ‘free market’ ideology about shareholder ownership and risk-taking no longer apply to today’s mega-corporations.

Yet the FRC has been oblivious to massive social and economic changes. It continues to believe that its main mission is to serve the interests of short-term shareholders. In sharp contrast, employees, suppliers, governments, taxpayers and societal stakeholders have a long-term interest in the wellbeing of companies. They bear heavy risks as shown by the banking crash and the collapse of BHS and Carillion. If despite the huge social cost, all that financial reporting is based upon is the commitment to provide dubious predictive information to short-term shareholders, or speculators, then the contribution of financial reporting to the welfare of democratic societies is remarkably limited. The FRC has shown absolutely no inclination to address stakeholder concerns. It should be noted that the Labour

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<sup>438</sup> The Daily Telegraph, How long does the average share holding last? Just 22 seconds, 18 January 2012 (<http://www.telegraph.co.uk/finance/personalfinance/investing/9021946/How-long-does-the-average-share-holding-last-Just-22-seconds.html>).

<sup>439</sup> Haldane, A.G., Who Owns a Company? Speech at the University of Edinburgh Corporate Finance Conference, 22 May 2015; <https://www.bis.org/review/r150811a.pdf>

<sup>440</sup> Prem Sikka, Bernard Matthews Limited, Bernard Matthews Holdings Limited and Pension Scheme. London: House of Commons Work and Pensions Committee; <https://www.parliament.uk/documents/commons-committees/work-and-pensions/Bernard-Matthews-administration-arrangement-Prem-Sikka-briefing-05-10-2016.pdf>

<sup>441</sup> Prem Sikka, Revealed: How a private equity takeover contributed to Maplin’s demise, 2 March 2018; <https://leftfootforward.org/2018/03/revealed-how-private-equity-contributed-to-maplins-demise/>

<sup>442</sup> Prem Sikka, Here’s how Caffè Nero made £2bn in sales but didn’t pay a penny in corporation tax, 12 March 2018; <https://leftfootforward.org/2018/03/heres-how-caffe-nero-made-2bn-in-sales-but-did-not-pay-a-penny-in-corporation-tax/>

<sup>443</sup> David Dayen, Toys ‘R’ Us Workers Take on Private-Equity Barons: ‘You Ought to Be Ashamed’, 5 June 2018; <https://www.thenation.com/article/toys-r-us-workers-take-private-equity-barons-ashamed/>

<sup>444</sup> Fischer Black and Myron Scholes, The Pricing of Options and Corporate Liabilities, *Journal of Political Economy*, 81(3): 637-654, 1973.

Party has given commitment to put employee elected directors on company boards<sup>445</sup>.

## **SUMMARY AND DISCUSSION**

This chapter has provided further evidence of regulatory failures. The RSBs and the FRC do not meet the principles of good regulation specified at the beginning of this chapter. They have no independence from the accounting industry and have presided over poor audit quality for far too long. The reports into audit failures are not timely and some of the investigations have been abruptly abandoned without any proper explanation. The sanctions for poor audits are one-dimensional and puny. The poverty of the FRC accounting and auditing standards was exposed by the banking crash, but little has changed. Audit quality at banks has not been investigated and parliamentary committees had to push the FRC to investigate HBOS audits. It abandoned even that investigation and by its own admission its practices were not satisfactory. The regulators have aligned themselves with the interests of big firms in opposing reforms of auditor independence, liability, rotation and related matters. The public has no direct say in the operations of any of the regulatory bodies. The inescapable conclusion is that the current regulatory apparatus is dysfunctional and unfit-for-purpose. The regulatory powers of the RSBs and the FRC must to be removed. In a separate report (soon to be published), we have sketched out the details of a Companies Commission which will oversee all aspects of the UK company law, including accounting and auditing.

The FRC has normalised accounting manipulations by legitimising fair value accounting and mark-to model accounting. The imprudent accounting practices advanced by the FRC have enabled companies to avoid making provisions for foreseeable losses. Its rules permitted companies, such as Carillion to report goodwill without any amortisation. Its rules added opacity to financial statements published by BHS. It created standards which overstated profits and assets and enabled executives to collect higher performance related pay at Carillion. The poverty of accounting standards was exposed during the banking crash, but little has changed since. The FRC's model of financial reporting remains geared to provide information to speculators and short-term shareholders. Many long-term stakeholders; including investors, savers, pension funds, employees, suppliers and insurance companies have been misled by accounting standards. The FRC has failed to consider their needs for information.

