

Audit's existential crisis

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Richard Murphy

Professor of Practice in International Political Economy, City, University of London

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Introduction

Many thanks to the organisers for asking me to speak today. I appreciate the chance to do so.

Recent audit failures in the UK have left the audit profession reeling, politicians baying and even the profession's own UK based regulator asking about the future of the profession.

But it's hardly surprising that this has happened. The recent history of auditing is one of a collective retreat from responsibility as auditors, and their captive regulators, have sought to ring-fence their risk in pursuit of their own self-interest. In the process they have undermined their whole social purpose, and so their reason for being.

Audit is now in existential crisis. It has to face that fact or it is at risk of ceasing to be, with potentially catastrophic consequences for the world's markets, both financial and tangible.

The time for audit caution is over: it's reform or bust now. The only questions left are about how to achieve that goal.

These are my themes this afternoon.

A matter of perspective

What I stress is that I have been asked to speak as a practitioner today. Some of you will be aware that I now have an academic role and title to go with it, but I have had a practicing certificate as a chartered accountant for a lot longer - since 1985, in fact. Please don't doubt it - accountancy and audit practice is something to which I am dedicated.

That's why it troubles me to tell you that in my opinion - and I won't be beating around the bush here - accountancy and audit in the UK face an existential crisis. No other description is appropriate.

I want to make clear I am not just talking about some recent failing here: the succession of firms that KPMG seem to have audited that have gone to the wall after their audit reports have been issued; the disaster of Carillion, and the dismal failure of the Financial Reporting Council to show any initiative at all in the face of such issues arising are not what has created a crisis. Important as all these things are I suggest to you that they are symptomatic of a much greater malaise that is what really needs to be addressed.

The greater issue is one that I suggest that anyone who has interest in saving the market economy should rally to support. That issue is that without data; without verification; and without trust that the data supplied is both useful and reliable, then markets as we know them will cease to exist.

What do I mean by that? I suggest that:

- * People will stop saving - at least in shares;
- * The cost of bond finance will rise, not because the risk free rate will rise but because the risk premium does;
- * People will not trust the assurances of big business on almost any issue - and so real, on the ground investment will be harder to deliver;
- * Existing employment structures - which depend on a high degree of trust that people will be paid - will be strained;
- * The long term ability of markets to meet need will be challenged because faith in the durability of companies will be shattered;
- * Tax revenues will be imperiled.

In that case audit assurance matters. But that means we must understand just what we expect from both accounts and audit and then work out, afresh, how to deliver against that expectation.

What is accounting?

In principle accounting is simple: it relates to the stewardship of funds. It does not matter why the funds were entrusted - accounting principles are unrelated to the profit motive or markets. What accounting data must do is supply information that says:

- * Who is accountable;
- * With what they have been entrusted;
- * What they did with it;
- * With what outcome;
- * And for whom that has consequence.

Note that this says nothing about numbers: the narrative of accounting is at least as important as any data. That is because almost any accounting has these stakeholders:

- * The providers of funds;
- * Those from whom purchases are made;
- * Those to whom services are supplied;
- * The people engaged in the process;
- * The communities of which they are a part;
- * The governments that those communities choose to represent them and their:
 - * Regulators;
- * Law enforcement agencies;
- * Tax authorities.

Accounting is the process of reporting relevant, reliable, complete, comparable and comprehensible data of use to these stakeholders. Ignore the technicalities: this is what it's really about.

What then is audit?

If accounting is reporting audit is the process of testing the data to be supplied by the person preparing an account to ensure that it truthfully and fairly reflects the actions of

the person reporting in a fashion that meets the needs of the likely user of the data

What has gone wrong with accounting?

None of that is rocket science, so what has gone wrong?

There are a number of completely straightforward answers to this question. Let's not spend hours agonising on this: the answers are almost as simple as saying the Emperor is wearing no clothes.

First, accounting has restricted the stakeholders to whom it has responsibility to shareholders alone. Everyone else has been abandoned: they are told they must make do. The social foundation of accounting was abandoned at that moment and the consequences are now clear.

Second, accounting has denied access to data: the profession has cheered as the amount of accounting data available to stakeholders has been steadily reduced. Around the world opacity is becoming the norm, not just in tax havens but in the company registries of Europe. A clearer exercise in self destruction of professional relevance is hard to imagine: the small business community has already been forced to work in the dark, and so too have far too many tax authorities.

Third, accountancy has resorted to faux science. When economists copied physicists they tried to build financial models. When accountants copied economists they delivered what I call CRAP. That, I assure you, is a technical term: it stands for Completely Rubbish APproximations to the truth. And that, as we now know all too well, is what a great deal of accounting is.

Fourth, in the process accounting forgot the thing that made it a profession: that is, its ethics. Rules were substituted and in the process the loss of a single world changed everything: prudence went out of the window and with it went any sense of judgement, responsibility and duty to engage with the task in hand. Purely mechanical approaches were considered sufficient. We have all paid the price for that.

So how did auditing fail?

Audit has failed because, unsurprisingly given their common commercial roots at present, it has followed a similar path to accountancy.

In particular, auditors have sought to ring-fence their liability liability so that very few stakeholders had any chance of holding an auditor accountable for their opinion.

And auditors also abandoned a key principle: in their case it was true and fair that went out of the window. What was substituted was compliance with an accounting framework: a rule based audit. The law might have said true and fair was required: I put it to you that the profession substituted its own inappropriate, and quite probably

illegal, interpretation of its duty that has failed society.

In a nutshell

To put it in a nutshell, all branches of this profession have sought to act in what they see as their own rational self-interest, which has been achieved by transferring much, if not all, of their risk arising from their duty to stakeholders back onto those stakeholders, to whom they then deny any duty of care. The profession has, as a result, effectively ceased to be. The Big 4 firms, the tax havens that they promote and underpin, the professional bodies that they dominate and the regulators that they populate with their alumni; all of them have played their part in this wilful act of professional self-destruction.

