



**The Centre for Economic Justice**

# **THE TRUTH TELLERS**

**WHY WE NEED  
PROFOUND  
AUDIT SECTOR  
REFORM NOW**

**BRIEFING 1**

**Carsten Jung and  
Shreya Nanda**

April 2021

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## ABOUT THIS REPORT

This report meets IPPR's overall objective of research and education into industry, commerce and public services. It also meets our objective to advance sustainable development and improve the efficiency of public services.

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# INTRODUCTION

In 2017, seemingly out of the blue, the construction giant Carillion collapsed. Until just before its failure it had booked significant profits, paid out sizeable dividends to shareholders and was employing 43,000 people. What happened? The official inquiry into its failure describes the situation running up to the company's collapse as follows:

*“Carillion’s rise and spectacular fall was a story of recklessness, hubris and greed. Its business model was a relentless dash for cash, driven by acquisitions, rising debt, expansion into new markets and exploitation of suppliers. It presented accounts that misrepresented the reality of the business, and increased its dividend every year, come what may. Long term obligations, such as adequately funding its pension schemes, were treated with contempt. Even as the company very publicly began to unravel, the board was concerned with increasing and protecting generous executive bonuses. Carillion was unsustainable. The mystery is not that it collapsed, but that it lasted so long.”*

DWP and BEIS select committee (2018)

In this report, we highlight that dramas like this one are playing out in smaller forms in other UK businesses every year. This leaves the UK economy with significant costs. Bad governance and poor management with too little accountability in businesses is at the heart of this problem (BEIS 2021). But auditors should be the gatekeepers helping to keep such financial mismanagement at bay, yet too often they are failing to do so. The government has recognised this and begun to consider reforms. But three years after Carillion, no significant policy action has been taken (ibid). There is a real risk that unambitious reform leaves some of the central problems unaddressed and that the costs for society will continue to occur year after year.

## **This status quo is ultimately in no one’s interest.**

Almost two-thirds of the public say that they do not trust that the current audit system provides independent and accurate assessments of companies’ financial positions (Mazars 2019). This hampers audit firms’ growth into new business areas where their professional expertise and independence are needed, such as in assessing companies’ climate risks. Businesses that use auditors, in turn, can lose out on the rigorous challenge that could strengthen their business strategy, and the economy as a whole loses out when sub-par auditing can lead to sub-par investment decisions. Conversely, a well-functioning audit sector can be a beacon for transparency and trust, enabling management, workers, investors and regulators to make more informed choices. This could not be more important in a world of strained balance sheets following the Covid-19 pandemic.

“ a well-functioning audit sector can be a beacon for transparency and trust, enabling management, workers, investors and regulators to make more informed choices

**In this first report of a three-part series, we provide an assessment of the core problems of the audit sector and their costs for society.** We will also show how a reformed audit sector could be boon for a productive economy. In the following two papers we will outline a plan for action:

- **Part two: Regulation, purpose and culture.** This report will outline in more detail the role of audit in ensuring business is aligned with society's goals through regulation and a profound shift in audit firms' culture.
- **Part three: What does good look like?** This report will provide an assessment of the government's audit policy agenda and will highlight priorities and gaps.

# 1. AUDITORS SHOULD BE THE TRUSTED REFEREES OF CORPORATE BRITAIN

Audit exists to help establish the truth about business finances. It should help demonstrate, to a wide range of parties, whether businesses are run sustainably. This includes checking the financial accounts and ensuring businesses truthfully and transparently report how they are run. As such, auditors are supposed to be the ‘referees’ of corporate Britain.<sup>1</sup>

A well-functioning audit sector should be expected to flag problematic accounting practices and risky business activities to inside and outside stakeholders before they turn into damaging debacles. However, the current legal set up does not require this from auditors. It too often is akin to a ‘tick box exercise’. Auditors, in turn, do not regard it as in their remit. In the case of Carillion, better functioning audit could have raised red flags for investors, clients and regulators potentially years earlier (see box 1). These stakeholders could in turn have pushed Carillion’s directors out and replaced them with a more responsible team. This might have saved the company, avoided investments being wasted, preserved jobs and ensured contracts were fulfilled. In other cases too, like that of the drinks retailer and wholesaler Conviviality (see box 2), auditors might have helped investors make more informed decisions about its breakneck expansion, and its finance and business plans – which were ultimately unviable.

High quality auditing will of course not prevent all, or even most, business failures, and nor should it. But it is essential in ensuring markets and wider stakeholders have the information they need to make an informed judgement.

**While providing significant win-win opportunities for business and society, the audit industry is currently failing to deliver on its role as trusted referee.** While UK auditors were closer to their role in the first half of the 20th century, the audit sector now seems to have lost its way, with one in three audits found to be problematic (FRC 2020a, Brooks 2018). Rather than meticulously monitoring on behalf of society and to the benefit of the economy, many audits today are not living up to expectations. The Competition and Markets Authority (2019) found that:

*“Many stakeholders – including audit firms – accepted that recent instances of high profile corporate failures have exposed serious concerns around audit quality and diminished trust in the audited financial statements of large companies overall.”*

**Auditors must regain their status as trusted referees of business finances, but the need for public trust in business goes beyond this.** Functions ranging from assessing environmental performance and good governance to the handling of personal data; a well-functioning market economy needs accurate information so stakeholders can decide whether they trust a business. This was the conclusion

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<sup>1</sup> Auditors also perform a similar function for public institutions such for example NHS trusts or local councils.

of the Brydon review (2019) commissioned by the government. The government too wants audit to be 'more trusted, more informative, and hence more valuable to the UK' (BEIS 2021). Audit firms, in other words, ought to both repair their core business of 'monitoring finances' and take a more comprehensive view on firms' behaviour. So – as we will argue in the next paper in our series on audit reform – **audit's purpose could and should be expanded**. This would provide enormous business opportunities for the sector.



## 2. WHEN AUDIT FAILS

**When audit fails, it means there are insufficient checks to establish trust in firms' finances, sometimes giving a pass to outright fraud but more often to more subtle, but damaging, forms of accounting.** This is partly due to not doing enough to challenge the businesses they audit, and partly due to them seeing certain tasks as 'beyond their brief'. As a result, there is almost unanimous agreement that audit firms are failing to live up to society's expectations and needs (BEIS Select Committee 2019, CMA 2019, Kingman 2018, Brydon 2019, FT 2018a).

