Funding the Future

Audit is in desperate need of reform

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Those of us who have an interest in audit reform (who I know are not the biggest group in society) have been awaiting a report from the government on this issue for a couple of weeks now. The reason for the delay is not known. That is it is being related is certain. The possibility that the vested interests in the profession have got their lobbying in early cannot be dismissed. And those vested interests are powerful, whilst the problems are enormous.

In this guest post, my old friend, co-author and former colleague [Prof Atul Shah ACA] considered some of the issues. I do not agree with everything he has to say, particularly on the history of the profession, but his analysis of its current malaise indicates why reform is overdue:

The industry and profession of accounting are in a profound crisis. Last week, the Chairman and Chief Executive of KPMG in the UK, Bill Michael, was forced to resign for insensitive and discriminatory statements he made to his own financial consulting colleagues, who wanted better bonuses.

In the UK, KPMG has been in the limelight for a spate of audit failures from HBOS in 2008, to Co-op Bank, Carillion and many others, but this has not hurt its pocket nor repaired its broken culture. Even the Financial Reporting Council (FRC), has consistently criticized KPMG for poor audit quality. The multinational corporate clients have been 'feeding' the Big 4 firms regardless of this record. A senior 'rainmaker' KPMG partner was recently sacked for alleged misogyny and bullying - of other partners. These are symptoms of a much larger cultural malaise, which is the commercialization and monopolization of accounting and consulting by these giant multi-disciplinary firms. In the hunt for revenues, a culture of greed has become normalized. Well-paid professional employees are demanding even more money.

Historically, the Big 4 started as audit firms, and they were deemed professional because their primary duty was to protect the public interest. Today, the public interest is very far from view, and the private interest has become all consuming, at a time when the planet and our society are facing a profound sustainability crisis. Their wide range of services encourage and breed vast conflicts of interest, which have flourished. Despite being regulators, the Big 4 have become allies of the regulated and facilitate systemic regulatory arbitrage.

Contradictions are rampant. Leaders set the perfect example: If you were to look at the Board members of KPMG UK, there is not a single non-executive outsider in the main Board, and the Chair was also the CEO. This is true even though KPMG 'polices' the FRC code on Corporate Governance, which recommends a good number of independent external directors as basic to robust governance. As the entire Board is composed of internal partners — there is no room for independent challenge or oversight. The cultural tone at the top is hypocritical at best & dishonest at worst.

There has hitherto been no ***personal*** punishment for greed, hubris or audit failures. The FRC has regularly called for a new 'challenge culture' where professional scepticism is a core part of the audit. KPMG in the UK had opened a private club in Mayfair, to schmooze their favoured clients and fee payers. The 'clients' of the Big 4 are not the shareholders of large corporations but the managers who run them. Richard Brooks' bestselling book on the Big 4, 'Beancounters', opens with this slick venue, showcasing the height of hubris, and the real culture which prevails, fuelled by 'other peoples' money'. Has this culture of strategic networking continued?

To change culture, there needs to be profound structural changes — simply finding a new leader will not do. Audit and Consultancy urgently need to be separated — the two are culturally incompatible. Whereas audit is supposed to be sceptical, consulting is supportive & value enabling. This requires a break-up of the Big 4 — consultants can then keep their own rewards, but also stop relying on audit to get their foot into the corporate boardroom. A smaller organization is much more able to harness these factors than a large one-stop global advisory shop. Culture is about human relationships, trust and relationship capital. This includes equality and diversity across gender, race and faith — and genuinely enabling a plural culture which is beyond box-ticking. If they want to keep the 'professional' label, such firms must demonstrate public interest through fixed salaries, ethical policing and a more active sense of public purpose. Revenue-based incentives should be removed from the audit partners. They should conduct research and issue regular public warnings on dangerous business and financial risk-taking. Above all, ethics and morality should be at the core of their character if they wish to remain sustainable.

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