Submission to Independent review into the quality and effectiveness of audit from Richard Brooks

I am the author of a book published last year on the accountancy profession, *Bean Counters – the Triumph of the Accountants and How They Broke Capitalism*. I am also a journalist with *Private Eye* magazine.

This is a short submission on what I consider some important broader and more historic issues that I think have not been given due weight in the terms of reference for this review, as well as those of the related Kingman and Competition and Markets Authority reviews.

The point of my book was to show sound accounting as a great force for good, a foundation stone of a well-functioning economy and society, and then to demonstrate what happens when it goes wrong.

One of my main conclusions was that the importance of good accounting has been under-estimated. Auditing in particular has been relegated to just one part of the "professional services" industry, both by the firms that perform it and by policy-makers. Current discussions focused on the competitiveness of the market in auditing and conflicts of interest with non-audit services miss this more fundamental point.

Accounting failures are one of the more common and damaging consequences of the 'principal-agent' problem. As these have become ever more serious with modern patterns of corporate ownership, executive remuneration and incentives etc., so the importance of strong auditing has grown. Yet, at the very same time, auditing has become a mere sideline for the 'Big 4' professional services firms that perform it for all major companies. At present, these firms earn just around a quarter of their income from auditing. The task is seen as secondary to the more lucrative business of consulting, to which young accountants aspire. Auditing has largely become a mere stepping stone to other opportunities rather than a valued discipline in itself.

Rather than focus on modifying the existing structure of the audit "market", for example by internal separation of audit and non-audit businesses or facilitating more competition, it is time to think again about what today's economy needs. The answer to this, in my opinion, is auditing organisations that are focused exclusively on auditing. Without the distraction of other services, the accountancy profession could regain a lost sense of its purpose and pride in its role in supporting a strong economy by ensuring sound accounting. At present, I sense from talking to many senior partners at the Big 4 firms that they feel that they're at their most useful when they're helping clients achieve their commercial goals. In fact they play a far more useful role for society when they strongly and objectively question the practices and risks associated with that.

The terms of reference of all the current reviews essentially ask how current problems should be fixed. A better question, in my opinion, would be: if we were creating a system for auditing UK business, what would it look like? I think it would certainly have at its core an auditing profession that has no other interests than getting the numbers as right as possible.

My main recommendation for the future of audit is therefore that the major firms should be broken up so that all significant companies are audited by firms that are exclusively auditing firms. I would further recommend that the perverse incentives that can be created when the auditee pays the auditor are addressed by ensuring that a regulator appoints the audit firm at regular intervals. In the case of the most systemically important institutions such as the major banks, I also recommend that auditing becomes a public function alongside other regulatory functions, subject to democratic accountability.

Objections voiced so far to splitting auditing and non-auditing, even merely within the same firms as proposed by the Competition and Markets Authority, have come from vested interests concerned with maintaining the status quo. They claim that auditors require access to their expert consultancy colleagues. But this arrangement has repeatedly failed to work and has almost certainly in fact harmed the quality of audit. Those experts have strong interests in, for example, downplaying the risks associated with what they advise on (even to non-audit clients). The financial crisis was a case in point, where supposed expertise in financial products – on which the Big Four provided extensive consulting services - certainly didn't help auditors spot clear looming risks. When an auditor turns to an "in-house" expert, he or she does not get an objective view.

One other aspect covered by the discussion paper is auditor liability. I think that, rather than limiting this further, many of the limitations created in the last thirty years should be substantially reversed. In particular, the effect of the *Caparo* judgment of 1990 should be countered by legislation at least to give shareholders substantial recourse, and possibly to enable employees of failed business similar redress. Consideration should also be given to removing "limited liability partnership" status from major auditors, given that two decades of history shows it has allowed major partnerships to prioritise profit over sound auditing with little fear for the personal consequences – something that, as professionals, they should have. But the question of liability is inextricably linked with other reform issues such as if and how the big firms are broken up; the more conflicts and financial incentives distort auditing, the greater the auditor's potential liability should be. And the less concentrated the profession, the less there would be to fear from the loss of any one firm.

I would be happy to discuss any of these issues further.

Richard Brooks
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