We categorise audit failure into four different types of problematic behaviour. We define these failures against what the reformed audit sector *should* do to live up to society's expectations and economic needs, rather than what it is strictly required to do in today's unreformed set up. Throughout this report, unless otherwise stated, we refer to 'audit failure' as either of these four categories:<sup>2</sup>

- **Not detecting fraud.** This includes cases of deliberate and systematic misstatements by a business in financial accounts to paint a misleading picture of company accounts.
- **Giving a pass to accounts which fail to be 'true and fair and free from misstatements'**, even where there was no fraudulent intent. These are cases where there are significant omissions, misstatements, or a lack of appropriate control environment, such as in the case of Carillion (which some say misclassified some its debt) or Conviviality (failing to account for a tax bill) (see boxes 1 and 2). This is broadly the definition the FRC is using when assessing audit quality (FRC 2020a).
- **Rule arbitrage.** These are cases where rules are not violated but are used and interpreted in such a way that they yield an undesirable outcome from a public accountability perspective. Carillion in as an example for this too – it used potentially legal but aggressive accounting practices to pay out high profits, by emphasising future profits and de-emphasising current costs. Similarly, it used 'difficult to justify' assumptions about the value of its businesses (DWP and BEIS select committee 2018).
- **Consulting failure.** This is a case where audit-related consultancy services are not in violation of rules but are actively promoting actions that go against the refereeing role that auditors should strive to. Audit firms, in one place, might advise on how to transparently and usefully present financial accounts; and in another place devise creative ways of not doing so. For example, they might 'advise managers on how best to maximise shareholder distributions using a variety of creative accounting techniques' (Leaver et al 2020). In addition to this, consultancy activities can act against society's interest in other subtle ways, such as in the case of helping businesses to avoid tax (Public Accounts Committee 2013, 2015).

When audit fails, according to one of the four above definitions, it often follows a 'boom' and 'bust' pattern (figure 2.1) – as explained in the case study of Carillion (box 1). A rosy accounting picture is painted, including by using the large wiggle room present in current accounting rules, and given a pass by auditors. This allows large pay-outs to investors and management, even while the underlying financial

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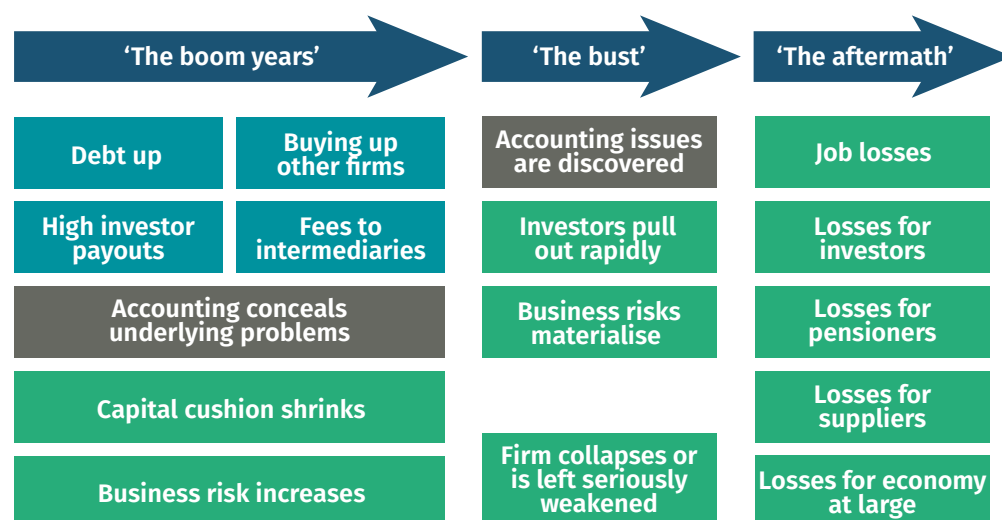
2 This is building on the classification in Leaver et al (2019).

performance is on shaky foundations.<sup>3</sup> These we call the ‘the boom years’, in which optimism and exaggerated accounting are coupled with an aggressive expansion of the business, including a sharp increase in debt.

When audit fails, rather than flagging problems (as they should), auditors are allowing accounting rules to be used to emphasise expected *future* gains, de-emphasising losses, and pursuing a strategy of expansion and increasing debt. In fraud cases, such accounting trickery ends up breaking the rules and is akin to a Ponzi scheme.<sup>4</sup> And in some cases it is audit firms themselves that are helping businesses devise potentially problematic strategies (DWP and BEIS select committee 2018).

Ultimately, when underlying weaknesses or misstatements can eventually no longer be concealed and markets realise the risks, investors and lenders suddenly pull out, exacerbating the underlying problems. The business ends up collapsing or survives seriously weakened. In the aftermath jobs are shed, investor losses pile up, pensioners and suppliers are faced with losses and the economy suffers from productivity losses.

**FIGURE 2.1**  
Stylised timeline of an audit failure



Source: Authors’ analysis

3 Note that there are also audit failures that lead to a more subtle impacts on businesses and are therefore harder to spot from the outside. Conversely, there are of course booms and busts of firms that are driven on solid accounting and audits (for example, the high failure rates of fast-growing start-ups). But in these cases, transparent accounts should mean fewer surprises for outside investors.

4 A fraudulent scheme that takes money from later investors to pay earlier investors. Such a scheme is ultimately bound to fail once no new investment can be attracted.

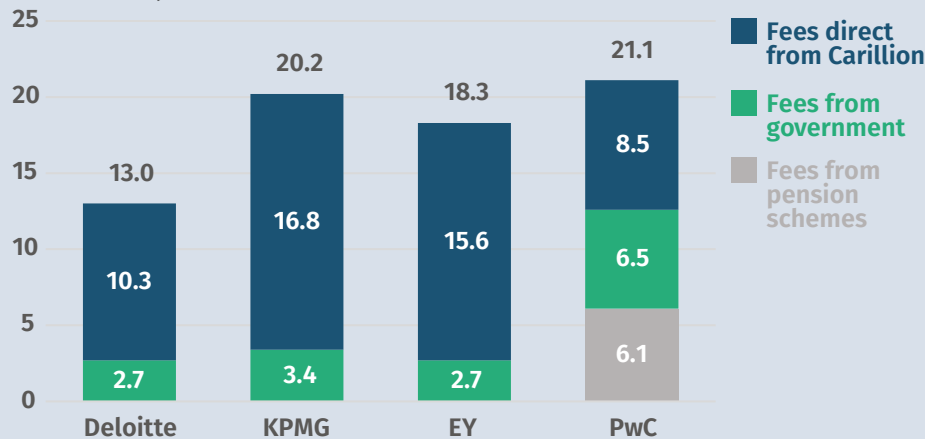
### BOX 1: ANATOMY OF AN AUDIT FAILURE – CARILLION

Carillion was a construction and facilities management service, which provided many services to the UK government: running NHS facilities, building schools, transport projects, and managing prisons. It collapsed in 2018, in the ‘largest ever trading liquidation in the UK’ (The Insolvency Service 2018).