Accounting standards affect the distribution of income wealth, risk, wages, dividends and social welfare. There are competing claims on accounting rules which have distributional consequences. In democratic societies, only parliament has the democratic mandate to adjudicate on competing claims or affect the redistribution of income and wealth. Therefore, accounting standards must be set by parliament. The Companies Act must be revised to state the principles of accounting practices. This

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<sup>445</sup> Prem Sikka, Alastair Hudson, Tom Hadden, Hugh Willmott, John Christensen, Christine Cooper, Colin Haslam, Paddy Ireland, Martin Parker, Gordon Pearson, Ann Pettifor, Sol Picciotto, Jeroen Veldman, A Better Future for Corporate Governance: Democratising Corporations for their Long-Term Success, September 2018; <http://visar.csustan.edu/aaba/LabourCorpGovReview2018.pdf>

would make them authoritative and enforceable and their violation would be an offence. The principles need not be detailed, For example, they may state that “goodwill shall be amortised over a period not exceeding five years” and “inventory shall be valued at the lower of cost and net realisable value”, and so on. The Companies Commission shall be responsible for adding details to accounting principles. For example, it can explain how the goodwill disclosures should be reported; the meaning of the term cost and net realisable value; and so on. It shall stress test accounting standards to ensure they are delivering the policy outcomes. It shall monitor company accounts to ensure that accounting standard have not been dysfunctional, are not being abused and are not eroding the capital base of companies.

The 2007-08 banking crash, BHS, Carillion and other episodes continue to raise questions about auditor duties. The financial statements can hardly be ‘true and fair’ when they are full of financial engineering and overstatement of assets and profits, whether through downright untruths or creative reading of the rules. Auditors continue to elide responsibilities for designing audits for detection and reporting of fraud or even determining whether the client company was a going concern at the balance sheet date. They too easily accept management’s claim that all is well. In the words of Lord Denning, an auditor’s

“task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform his task properly, he must come to it with an inquiring mind—not suspicious of dishonestly, I agree—but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none<sup>446</sup>”.

However, throughout the headline cases examined in this report, there is little evidence that auditors came to the audit with an inquiring mind and design audit tests accordingly. Any mention of designing audits to detect and report fraud draws hostile responses from the auditing industry. However, a degree of that duty already exists in the financial sector where auditors have a duty to report irregularities to regulators even without client knowledge. At the very least, that must be extended to all sectors.

When the audit industry wants to protect its fee earning opportunities, it is quite happy to associate audits with fraud detection. For example, in response to a government consultation paper on reduction in audit requirements for unlisted companies, ACCA said: “Any reduction in audit costs which might materialise as the result of the adoption of the proposed option must therefore be balanced against the likely reduction in the capacity of audit to uncover fraud and error and to report instances of financial crime<sup>447</sup>”. ACCA’s response to the possibility of raising the small company audit exemption threshold was that “some have warned that raising the audit exemption threshold could increase the risk of fraud, with large unaudited businesses potentially

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<sup>446</sup>Lord Denning in *Fomento (Sterling Area) Ltd. v Selsdon Fountain Pen Co Ltd* [1958] 1 All ER11 at 23.

<sup>447</sup>Comments from ACCA to the Department for Business, Innovation and Skills (BIS), 29 December 2011; <https://www.accaglobal.com/uk/en/technical-activities/technical-resources-search/2011/december/consultation-audit-exemptions.html>

hiding criminal – or even terrorist – activity<sup>448</sup>”. Previously ACCA said that “The statutory audit has always seemed to the Association to be an important weapon against fraud ... and provide a continuing protection against fraud<sup>449</sup>”. As the UK accountancy bodies associate audits with fraud detection they can have no objection to a statutory requirement for auditors to design audit tests which have a high probability of detecting fraud and reporting their findings to regulators and societal stakeholders

Details of directors’ duties are contained in the Companies Act 2006, but there is comparatively little clarity about auditor duties. In this vacuum, the auditing industry has sought to dilute its duties through the auditing standards issued by the FRC. The FRC formulates auditing standards, but it has no independence from the auditing industry. Auditing standards are mostly framed to economise on audit effort, protect firms from liability and enhance their profit making opportunities. This is unacceptable. The Companies Act must be revised to clarify auditor responsibilities. In the absence of statutory specification of auditor duties, stakeholders cannot easily seek redress from negligent auditors. Society spends a vast amount of money on company audits and they have to meet some public policy objectives which should be the protection of stakeholders from misleading information. Stakeholders want meaningful financial reports and assurances on corporate probity, but all too often auditors have been able to escape responsibilities because of soft auditing standards. Auditing standards must to be formulated by an independent Companies Commission. Auditors must have a duty to detect and report fraud and material irregularities. Auditors must be required to take active steps to assure themselves that the audited entity is a going concern at the date of the balance sheet.

