

Accounting has to be radically reformed

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As the [Guardian has](#) reported:

Britain's big four accountancy firms should face a full break-up to weaken their "stranglehold" on an audit market discredited by corporate failures including Carillion and BHS, MPs have suggested in a hard-hitting report. The business, energy and industrial strategy (Beis) committee said the competition watchdog — which is due to release its final recommendations for reform of the audit industry — should consider the break-up of the country's biggest accountants by separating their audit and consulting arms.

They added:

Between them, the four big players — KPMG, Deloitte, PwC and EY — conducted the audits at all but one of the UK's 100 biggest listed companies last year.

The move is hardly surprising, the evidence that the oligopoly of the Big 4 accounting firms is not in the national, public or economic interest of the country is not news, in itself. The BEIS committee came to the only rational decision that is available. Which does not, of course, mean that this will actually happen. Captured regulators will not necessarily agree with the Commons, and because we have passed too much control, including of the regulatory bodies (even now) to those whose interests are too much aligned with the Big 4, that they will survive intact, subject to some sham, constraints is still likely.

More interesting though was sting in the tail of the BEIS committee report. The committee also suggested that in future accounts should explicitly identify the realised and unrealised reserves of companies on their balance sheets. This might sound like very dry accountancy. That's because it is. But it's vital. And it is for that reason that I [reproduce the summary of what the Committee said here](#):

13. Compliance with the capital maintenance regime is patchy at best and it is not adequately audited. We recommend that the FRC urgently reminds directors and auditors of their duties relating to the accounts and impose severe sanctions for

breaches. Most importantly, auditors must be prepared to challenge management on their accounting of realised profits and distributable reserves. (Paragraph 61)

14. We are alarmed and disappointed that the FRC has not provided clarity on these fundamental issues, given the potential and actual problems that have arisen. *The Government and the FRC should work together to resolve these issues as soon as possible, and produce simple and prudent guidance for companies and auditors to follow. (Paragraph 78)*

15. *We recommend that the Government and the FRC urgently produce a clear, simple and prudent definition of what counts as realised profits for the purpose of distributions. We support defining realised profits as realised in cash or near cash. (Paragraph 79)*

16. *We reject any legislative change the aim of which is to adapt the law to the accounting standards. Instead, auditors and directors need to be reminded that compliance with the accounting standards does not fulfil all legal obligations, and that the law comes first. We regret that the FRC has failed to clarify this basic point with those it regulates. We recommend that the FRC and its successor vigorously enforce the revised capital maintenance regime. (Paragraph 80)*

17. We strongly support the Government's proposal to require companies and auditors to take a more critical look at the valuation of goodwill for the purpose of distributions. *We recommend that the Government urgently take steps to tighten the net assets test. (Paragraph 86)*

18. The Government cannot unilaterally change the international accounting standards, but it can seek to tighten the law. Stopping imprudent distributions makes companies more resilient and encourages management to think longer term and tackle problems earlier. *The principle of prudence should be made explicit in the law and its interpretation. (Paragraph 90)*

19. *The Government and the FRC should lead international efforts to improve accounting standards. If the Government wants to achieve its ambitions of a Global Britain advancing UK influence and interests, then it should be prepared to spell out how it wants to lead international standards on key sectors such as accounting and audit. (Paragraph 91)*

20. *We recommend that companies be required to disclose the balance of distributable reserves in the annual accounts and break down profits between realised and unrealised. (Paragraph 93)*

21. A solvency system should complement the revised capital maintenance regime that we recommend, not replace it. *We recommend that the Government adopts a complementary solvency-based system in which directors must state that dividend payments will not make the company insolvent or create cashflow problems.*

(Paragraph 96)

That is a damning indictment of UK auditing. I take my hat off to Tim Bush of Pensions & Investment Research Consultants Ltd and the Local Authority Pension Fund Forum who has done much to inform this committee on this issue. I have had the pleasure of working with him for more than a decade, and we have discussed this issue, often. But the success is all his.

That is because this issue goes to the very heart of auditing. The Companies Acts do, despite denials from the Institute of Chartered Accountants in England and Wales, Financial Reporting Council, and others, define very precisely what the audit term 'true and fair' means. It means that a company has sufficient available retained reserves to pay a dividend without compromising the interests of its creditors i.e. everyone else can be paid in full meaning that the shareholders can also enjoy a return.

For well over a decade the ICAEW has denied this, in blatant contradiction of UK company law. They have instead relied upon the largely Big 4 created International Financial Reporting Standards to define this term, and have as a result simply said that a dividend can be paid if a company has a surplus of assets. But, since a surplus of assets can include goodwill and asset revaluations, which are not reflected in any current cash value, the payment of a dividend based upon the value of these intangible assets can, by definition, prejudice the interest of creditors because cash may not be able to meet their needs. In that case the shareholders have taken priority, which is precisely what the Companies Acts seek to prevent.

Three consequences have followed. First, accounts have been, in my opinion, deliberately misstated with the connivance of auditing and accounting bodies. Creditors have not been protected, which is the fundamental duty of an auditor.

Second, the ICAEW and others have shown themselves quite unable to interpret the law in an objective fashion.

Third, that means that the public interest has been compromised and there have been real consequences: the failures of some companies, including Carillion and Interserve, were predictable for this reason.

The conclusion is inevitable: accounting regulators acting in the interests of the Big 4 firms and their clients have corrupted our reporting systems so that they failed to meet the statutory requirement imposed upon them, and those regulators have, as a consequence, acted to facilitate breaches of the law. There will come of course, be no consequence for them in any direct way. Indirectly, however, there should be: regulation has to be reformed and those who are willing to act in the public interest have to be put in charge of it, including civil servants and those who are objective simply because they lack conflicts of interest.

Appointing Tim Bush to such a body would be a good starting point.