KPMG, as Carillion’s main auditor, was heavily criticised for its role in the collapse. But all of the ‘big four’ audit services firms were involved at some point during the run-up and collapse: KPMG as Carillion’s external auditor; Deloitte its internal auditor;<sup>5</sup> Ernst and Young (EY) as consultants; and PricewaterhouseCoopers (PwC) as special managers of the liquidation process. In addition, all four had provided various consultancy services to Carillion, and all had been involved in some capacity in advising government in relation to Carillion’s work (DWP and BEIS select committee 2018), creating the potential for conflicts of interest (FT 2018c, 2018d). Between 2008 and 2018, the big four received £72.6 million in fees relating to Carillion (figure 2.2).

FIGURE 2.2

All of the ‘big four’ firms were involved with Carillion  
Fees received from Carillion since 2008 (£m)



Source: Consultancy.uk (2018)

Carillion put itself into a financially precarious position by systematically borrowing against ‘optimistically booked, and in hindsight unrealised’ expected future profits (DWP and BEIS select committee 2019), and using this money to pay dividends and bonuses. Auditors did not raise red flags even though some critical assumptions in the accounts were ‘difficult to justify’ (DWP and BEIS select committee 2018). It has not yet been established whether this constituted a breach of audit standards, or was simply a result of overly-lax accounting rules. Between 2009 and 2017, ‘Carillion’s debts rose by 297 per cent, whereas the value of its long-term assets grew by just 14 per cent’ (Sikka et al 2018).

When contracts started to underperform, Carillion did not respond by writing down their value, but instead responded by submitting more risky

<sup>5</sup> An external auditor provides information to those outside the firm (such as shareholders and creditors), reviewing a firm’s financial statements. An internal auditor provides information to those inside the firm (managers, for example), ensuring that a firm is compliant with regulations and that it is managing risk efficiently.

bids for new projects, in what was later likened by the *Financial Times* to a 'lawful sort of Ponzi scheme' (FT 2018e).

Market analysts voiced concerns about Carillion's accounting practices, including around how it presented its indebtedness, in 2015 (Bloomberg 2018). But these concerns were not flagged in financial accounts or other documentation for shareholders. In some cases, this has been found to constitute a breach of disclosure standards – the FCA has since ruled that three market updates in the year before the collapse were misleadingly positive (Construction News 2020). In July 2017, the company was finally forced to issue its first profit warning (Construction Index 2018), before going into liquidation in January 2018.

In terms of auditing standards, whether a breach has occurred is as yet unclear. The FRC's investigation into KPMG's audit of Carillion suggested that some possible breaches of accounting standards were found, though information on what these were is not yet public (Reuters 2020). KPMG have responded to the FRC's initial investigation report: 'We are cooperating fully with the FRC's investigation. We have and will continue to respond appropriately to the initial investigation report' (Sky News 2021).

Over 3,000 employees lost their jobs (The Conversation 2021), as well as likely further job losses among suppliers, who lost around £2 billion which was owed to them by Carillion (Construction Index 2019). In addition, over 27,000 pension scheme members faced reduced pensions (House of Commons 2019); there were knock-on effects for 450 unfinished public sector projects (Guardian 2020); and over £150 million was spent by the government on the liquidation process and redundancy payments (Guardian 2018).<sup>6</sup>

“ There are potentially a large number of small-scale, silent Carillions happening every year

There are ongoing costs from audit failure even aside from prominent business collapses. While prominent audit failures like Carillion loom large, many do not make the news or may indeed never be discovered and thus exert ongoing indirect costs on the economy. In 2020, **about one in three audits that the regulator checked were problematic** (FRC 2020c) (figure 2.3).<sup>7</sup> These included cases where the auditors provided insufficient challenge to management, insufficiently probed the viability of a business, insufficiently scrutinised the international aspects of a business, made inappropriate auditing judgements or collected evidence of insufficient quality (ibid). Note that this definition of problematic audits used by the FRC is narrower than our definition introduced above.

This means there are potentially a large number of small-scale, silent Carillions happening every year. Some likely result in small 'busts' (see figure 2.1) and costs accumulate by the time they are discovered. Yet, despite a string of audit failures in

<sup>6</sup> In May 2020, the Insolvency Service, a government agency, was reported to be preparing a £250 million negligence lawsuit against KPMG, in the first case of its kind (FT 2020a). KPMG has rejected the service's application to access its (KPMG's) accounts, calling the sequencing 'unusual' and 'unnecessary' (New Civil Engineer 2020). The Insolvency Service has also applied for eight directors and former directors of Carillion to be disqualified on the grounds that their conduct makes them unfit to be concerned with the management of a company (Insolvency Service 2021). They have not yet publicly commented.