## **RECOMMENDED REFORMS**

- 50 No statutory regulatory powers for accountancy trade associations acting as the Recognised Supervisory Bodies.
- 51 No statutory regulatory powers for the Financial Reporting Council.
- 52 All aspects of the UK company law, including accounting and auditing, to be overseen by Companies Commission. It will licence auditors and monitor audit quality.
- 53 Societal stakeholders to have presence on the Companies Commission.
- 54 The entire regulatory structure to be the subject of freedom of information laws.
  - Accounting standards must be set by Parliament and emphasise prudent accounting practices.
  - Accounting standards must meet the needs of stakeholders.
  - The Companies Commission shall provide guidance on the accounting principles set by Parliament.
  - All accounting standards must be stress tested to ascertain their effects.

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<sup>448</sup> Sarah Perrin, The raising of the audit exemption threshold is a challenge but also an opportunity for practitioners to offer broader assurance and form deeper relationships with clients, 1 April 2016; <https://www.accaglobal.com/hk/en/member/member/accounting-business/2016/04/practice/audit-threshold.html>

<sup>449</sup> Sansom, A., A long life ahead for small company audit, Accountancy Age, 27th October, 1988, page 14.

- Auditor duties to be clarified by a revised Companies Act.
- Auditing standards must be formulated by the newly established Companies Commission.
- Auditors shall approach each audit with an inquiring mind and design audit tests to determine whether financial statements are free from fraud and material irregularities, and report the matter to regulators.
- Auditors shall to have a statutory duty to design audit tests to determine whether the auditee is a going concern at the date of the balance sheet.
- Legislation shall be enacted to give regulators powers to implement a greater range of sanctions against auditors delivering persistent low quality audits. These can include banning firms for a specified period from securing new clients and the possibility of closure.
- No further jurisdictions shall be awarded to auditing firms until they have addressed the quality gap and shown ability to deliver high quality financial audit.
- The provision of false information to regulators and stakeholders shall be a criminal offence.

## CHAPTER 13 CONCLUSIONS

This report has sought to examine some of the deep-seated problems in the accounting industry. Most of the problems are due to poor architecture and regulation of the auditing industry. Regulators are concerned about the lack of competition and increased concentration of audit services in the big four firms, but their analysis glosses over the persistence of poor quality of audits over the last fifty years. The audit quality was no better when the industry was dominated by five, six, seven or eight firms. The accountancy trade associations and regulators have been unwilling and unable to address the issues as they are dominated by the industry. They have been acting as cheerleaders rather than as regulators operating with a mandate to protect the people from anti-social practices.

The 2007-08 banking crash provided wake-up call to the industry, but it resisted any meaningful change. The debacle over the investigation of HBOS audits is an example of how things are swept under dusty carpets. The business as usual approach has continued to leave a trail of scandals robbing people of savings, pensions, jobs and investments. Too many innocent suppliers, employees, pension scheme members, investors and taxpayers have suffered whilst auditors have continued to enjoy their state guaranteed markets. The most common question posed to us by normal people is: in view of their record why are auditing firms still in business? We would echo that question and hope that legislators can answer it. Even by the feather-duster standards of the FRC, some 27% (19% in 2017) of the audits are substandard<sup>450</sup> and 50% of KPMG's FTSE 350 audits required more than just limited improvements<sup>451</sup>. It is hard to imagine suppliers with the same rate of deficiency surviving in any other industry. Just how many avoidable audit scandals can the UK afford? Perhaps, the firms are in a last chance saloon.

It is misleading to examine the audit market in the same terms as the market for consumer goods and services. The market for auditing is created and guaranteed by the state and is reserved for accountants belonging to a select few trade associations. The normal rules of competitive markets do not apply. In competitive markets those producing shoddy goods/services and deriding customers for expecting higher quality are pushed out of business. They can face mega lawsuits. But despite monumental failures, auditors stay in business because the audit market is guaranteed by the state and regulators do nothing.

The state-guaranteed market for audit is accompanied by feeble regulatory pressures. Producers of potato crisps and toffees have to ensure that the product is fit for purpose and does not injure current or future consumers. There is no equivalent requirement for auditors. Some commentators may hark back to golden era when, during the 1970s, 1980s and the early 1990s, auditing firms traded as partnerships, with each partner having 'joint and several' liability. Yet, even those,

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<sup>450</sup> Financial Reporting Council, Report and Financial Statements for the Year Ended 31 March 2018; <https://www.frc.org.uk/getattachment/4f46c7dd-f0b7-43d6-96c9-c52136281a18/FRC-Annual-Report-and-Financial-Statements-2018.pdf>

<sup>451</sup> Financial Reporting Council, Big Four Audit Quality Review results decline, 18 June 2018; <https://www.frc.org.uk/news/june-2018/big-four-audit-quality-review-results-decline>

supposedly more biting liability arrangements, were not sufficient to deter mega scandals and failures. Successive governments have granted liability concessions to audit firms. It is almost impossible for stakeholders to sue auditors for negligence. Such developments have further weakened the pressures to deliver good audits.

