

## Is the audit profession credible?

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I had a conversation yesterday on the future of the audit profession. It does not matter who with, where or why. What it did was to challenge me to think about the credibility of a profession of which I was once a part (I held an audit license for many years, but no longer do so).

I suggested that there were at least five reasons why the audit profession lacked credibility and had done so since the introduction of the [International Accounting Standards Board's \(IASB\) International Financial Reporting Standards \(IFRS\)](#) as near universal standards in 2005, a move that I intimately associate with the (I think closely related) [International Auditing and Assurance Standards Board's \(IAASB\)](#) auditing standards.

The first reason for this lack of credibility is that the audit report is addressed to the shareholders of a company and case law has limited the liability of auditors to them, and even then effectively only in the case of a liquidation of a company. The reality is, of course, that most companies are not liquidated and the vast majority of the members of a quoted company own their shares in it for a period of less than a year on average, meaning that few hang around long enough for an audit report to have any relevance to their decision making. That means that the audit, by definition, excludes itself from responsibility to the providers of maybe 95% of the capital a company uses (whether that capital be provided by loans, bondholders, bankers, trade creditors, tax authorities and even staff who are owed their wages) and that is absurd. Nothing, let alone an audit, can be relevant if it addresses itself and restricts its liability to a tiny minority of those who might be interested in it.

This problem is exacerbated by a flaw within International Financial Reporting Standard. Under International Financial Reporting Standard the 'stewardship' approach to accounting has been specifically rejected, as has the idea that the accounts are primarily prepared for the benefit of the shareholders. Instead a 'separate entity' approach is adopted which presumes that those shareholders are just one of many providers of capital and have no special claim. But that is not what the audit assumes: it is therefore auditing using an inappropriate criteria for the accounts that are

presented.

Secondly, the accounts that auditors report upon are, by definition, of no relevance to the vast majority of those who might have an interest in the affairs of the company to which they supposedly relate. That is because the International Accounting Standards Board (which is, of course, dominated in its considerations by the Big 4 firms of auditors) [has said the following on the purpose of accounts:](#)

*The primary users of general purpose financial reporting are present and potential investors, lenders and other creditors, who use that information to make decisions about buying, selling or holding equity or debt instruments and providing or settling loans or other forms of credit.*

*The primary users need information about the resources of the entity not only to assess an entity's prospects for future net cash inflows but also how effectively and efficiently management has discharged their responsibilities to use the entity's existing resources (i.e., stewardship).*

*The IFRS Framework notes that general purpose financial reports cannot provide all the information that users may need to make economic decisions. They will need to consider pertinent information from other sources as well.*

*The IFRS Framework notes that other parties, including prudential and market regulators, may find general purpose financial reports useful. However, the Board considered that the objectives of general purpose financial reporting and the objectives of financial regulation may not be consistent. Hence, regulators are not considered a primary user and general purpose financial reports are not primarily directed to regulators or other parties.*

In that case auditors willingly provide reports to the wrong people on accounts that wilfully exclude from consideration most of those who might have legitimate reason to know about what a company is doing. Unsurprisingly the audit and the role of auditors who are well paid for undertaking this almost meaningless task might be considered meaningless (at best) as a result.

Thirdly, auditors have compounded this problem — largely because the rules of international auditing are largely written through the auspices of the IAASB that is largely controlled by the very same firms that control the IASB. As a result instead of the old concept of the auditor expressing their own opinion that confirmed that the accounts presented (or not, as the case may be) a true and fair view of the state of the affairs of the company is no longer what is required. That expression of opinion is now constrained but whether or not the accounts comply with International Financial Reporting Standard or not. This is a very different question from whether they present a true and fair view. The reality is that to present a true and fair view it is quite possible that in many cases they should not comply with IFRS, but then the auditors face a

dilemma; what is called the 'true and fair override' should apply but has been absolutely notable by its absence in recent years. It hardly ever happens. In that case the audit has been reduced to an exercise in checking IFRS compliance and that is not, in my opinion, an audit at all.

To give an example, before the banking crash of 2008 bank accounts included debts that in retrospect everyone knew would not be paid because IFRS allowed that. The result was not a true and fair view: it was nonsense. In fact it was a nonsense so dangerous that it crashed the UK economy but the auditors could say the accounts were true and fair on the rigged basis they had concocted for auditing standards that only declared compliance with accounting standards they had also rigged in favour of their clients.

Fourthly, and in this case with a little more complexity, audit makes no sense because it would seem that both the accounting and auditing professions have forgotten what the purpose of accounting and auditing is. At its core accounting is very clearly required by the Companies Acts, up to and including the Companies Act 2006, to show that the directors of the entity being audited are exercising good stewardship of the assets that are entrusted to their care and have maintained the value of that organisation for which they are responsible to ensure it has sufficient capital available to it to ensure that it can meet all its liabilities as they fall due. This is what is called a 'capital maintenance concept' that has at its heart the protection of creditors whilst demanding that assets be stewarded for the benefit of shareholders. The interests of one is not set above the other: both have to be considered.

Under IFRS this concept has been abandoned. To ensure creditors can be paid cash must be available and that means profits must be 'realised' in cash and dividends, for example, can only be paid if there is sufficient cash based capital (called 'realised profit') to ensure that other creditors are not prejudiced by doing so. But under IFRS realised profit is not a relevant concept: any profit including revaluations that give rise to no cash value can be considered when assessing the growth in the capital of the business out of which dividends may be paid. The result is that accountants have no idea of the purpose of their accounts, and are almost certainly preparing accounts that do not comply with the UK Companies Act requirement that creditors be protected and auditors have little understanding of what they are signing because they appear to share the misconception. Unsurprisingly audit has little value in that case.

There is a fifth reason for concern. When, [as Action Aid noted during this last week](#), audit firms appear to be undertaking commercially questionable acts the credibility of the profession is undermined. The obvious answer is that audit firms must audit and do nothing else.

Is it surprising that people doubt the credibility of the audit profession?