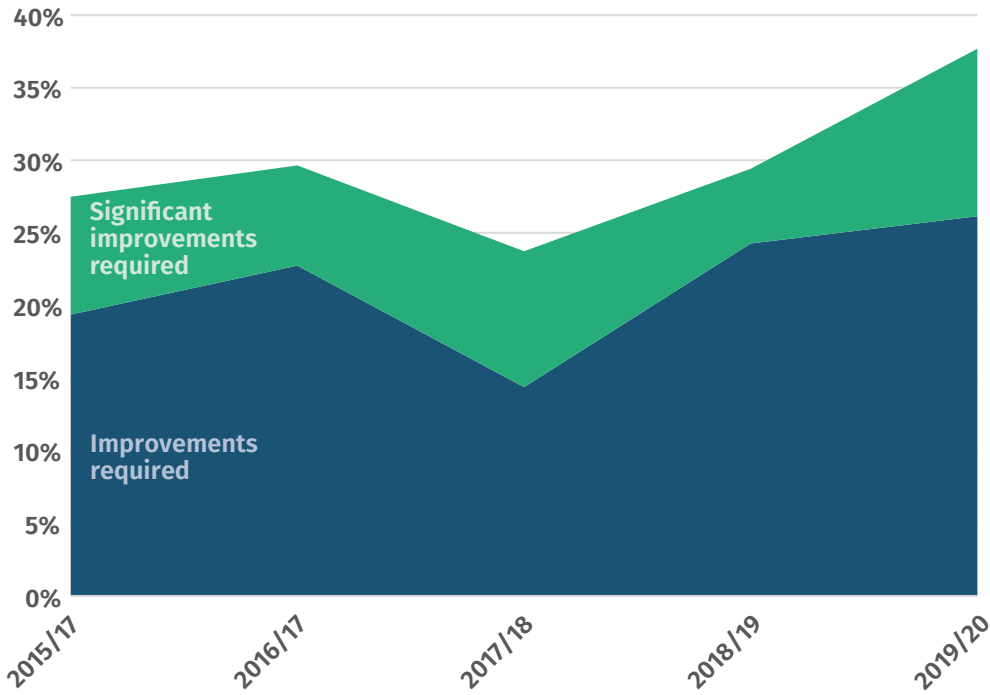
<sup>7</sup> This number might not necessarily be representative of all audits, as the FRC aims to focus on higher risk audits. On the other hand, our definition of audit failure above is much broader than that of the FRC, so the share of audits being problematic judged against what we think audit should achieve is likely larger.

the last years, and the associated increase in public attention, the number of faulty audits has not materially changed in the last three years (figure 2.3) (FRC 2020).<sup>8</sup>

**FIGURE 2.3**

**Around one in three audits are flawed**

*Share of audits checked by the regulator that were problematic and required improvements*



Source: IPPR analysis of FRC (2020a, 2020b)

8 Given the small sample size, changes in the trend might not be statistically significant (Kingman 2018).

### 3.

# UNEQUAL OUTCOMES: THE SOCIAL COSTS OF AUDIT FAILURE

The costs of audit failure can be divided into direct and indirect costs. Direct costs include, for example, workers losing their jobs and investors losing their money. Indirect costs are those that affect the economy at large.

#### DIRECT COSTS

Table 3.1 provides some examples for direct costs. For instance, in the case of BHS, 11,000 workers lost their jobs, and in the case of Carillion, 27,000 people saw some of their pension savings at risk. Moreover, the table highlights direct costs to the wider economy. For instance, in the case of the Carillion collapse, £2 billion was owed to suppliers which was not paid, and the ripple effects of the collapse were felt across its supply chain network (DWP and BEIS select committee 2018). Many investors, too, often face large losses when firms' accounts turn sour. However, there are some 'intermediaries', which include audit firms themselves, who financially benefit during the 'boom' phase which precedes an audit fraud; for instance, during the phase of rapid expansion of Carillion (ibid).

**TABLE 3.1**

**Direct costs of audit-related failure, selected examples**

	Industry	Jobs lost	Investor/pensioner losses	Direct costs to wider economy
<b>BHS (failed in 2016)</b>	Department store	11,000	£208m pension deficit across 19,000 employees	£64m owed to 1,200 creditors
<b>Carillion (failed in 2018)</b>	Construction	Over 3,000	27,000 people facing reduced pensions	£2bn owed to suppliers, unfinished projects, over £150m costs for taxpayer
<b>Patisserie Valerie (failed in 2019)</b>	Café chain	900		
<b>Conviviality (2020)</b>	Retail, wholesale		4.1% losses for Acorn investors in March 2018	
<b>Redcentric plc (2019)</b>	IT		£31.6m	As NHS supplier, the performance drop could negatively affect the NHS

Sources: BHS: Guardian (2019), Guardian (2017), Fashion Network (2018); Carillion: The Conversation (2021), House of Commons (2019), Construction Index (2019), Guardian (2018); Patisserie Valerie: Accounting Web (2019); Conviviality: Catering Today (2018), City Wire (2018), FT (2018f); Redcentric: FT Adviser (2020), Best Practice Group (2020).

## INDIRECT COSTS

Beyond the direct cost of audit failures, there are ongoing costs exerted by bad practices in the audit sector. This can be divided into five types of costs:

### Indirect costs 1: bad investments

When financial accounts are not sufficiently informative, it leads to money backing the wrong projects. For instance, Carillion was overly optimistic in its estimates of future profits (DWP and BEIS select committee 2018, and when it was finally announced that profits would be lower than expected, Carillion's share price dropped by 70 per cent (ibid). This means money that was invested in Carillion that could have been invested in firms whose accounts were transparently reported. As such, audit failures distort the market, diverting resources away to 'unworthy' firms that are better at presenting themselves in accounting terms rather than being truly more productive. From a corporate finance perspective, unduly optimistic accounts – not flagged by auditors – drive firms' share prices up which in turn drives them to expand (Edmans et al 2020). When the accounting problems become apparent, that value is destroyed (ibid).

Moreover, current accounting practices may be helping to overstate the benefits of mergers and acquisitions (M&As) (Ramanna 2015).<sup>9</sup> Findings in the corporate finance literature highlight that M&As are often not value-enhancing (Gu and Leve 2011, Andrade et al 2001). However, often the way financial accounts are done during M&As can result in a bias in favour of the merger. The pattern that emerges originates with overpriced shares, driving stock-financed acquisitions, and ultimately to substantial goodwill write-offs (Gu and Lev 2011). This pattern is similar to what happened in the case of Conviviality (see box 2).

### BOX 2: TAKEOVERS, BOOM AND BUST – CONVIVIALITY

A private equity firm purchased the off-license and convenience shop chain 'Bargain Booze', increased its debt and floated it on the stock market in 2013 as Conviviality. They then started buying up other firms for hundreds of millions of pounds, financed through stock. This included drinks wholesaler Matthew Clark (acquired for £200 million), wine merchant Bibendum (acquired for £60 million) and outdoor events operator Peppermint (acquired for £8 million). This rapid expansion took the business model towards becoming a wholesale supplier for bars and restaurants (FT 2018b). The new growth model was praised by investors and rewarded with a stock market valuation of close to £750 million in November 2017 (ibid).