What is left is just a husk: a body of technicians without an ethic and now without a social purpose.

The question is, what are we to do?

What are we to do?

I could spend all evening discussing this so let me offer highlights instead, and then leave time for questions.

First, we have to say that accounting is about meeting the needs of all stakeholders. And I mean all. And just to make sure my point is really heard I stress again that by this I mean:

- * Customers;
- * Suppliers;
- * Employees;
- * The communities that host the activities that companies undertake;
- * The governments and regulators of those communities;

And, last of all — because they are the most transient of stakeholders in a great many of our corporations and therefore those with the lowest priority:

- * The suppliers of capital, and their advisers.

In other words, accountancy has to be turned on its head as to priorities.

Second, accounting has to be about delivering decision-useful information - not technically fancy data that only a tiny number of people understand and the rest have to take on trust - which they are no longer willing to do. Forget IFRS: if anything is

destroying this profession, it is.

Third, accountancy has no right to ever again ask directors to sign accounts that they cannot understand - which is what we do from top to bottom of this profession right now, from the FTSE 100 right down to the SME because of some of the absurd requirements of new accounting standards.

Fourth, the idea that we are delivering information for investment appraisal when producing audited annual financial statements has to go, once and for all: what is apparent is that in terms of the market worth of most companies accounting data makes little impression on value. Broader sentiment does that. In which case accounting data needs to meet other needs.

Fifth, it has to be appreciated that all these other needs all come down to durability, cash flow, ethical conduct and sustainability.

These, then, are the questions accounting data has to answer if it is to be credible once more:

- * Will this company survive in the long term and meet its obligations to me as a customer?
- * Will this company pay me as a supplier, in the country I am in?
- * Will this company pay me fairly as an employee, wherever I might be?
- * Will this company pay my pension?
- * Will this company pay its taxes in all the jurisdictions in which it works?
- * Is this company's dividend legal, and sustainable?
- * Has this company the resources it needs to survive?
- * Is this company adding value to my community as a consequence of us hosting it?

What this means

What we need then is a new accounting framework to answer these questions - which IFRS does not - and make this new framework the accounting norm.

And then we must require that the accounts of all companies — whatever their size - comply with its requirements, even if we permit some, albeit minor, adaptations to suit scale.

And we must ensure that those accounts are available on public record — it's our job to demand that, in fact.

And we must require then that auditors use their judgement to ensure that the accounts do not just comply with this new framework — but do so prudently so that the interests of creditors of all forms — which most stakeholders are — might be protected as an issue of paramount importance if the abuse of human rights that is implicit in limited liability is not to become actual abuse.

How will we know a new framework is relevant?

We will know if the new accounting and auditing framework is relevant if:

- * It provides the data to answer the questions stakeholders have. To make it clear this requires full information for all companies on public record:
- * What does this company do?
- * Where does it do it?
- * Who owns it?
- * Who manages it?
- * Is it solvent?
- * Is it generating or using cash, so potentially leaving its creditors risk? So, yes — I make clear — the cash flow has to be at the heart of accounting because our decision to ignore it is one of reckless irresponsibility.
- * How does it treat its staff?
- * How much are they paid?
- * Are their pensions funded?
- * What is the gender pay gap?
- * Is this company investing in people and technology for the future?
- * Is this company profitable?
- * Is it paying its taxes, by which I mean all its taxes, and if not at the expected rate, why not?
- * If it is operating in more than one country, which are those other countries and how much this activity takes place in each jurisdiction?
- * What subsidiaries does it have?
- * Are those subsidiaries viable?
- * How much of the group's trading is between related companies, and does this resulting profit shifting, or the prejudice of creditors?

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Auditing is restored as an essential protection for all companies employing 50 or more people, with appropriate financial considerations as an alternative, in the interest of protecting stakeholders and society at large.

- * The primary duty of auditors is stated to be to **all** the stakeholders of the company, with the restriction to shareholders alone being removed.
- * Auditors must be appointed by a new statutory Audit Agency who will be responsible for both regulating and paying them as well;
- * Private sector companies will still be able to do audits but with all audits being put out to tender subject to:
 - * a limitation on the proportion of the market that any auditor might secure: I suggest a maximum of ten percent of any part of the market;
 - * mandatory audit rotation after five years;
 - * a restriction on auditors providing any other service apart from the filing of statutory documentation;
 - * auditors to be paid from a levy on the turnover all companies subject to audit with additional charges for high-risk sectors;
 - * an obligation being imposed upon auditors to whistleblow with regard to fraud, tax abuse and other abuse of regulation.

How will we know things have changed?

We will know that the existential crisis in auditing is over when truly independent auditors are required express opinion upon account information that is of real use to the stakeholders who must depend upon it.

What will indicate when that has happened? Try this list:

- * There will be an end to the hegemonic thinking that accounting is all about the interests of a tiny proportion in society, which belief has brought the whole profession to its knees and which has rightly shredded our reputation;
- * We will have had the reform of company law to:
 - * set up the new accounting framework;
 - * establish a new, government backed, method of creating accounting standards;
 - * create a new, independent, accounting regulator;
 - * create the new statutory audit requirement managed by a new statutory Audit Agency to oversee, appoint and remunerate all company auditors;

* There will be a reform in professional culture so the accountants finally understand that it is their duty to communicate useful information;

Only these changes can make accounting and audit relevant again.

Our existential crisis demands radical reform. I strongly suggest that we go and deliver it.

And one final thought: I am open to offers from anyone who wants to help the revolution that we need.