Prof. Adam Leaver, University of Sheffield
Prof. Duncan Wigan, Copenhagen Business School
Prof. Atul K. Shah, City University London

Audit needs a major overhaul: the government's plans are a good start

For too long, audits have been plagued by conflicts of interest and poor standards, which lead to lost jobs, wasted taxpayer money, and companies failing to tackle the climate crisis. We welcome Business Secretary Kwasi Kwarteng's decision to prioritise audit reform, and urge him to deliver bold and radical change.

Good audits are a basic building block of healthy, fair economies and societies. They make sure that directors aren't misrepresenting company finances, including putting people's jobs or pensions at risk, or overvaluing polluting assets and business models. Audits build trust in companies and in our financial system overall, and are necessary for a properly functioning market economy. However, society is being failed by poor quality audits - with problems including conflicts of interest, poor standards, weak regulation, insufficient sanctions for malpractice, and weaknesses in the underlying accounting rules and principles which auditors check adherence to. All this means that stakeholders of companies do not get the information that they need. The package of reforms in the UK Government's White Paper makes a good start on addressing a number of these issues. But systematic and far-reaching change is needed - reform must not stop with the White Paper.

The purpose of audit: Audits perform an external check on a company or organisation's financial accounts. To do this properly, auditors must exercise critical judgement and independence. Strong and independent audits have the power to equip a wide range of stakeholders with the information and confidence they need to make good decisions. Small businesses can know if a major new potential trading partner could be at risk of collapse. Regulators and tax authorities can see how a company is structuring their business and if they could be avoiding tax. Employees and trade unions can get a clearer picture of how the organisation is being managed and whether their jobs and pensions remain safe. Civil society can see whether or not an oil company is taking its responsibility to reduce carbon emissions seriously. And shareholders and other providers of capital can make better decisions about where to put their money. Most auditors consider it their duty to prepare their reports solely to meet the needs of shareholders, despite so many more groups having a legitimate interest in an organisation's financial accounts. This needs to change. The purpose of audit must be redefined to give auditors a responsibility to ensure the needs of all relevant stakeholders are met.

Recent examples of audit failure in the UK:

- **Carillion**: Auditor KPMG is facing a lawsuit for failing to warn of financial problems at Carillion, and allowing the construction firm to pursue a reckless strategy of concealing debts and issuing big dividends. When Carillion collapsed in 2016, thousands of people lost their jobs, many of the company's 30,000 suppliers suffered financial losses, and taxpayers lost an estimated £148 million.
- **Climate change**: Companies are ignoring climate change obligations in their business plans and financial statements - for instance, over-valuing assets like oil and coal rather than recognising that they need to be phased out - which harms their profits and makes climate change worse. ClientEarth found that 90% of financial accounts and audit reports for the 250 largest listed companies in the UK made no reference to climate risks or their financial impact. While Shell has committed to achieving net-zero by 2050, the company claims that it does not need to include its net-zero targets in its operating plans and pricing assumptions because of uncertainty as to how society will reach net-zero. This raises questions over the credibility and feasibility of Shell's net-zero ambitions, and also leaves investors in the dark about the impact of such a transition on the value of the company and its assets.
- **Patisserie Valerie**: Auditor Grant Thornton faces a lawsuit over failing to raise the alarm bells over suspected fraud at Patisserie Valerie. Over 900 people lost their jobs and investors suffered losses when the cafe chain went into administration and its value plummeted from £580 million to zero.

Recommendations

Ensure the new regulator is independent and has teeth: The proposals in the White Paper will stand or fall based on how the new audit regulator, Audit, Reporting and Governance Authority (ARGA), is established: a weak regulator that is beholden to the industry will not deliver the shake-up of audit that is desperately needed. We strongly welcome the creation of ARGA but to ensure it is strong and effective, the government must ensure it has robust governance arrangements - including open and transparent recruitment processes, a statutory code of conduct, and effective policies to deal with any potential conflicts of interest auditors face. ARGA must also be properly resourced to deal with complex investigations - the government should consider a levy on all entities requiring an audit to fund ARGA, in addition to the proposed levy on audit firms. Finally, ARGA must have the power to issue effective sanctions. Current fines on audit firms for malpractice are insignificant and are considered a cost of doing business: they are not a meaningful disincentive. We welcome the proposals to make it easier to clawback director bonuses if a company collapses or serious failings are identified.

Integrate climate reporting into company accounts: Companies must act now to align their business models with the UK's 2050 net zero goal and interim targets - failing to do so harms both the planet and long-term profits. The government should create specific duties for companies, and their directors and auditors, to ensure climate risk is reflected in financial statements. This should include stating whether and how they have adopted assumptions about the net-zero transition, and if not, explain what the impact would be if they had.

Go further to tackle conflict of interest through full structural separation: The Big Four audit firms make the majority of their profits through separate and highly lucrative consultancy services, many of which are specifically aimed at gaming the rules for which they as auditors are also supposed to assure compliance. This includes offering advice on how to avoid tax or circumvent regulation. This compromises the effectiveness and integrity of audits, and undermines public confidence in the profession. The government's proposal to enable ARGA to impose an operational split between the audit and non-audit functions of accountancy firms is a welcome step. However, to truly end conflicts of interest we urge the government to back full structural separation, so that audit and non-audit services are carried out by separate companies.

Strengthen responsibility to detect fraud: Auditors have failed to spot or challenge huge cases of corporate fraud in recent years - like with Wirecard in Germany or Patisserie Valerie in the UK. Tweaking International Standard on Auditing (ISA) rules is not enough to prevent these sorts of complex frauds. Auditors should have to report on the steps they have taken to verify directors' statements and detect potential fraud, such as to verify revenues, check for concealed liabilities and expenses, and assess for improper asset valuation. Directors should also have increased obligations to deter fraud within their own companies, including being required to meet standards of honesty and integrity when carrying out their corporate reporting and audit duties.

Fix loopholes in the new capital maintenance rules: Strong capital maintenance rules are vital to ensure the resilience of companies and help prevent future collapses. They mean that a company can only pay dividends out of profits where all costs have been accounted for. The government's proposals to strengthen capital maintenance rules are very welcome. However, there are loopholes in the new rules that need fixing. For example, the rules that decide how dividends are distributed should focus on the group of companies that are being audited rather than their parent company. This would help prevent companies gaming the system to pay inappropriately large dividends.

Reform accounting rules and encourage critical auditing: The generally accepted accounting frameworks in the UK which auditors check adherence to - whether that is International Financial Reporting Standards (IFRS) or UK generally accepted accounting principles - do not always encourage prudent accounting, and offer a large degree of flexibility which is abused by some companies. Too often, audits are a tick box exercise: an auditor might spot problems with a company, but if the accounts meet accounting rules then they give the firm a clean bill of health, only for it to collapse soon afterwards. Global accounting standards like IFRS need to be reformed, but just as importantly auditors must also be encouraged to use their professional judgement and speak out when they spot problems - whatever accounting framework is in use, and even if the rules have apparently been complied with.

For more information, contact: jon.date@digacommunucations.com / +44 (0)7533 011983.