However, with astonishing speed, the financial success story unravelled. Within five months the business went into administration, taking down the businesses it had acquired with it. The trigger for this was that profits had been forecasted erroneously, and a £30 million tax liability had been 'forgotten' (ibid). Here, too, auditors were involved in problematic ways. The FRC fined the audit firm £3 million; it had 'admitted breaching very important standards designed to preserve the integrity, objectivity and independence of audit'. An audit partner too was fined, as they had worked as an advisor to the firm, subsequently advising Conviviality on its business strategy in violation of rules (FRC 2020d). The audit firm has recently taken action to address these issues. Another auditor of Conviviality is currently under investigation, with regards to 'the preparation and approval of Conviviality's financial statements and other financial information' in the four years up to April 2017 (FRC 2020e).

While the exact details of Conviviality's failure are not publicly accessible, the pattern of fast expansion, acquisitions and ultimately overly optimistic expectations around future revenues fit the pattern of other audit failures. What this example demonstrates well is how value can be destroyed: as the business failed, so did much of the value of those it had acquired on the way.

9 This is due to the favourable accounting treatment of good will.

### Indirect costs 2: Underinvestment

The UK has been plagued by chronic underinvestment from businesses over the last five years, due to a range of underlying factors (Bank of England 2020). One of them is likely the so-called ‘capital maintenance regime’, which is the set of rules that determines how much money can be paid out to shareholders by a business (Baker et al 2020, Leaver et al 2021). The current set up means that firms can use accounting rules such as to pay more money to their investors than might be prudent or underinvest in the business. (ibid).

“Lax accounting rules are permitting firms to ‘eat themselves

To illustrate this: between 2009 and 2018, on average, 25 per cent of FTSE100 firms paid out more money to their investors than they earned in net income over that same period (Baker et al 2020). Firms were paying out their underlying financial buffers to investors even though they are crucial for their long-term sustainability. The Bank of England’s chief economist once described this as firms ‘eating themselves’ (Haldane 2015). This could be prevented by strengthening the requirement that management’s core obligation is to strengthen the capital base of the business, checked by auditors. Without this, it is right to say that that lax accounting rules are permitting firms to ‘eat themselves’.

### Indirect costs 3: Contribution to financial stability risks

Accounting practices can also exacerbate threats to the financial system which, in turn, can have negative impacts on the economy. The financial crisis of 2008-09 showed that optimistic accounting practices concealed how huge risks were building up on a system-wide level. First and foremost, this was caused by lax financial regulation and insufficient concern about systemic risks (Haldane 2017). But these problems overlapped with accounting and auditing issues – accounting rules allowed financial firms to avoid booking losses when they occurred, and continue to take risks (Kothari and Lester 2012, HBR 2009). Rather than highlighting risk as it was building up, accounting rules were used to conceal them until it all unravelled (ibid). This was not confined to a single financial institution. Instead, it led to higher risk taking across much of the American and European financial systems (ibid). This shows that the problems with inflated financial accounts explained above can occur on a *system-wide* level. Beyond just affecting individual firms, they can affect an entire sector and the economy at large.

### Indirect costs 4: Distortion of public policy decisions

Audit firms play an important advisory role to governments. In 2019, the ‘big four’ alone had contracts with the UK government worth £718 million (Tussell 2020). For example, in order for policymakers to assess whether the HS2 rail project was good value for money, consultants from the ‘big four’ were brought in as advisors to government to do a cost-benefit analysis. Before the green light was given, the cost was estimated at £15 billion (Brooks 2018). But this turned out to be hugely optimistic, and the actual cost may now be above £100 billion (FT 2020b). The £85 billion difference is resulting in huge costs to the taxpayer that may well have swung politicians’ decisions in a different direction. At the same time, the go-ahead decision has resulted in further consulting contracts for the auditors involved, advising on the delivery of the project (Brooks 2018).

Of course, cost overruns are an endemic problem in megaprojects such as HS2 and not principally the failure of audit firms’ advice. For example, a wide-ranging global study found that costs for rail projects overrun on average by 40 per cent (Flyvbjerg and Sunstein 2016). But a successfully reformed audit sector (including related consultancy services) would provide a more effective challenge when advising the government on them, protecting the public purse. As Flyvbjerg and Sunstein (ibid)



argue: ‘to promote accountability, the analysis [of megaprojects] should also be subject to external scrutiny (including scrutiny by independent experts and the public)’. This rigorous scrutiny could be established by audit firms. ‘Consultancy failure’ that gives a pass to overly optimistic management then is precisely the opposite of what we should expect from auditors as the referees of corporate Britain.

Another case of consulting failure, described in box 3, highlights the role of auditors in government regulation of firms. In fact, as was the case for Thames Water, there have been perceived conflicts of interest in place that draw into question whether the regulatory work by the consultancy is free from bias.

### **BOX 3: CONSULTANCY SERVICES AND THE PUBLIC INTEREST – OFWAT AND THAMES WATER**

Thames Water is the UK’s largest water company, supplying about a third of the water and sewage system in England, and serving 15 million customers. It was formed in the privatisation of the water network in 1989 and is regulated by Ofwat, the water regulator. It has undergone several scandals in recent years, including the discovery that it had illegally dumped 4.2 billion litres of raw sewage into the River Thames between 2012 and 2014 (FT 2017a). In 2017, this led to the largest regulatory fine (relating to six incidents) for river pollution in UK history. The issue of leakage and pollution is a wider-ranging issue in the UK water industry – with one in five litres of water being lost to leakage every day – which the Public Accounts Committee (2020) highlights require more investment by firms to fix.

At the same time as the company was polluting the Thames with raw sewage, large sums of money were paid out by the firm to management and investors. In the decade up to 2015, it paid out £1.2 billion in dividends summing to a large return on equity of 50 per cent over this time horizon (FT 2017a). At the same time, the firm doubled its debt and paid large sums to executives, worsening the firm’s financial position (ibid). Thames Water paid no corporation tax in 2011-2015 (due to the tax treatment of its investments and debt interest costs), and its pension pot went from surplus to a £260 million deficit, while bills for consumers rose (ibid). As of 2019, the firm was struggling with performance and quality issues (FT 2019). Thames Water highlights that its ownership structure, governance and dividend policy have since been significantly reformed and it stresses that the majority of its debt is investment grade. It also stresses that its pension deficit had shrunk to £115 million by March 2019 and is expected to be closed by 2027.