The auditing industry effectively sets its own standards which are often the lowest common denominator. A mechanical checklist mentality has developed. The standards are low, yet audit quality inspections show that many major firms fail to meet them. Audits are generally labour intensive and within firms there are pressures to increase profits. Individuals are subjected to performance appraisals and often their promotion and financial rewards depend on contribution to profits. The organisation dynamics, a key part of the audit production process have been totally neglected by the regulators. The regulators have been slow to investigate failures and these have been examined piecemeal, with minimal effort to address the culture of the audit firms in which the commercial imperative of generating profits, not audit quality, is prioritized. And no attention has been paid to the institutionalised role of accounting and auditing standards in downplaying problems and even nurturing failures.

The public accountability requirements for the auditing industry are low. At any mention of public responsibility firms invoke well-worn arguments about the expectations gap - something that they have done for decades in order to deride stakeholders for expecting reliable, informative audits. Stakeholders are not told anything about the audit contract; composition of the audit team, time spent on audit, questions asked, material replies received from directors or regulatory action against auditors. Audit files remain secret. There is no opportunity to assess the quality of audit. The transparency and public accountability revolution in many other sectors has been shunned by the auditing industry. None of the auditing standards in the industry say much about auditor accountability to societal stakeholders. The few ritualistic lines that appear in jargon-ridden audit reports say nothing about the quality of audits.

There are no magic bullets for addressing the woes of the industry. Our reform proposals are based in what is socially desirable rather than what the industry would prefer. To cut out the perennial use of audits as a 'loss leader' for selling other services, we recommend that auditors should act exclusively as auditors. It is time to move away from the failures of the auditing industry and create a state-backed auditor for the financial sector. This will also reduce the size of the big four firms and stimulate competition. The recommendation of joint audits will enable mid-tier firms to enter the hitherto closed sector of the market and also provide a cushion if one of the big firms is put out of business by its own recklessness. We also recommend removal of all barriers to entry to the audit market. It is ironic that big firms have been at the forefront of calls for competition and deregulation, but have jealously guarded their own ability to collect monopoly rents. To free auditors from fee dependency from companies, we recommend that they be appointed and remunerated by an independent body. To challenge cosy relationship with directors and continuation of cover-ups we recommend change of audit firm every five years and their pitch for business, audit tenders, be made publicly available. We recommend disclosure about the delivery of audits and public scrutiny of audit files. Auditor liability laws need to change so that negligent auditors can be brought to book. We recommend

that auditor duties are set out by parliament and that an independent Companies Commission is established to take responsibility for oversight of all aspects of company law, including accounting and auditing. We recommend that accountancy trade associations have no statutory regulatory powers.

The above recommendations begin to addressing the deep-seated problems of the auditing industry. We anticipate that the recommendations will be resolutely resisted by accountancy trade associations and many in the industry who have become accustomed to delivering little of value for large fees and being indulged and even handsomely rewarded for repeated failure. This indulgence cannot continue as the public cannot continue to pay the price of audit failure and auditor unaccountability. Those who object to our proposals on the grounds that the costs of audit are currently 'private' conveniently ignore the social costs associated with poor quality audit and their failures. UK taxpayers provided £1,162 billion to support and rescue distressed banks<sup>452</sup> where auditors were conspicuous by their silence. Carillion, where auditors were also silent, has resulted in the loss of 19,500 jobs, billions in losses to 30,000 suppliers, and the loss of pension rights for employees. Why should the public continue to indulge and bank-roll such failures and losses?

History<sup>453</sup> shows that much of the change in the world of accounting and auditing has been introduced in the teeth-of-opposition from accountancy trade associations and accounting firms. The same approach must be taken in order to make audit work for, and be accountable to, the many, and not the privileged few. Otherwise, there will be more avoidable scandals resulting in loss of pension rights, jobs, businesses, savings, investments and tax revenues, social instability and ultimately loss of faith in the ability of institutions of democracy to connect with the plight of the innocent bystanders.

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<sup>452</sup>National Audit Office, Taxpayer support for UK banks: FAQs, <https://www.nao.org.uk/highlights/taxpayer-support-for-uk-banks-faqs/>

<sup>453</sup> Tony Puxty, Prem Sikka and Hugh Willmott, (Re)Forming the Circle: Education, Ethics and Accountancy Practices, *Accounting Education*, Vol. 3, No. 1, 1994, pp. 77-92. Austin Mitchell and Prem Sikka, "Accounting for Change: The Institutions of Accountancy", *Critical Perspectives on Accounting*, 1993, Vol. 4, No. 1, pages 29-52.

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