The water regulator, Ofwat, is responsible for approving pricing and investment plans of water companies, among other things. So ensuring that water companies work in the public interest is at the heart of its remit. Given this role, any appearance of a conflict of interest should be avoided.

Yet one of the ‘big four’ audit firms was providing consultancy services to Thames Water and several other water companies. This included advising some of them on their business plans, including bill prices and investment (ibid). But at the very same time the audit firm was also being employed as the ‘delivery partner’ for Ofwat in the three years up to 2015 (FT 2017b). To get a sense what this could involve: In the most recent delivery partner exercise this meant ‘embedding [the audit firms’ staff in [Ofwat’s] teams to assess [water] company business plans’. This includes advice on ‘outcomes’, ‘resilience’, ‘affordability and ‘vulnerability’. It also involved for it to ‘intervene when a [water] company was not meeting Ofwat’s expectations’.

As a result, the audit firm and Ofwat have been criticised for a potential conflict of interest (ibid). Ofwat acknowledged that, until 2016, there was not enough attention on leakage that ‘everybody took their eye off the ball’ (Public Accounts Committee 2020). Most recently the audit firm was again picked as one of Ofwat’s delivery partners. While it ceased to advise Thames Water, it became its auditor instead in 2018/19.

The audit firm said it ensured that ‘any perceived or potential conflicts are addressed’ (FT 2017b). Ofwat, in turn, said it took steps to ‘ensure that any existing actual and potential conflicts were identified and suitable measures put in place to ensure there were robust ethical walls’ (ibid). Defra and Ofwat said there is now a renewed focus on tackling leakage (Public Accounts Committee 2020).

However, in the future, the public might want more assurances that there is no real or perceived conflict of interest with regards to the regulation of businesses.

#### Indirect cost 5: audit firms’ role in tax avoidance

Aside from the conflict of interest described above, consultancy, both by the ‘big four’ and others, can have large social relevance. For example, the ‘big four’ audit

firms make about one-third of their revenue from tax advice for firms and high-net-worth individuals. It is no secret that the strategies for ‘tax efficiency’ that this entails are often aimed at reducing tax bills as much as legally possible. And it is also established that this mainly benefits larger firms and the wealthiest individuals, and that these schemes are ‘mass marketed’ by audit firms (Public Accounts Committee 2013, 2015). In other words, tax advice – though much of it surely benign – is explicitly and deliberately given so as to avoid the rules and regulations devised by elected governments. This type of tax advice, given by audit firms, is clearly acting against the public interest.<sup>10</sup>

“ This type of tax advice, given by audit firms, is clearly acting against the public interest

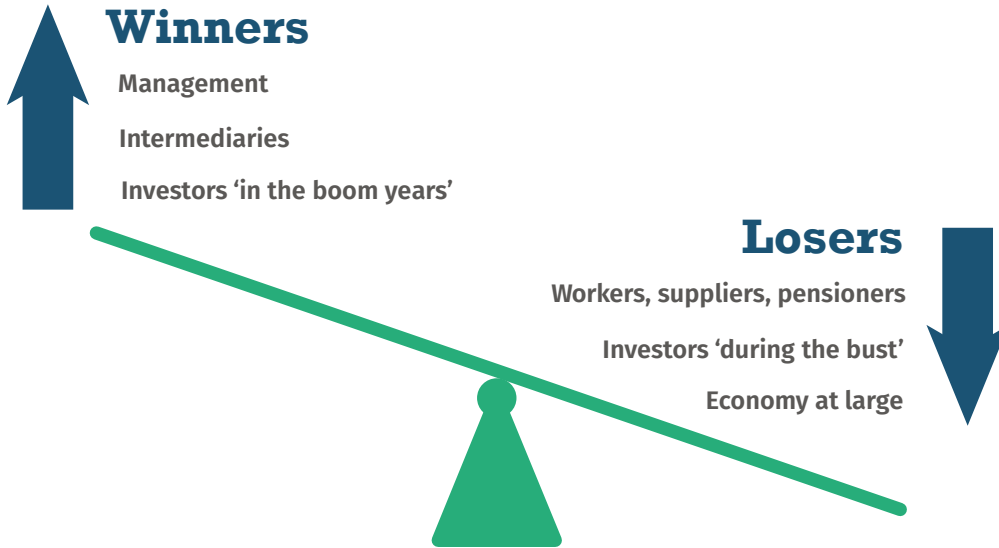
#### WINNERS AND LOSERS OF AUDIT FAILURES

There are various ways in which such audit failures exert a social cost. While it is a cost for society at large, **there are winners too – mostly intermediaries such as audit firms themselves, and those benefitting from the expansion during the ‘boom’ years (Ramanna 2015)**. These are the ones who are able to extract a large amount of financial value from a firm while the long-term value and viability of the firm is compromised.

10 A further risk of conflict of interest is introduced as the ‘big four’ also advise HMRC, the UK’s tax authority.

**FIGURE 3.1**

**There are winners and losers from audit failures**



Source: Authors' analysis

As the case of Carillion illustrates, it is often the management of companies that receive large pay-outs (through bonuses, high salaries, and equity stakes) that benefit them during the audit-failure-fuelled 'boom' years. In the case of Carillion, pay-outs for management continued even as the problems began to unravel (DWP and BEIS select committee 2018). In the many cases where no fraud is detected, this might be in the form of a firm being slowly bled of capital, in a quiet extraction of value (Leaver et al 2021).

Audit firms and other 'intermediaries' such as investment banks arranging mergers and acquisitions are also beneficiaries of the current system. They receive large fees in the 'boom' years and are insulated from the losses if things go wrong. For instance, in the case of the BHS failure, the auditor had to pay fines worth only 1.2 per cent of its audit fees (CMA 2019).

Investors are also often beneficiaries in the 'boom' years, as they receive large dividends. In all cases highlighted in table 3.1, substantive returns on equity were paid out to investors. It might be for this reason that there was insufficient challenge exerted on management by shareholders (DWP and BEIS select committee 2018). Overall, the literature points out that no one type of investor that is a winner in this sense, as it depends on the time the firm sells its shares and whether the firm goes bankrupt. Further research in this area would be desirable.

## 4.

# KEY DRIVERS OF AUDIT FAILURE

In response to a string of prominent audit failures (most notably Carillion and BHS), the UK government has announced it is determined to act to fill some of the most glaring regulatory gaps (BEIS 2021). The government commissioned three reviews, which were followed by an in-depth BEIS select committee report. The reviews covered updating the regulatory framework (Kingman 2018); addressing competition issues (CMA 2019); and assessing the wider purpose of audit (Brydon 2019). On March 18 2021 the government released a white paper outlining its policy response to these reviews. In this section we give an overview over the key areas that need reform, followed by the key principles for addressing them.

### A NARROW PURPOSE

The core purpose of audits today is to make sure business accounts are ‘true and fair’ (Brydon 2019). But in practice information could be ‘true and fair’ and yet not be useful at all to those requesting it. It comes as a surprise to many that auditors did not see it as their responsibility to flag the aggressive accounting practices at Carillion that overstated hypothetical future profits (DWP and BEIS select committee 2018). But over-optimistic assumptions underlying these rosy accounts *would* have been useful for shareholders and others to understand. They were never flagged, because they were seen as justifiable within the rules. Moreover, today, if auditors discover useful undisclosed information that would be useful for investors, they are in fact expected *not* to disclose this information unless it violates accounting rules (Brydon 2019).<sup>11</sup>

So, while the public expects auditors to provide useful information for outsiders, in some ways it is too close to a ‘tick-box exercise’ (Leaver et al 2019). Moreover, many areas where a trusted referee would be needed – eg around businesses climate risks – are also not under the purview of auditors at all.

### LIGHT TOUCH REGULATION

The UK has a very light-touch audit regulator that is currently poorly equipped to enforce meaningful standards in the industry (Kingman 2018). The government’s review of the UK’s audit watchdog - the Financial Reporting Council (FRC) – found that it is ‘an institution constructed in a different era – a rather ramshackle house, cobbled together with all sorts of extensions over time’ (ibid). Much of the FRC’s set up – including its very funding – is based on *voluntary* agreements with audit and accounting firms and not fully backed up by law. Currently, as the Kingman review argues, ‘audit firms in the UK are still regulated not by an independent body but, in effect, by their trade association’ (ibid).

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<sup>11</sup> This refers to an interpretation of ISA (UK) 701.

The main shortcomings of the FRC are that:

- its oversight powers and resources are insufficient to enforce that UK audits are of the highest quality.
- it does not have the statutory tools to hold audit firms fully accountable or require them to make structural changes to improve quality of their audits<sup>12</sup>
- it is too close to the audit industry itself.

This ‘closeness’ is in terms of both its own staff and in terms of how it devises and interprets rules and standards (CMA 2019; Kingman 2018). Overall, the Kingman review finds that ‘the FRC has been widely viewed as reluctant to act, slow to achieve results and therefore failing to create an adequate deterrent to wrongdoing’ (ibid).

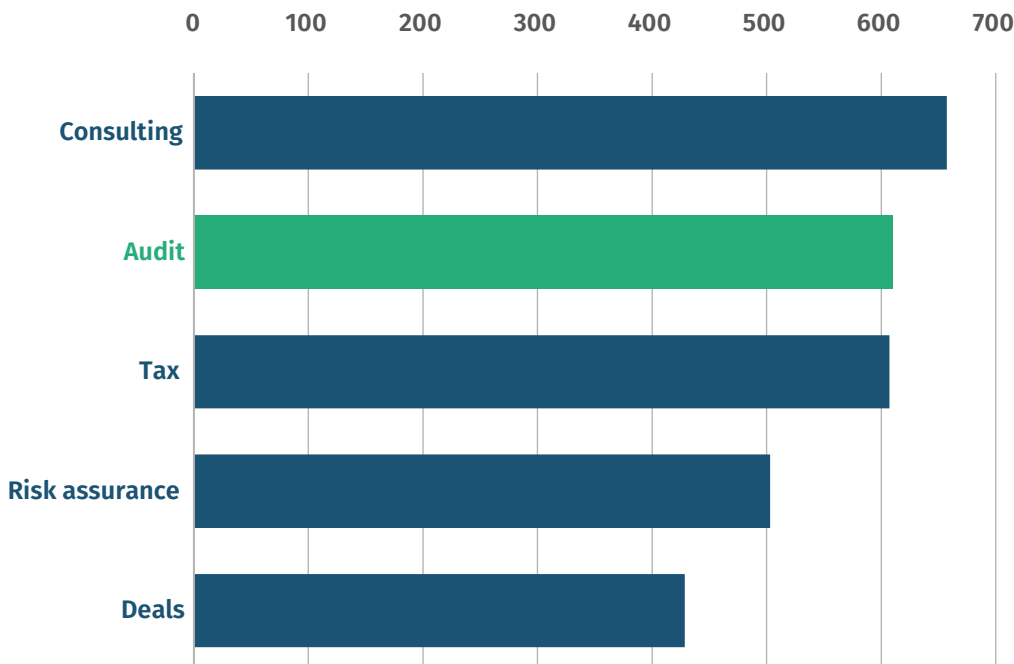
### PROBLEMS WITH CONSULTANCY

Next to their role as referees of corporate Britain, audit firms today play a significant separate role as consultants of corporate Britain. In this role, audit firms advise businesses on corporate practices such as how to present financial accounts, on their business strategy, regulatory compliance and tax, as well as helping with takeovers (figure 4.1).

**FIGURE 4.1**

**Audit firms make most of their money from non-audit activities**

*Average £ million revenue of the ‘big four’ in 2019, by activity*



Source: IPPR analysis of ‘big four’ annual reports

This presents two possible problems. First, in their consultant role, their aim naturally is to be most helpful to management, which is in opposition to their audit role where they are supposed to challenge management. As consultants they might suggest ‘aggressive’ accounting or business practices that an auditor

12 It can only hold accountable individual auditors (Kingman 2018).

might want to flag to outside stakeholders. For instance, in the case of Carillion, consultancy work by audit firms has been found to have been intimately involved in developing and promoting the ultimately disastrous business strategy (DWP and BEIS select committee 2018). As the report into Carillion's failure notes, '[t]he panoply of auditors and other advisors who looked the other way or who were offered an opportunity for consultancy fees from a floundering company have been richly compensated' (ibid).

Second, given the small size of the audit market, being both close advisor and trusted referee risks of conflicts of interest. In particular, the 'one-firm culture' in audit firms and the sharing of resources means that firms could have an incentive to challenge a certain business less in order to secure more lucrative consultancy contracts later on. This is exacerbated by the fact consultancy is the biggest revenue source for audit firms. In 2019, 80 per cent of revenues by 'big four' firms were non-audit revenues (FRC 2020a).

Some action has been taken to address this – for instance making sure that auditors do not audit and advise a firm at the same time. But as long as both consultancy and audit 'under one roof' and part of a 'one-firm culture' the risk of conflict of interest persists (DWP and BEIS select committee 2018).

And when auditors advise government, stronger assurances need to be in place that the outcomes are aligned with the public interest, backed up by a culture that values objectivity above incentives to land the next contract.

### **A TOO CONFORMIST CULTURE AND NARROW PURPOSE**

The CMA review finds that there was a 'problem of insufficient challenge across a substantial portion of large company audits' (CMA 2019). This refers to the issue that individual auditors do not feel empowered to speak up against the firms they audit, nor against their seniors, who are often expecting audits to 'go smoothly'. This means that audit firms too often champion the opposite of the professional ethos that ought to be the hallmark of their work (Ramanna 2018).

For instance, the FRC (2018) finds that in some firms 'audit specific values such as objectivity and independence are not sufficiently prominent'. They find that 'perception of the wider firms' commercial success taking priority over audit quality' (ibid). Many audit firms acknowledge that more could be done on this. One of the 'big four' said that it was 'open to remedies designed to enhance audit firm governance in order to better embed the right culture'. This issue – together with broadening the remit of audit firms – will be the subject of the second report in this series.

In this report, we have mainly pointed out the auditors' failure to flag problematic accounting practices, but, of course, other actors play an important role too. For instance, there is an equally important need for businesses – and their directors – to stick to the rules and act as good 'corporate citizens'. Directors of companies should be sufficiently accountable for the true and fair disclosure of what their firms are doing (Kingman 2018). In the case of Carillion, company directors were at the heart of problematic practices, but many so far have faced only limited repercussions (DWP and BEIS select committee 2018). Profound audit and corporate governance reform should equally tackle this issue and increase transparency and accountability of directors on the audit committee (CMA 2019).

## LAX RULES

The way the accounting rules currently work leaves a large amount of discretion for companies to act in problematic ways and for auditors not to flag this. Above, we highlighted issues associated with the ‘capital maintenance’ regime (Baker et al 2020) and the way future profits can be ‘brought forward’ via ‘fair value’ accounting and thus be used to justify huge pay-outs in the present. This can lead to the slow erosion of a firm’s financial buffers, diminishes its long-term prospects, and ultimately puts jobs and pensions at risk.

A related problem is that of how ‘goodwill’ is accounted for. ‘Goodwill’ is the value attributed to intangible assets like the value of a firm’s brand, contacts, and ability to raise credit (H Armstrong and Associates 2018). In 2016, 84 per cent of Carillion’s balance sheet was made up of ‘goodwill’. It used this to justify taking on large amounts of debt, subsequently increasing the financial precarity of the firm. But this increased risk was not reflected in the valuation of the firms’ goodwill, and the firm was effectively borrowing based upon an optimistic prediction of future returns (Leaver 2018). As a 2020 report into audit recommends a review into fair value accounting rules is needed (Leaver et al 2020).

## A DYSFUNCTIONAL MARKET

The audit market is currently somewhat of an oligopoly. Of the largest 100 firms in the UK, almost all (96 per cent) are audited by the ‘big four’ (FRC 2020a). Switching is rare (91 per cent of businesses do not switch auditors in a given year<sup>13</sup>), and 95 per cent of firms’ switching away from one of the ‘big four’ switch to another ‘big four’ firm (ibid).

Often the choice for firms to pick an auditor is even narrower. For instance, for competition reasons there can be restrictions on which work audit firms can carry out – eg to avoid an auditor working for two direct competitors. This then excludes some audit firms from bidding for certain contracts, and for many FTSE firms, this leaves only two firms to choose from (CMA 2019). Rather than a market, the audit industry ends up more akin to game of musical chairs with four – and often less – players.

The CMA (2019) argues that the resulting lack of choice likely leads to lower audit quality. In particular, they argue the concentrated market limits the degree to which auditors compete on the basis of quality, reporting that ‘investors agreed that competition can play a crucial role in driving quality, and that effective competition requires adequate choice when the audit is tendered’ (ibid).

The dominance of the ‘big four’ also means that the market lacks resilience. If one of the firms was to fail, it would severely restrict competition, leaving some firms with no choice at all.

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13 Currently, businesses are required to change their auditor only every 20 years.

## 5.

# NEXT STEPS: THE PROMISE OF A REFORMED AUDIT INDUSTRY

Profound reform can restore public trust in audit firms and see them become the trusted referees of corporate Britain. With this status gained, it could lead to a virtuous cycle in which trust fosters investment. It could also set the stage for the growth of new business areas for audit firms where their professional expertise and independence are needed, such as in assessing companies' climate risks.

In response to the five drivers of audit failure described above, there are five principles that serve to guide policy. **These are the subject of the next two reports in this series.** They are:

- **a broadened purpose.** Auditors should be the trusted referees of corporate Britain, helping disclosing useful information around business finances and beyond.
- **addressing lax rules.** Update rules and guidance are updated, including in global forums, to ensure accounting is able to fulfil its function.
- **overhauling oversight.** Giving the reformed audit regulators not just statutory powers but also sufficient resourcing to address them.
- **addressing perverse incentives.** Structurally separate audit from non-audit businesses to avoid the risks of conflicts of interest. Ensure that auditors working for government adhere to the highest standards of objectivity.
- **delivering culture change in the audit industry alongside a broadened purpose.** Ensure that auditors don't just play by the rules, but are their guardians across business lines. Broaden audit's remit to satisfy societies demand for a trusted referee, including around climate, governance and data.
- **increasing competition.** Ensure shareholders chose auditors not just based on price but also on high-quality service provision. Put in place measures that increase this choice.

### FUTURE REPORTS

As part of this programme, we will publish two further reports on the issue of audit reform. In the second report we will address the 'regulation, purpose and culture' of audit. It will tackle the issue of the four types of audit failures, including 'rules arbitrage' and those that are due to 'consulting failure'. We will examine how the government's reviews fail to address these points sufficiently and what needs to be done to do so. Crucially, we will argue that part of the solution will have to be solving cultural issues in audit firms.

The third report will go into some detail of 'what good looks like' with regards to audit reform. It will be a critical assessment of the policy agenda laid out by the government in its white paper.



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