

Corporate Accountability Network Audit Briefing - What ...

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As I mentioned recently, the Corporate Accountability Network, which I direct, is publishing a series of Audit Briefings that discuss the need for audit reform in the UK. The [background to this series](#) is noted here. The first substantive Briefing asks the question, [what are accounts?](#)

The reason for tackling this question before anything directly related to audit is explained in the opening paragraphs of the Briefing:

The Corporate Accountability Network believes that audit does need reform within the UK. However, it is our belief that the audit of a set of accounts or financial statements cannot be considered as an issue that can be addressed independently of those accounts. It is our opinion that audited accounts are ultimately an inseparable whole. As such we suggest that the success or failure of auditing and accounting in meeting the needs of the users of those accounts cannot be separately appraised.

The question to ask in that case is, what are financial accounts? And, as important is the immediate follow-on question, which is what are those accounts for? We see the two as inseparable and so treat them as a single issue in this Audit Briefing. By doing so we come up with an answer that is very different to that offered by existing accounting and audit regulators.

Before discussing what regulators think the purpose of accounts to be, CAN also suggests what its opinion on this issue is, suggesting that accounts serve these purposes:

- * To provide a report of the financial and other activities of any entity to those who might have a relevant interest in those activities;
- * To indicate the risks inherent within the activities of that reporting entity;
- * To suggest whether that entity might continue to trade into the future;

* To provide opportunity for an independent third party, referred to as an auditor, to express an opinion upon the truth, fairness, or otherwise of the report prepared by the reporting entity for use by its stakeholders

The Audit Briefing is framed within that broad understanding.

There is one other assumption implicit in what CAN proposes. As it notes

[There is a particular issue to consider] with regard to the accounting requirements of limited liability entities. Such concerns represent the vast majority of significant trading companies and other public interest entities (PIEs). The limited liability that shareholders enjoy means that they do not have to settle the debts of their companies if those companies become insolvent. Its creditors within society at large pick up that cost instead. That means that the shareholders of such entities are granted an extraordinary privilege by society. That privilege creates an obligation to account for its responsible use. It is our contention that this means that the full accounts of all limited liability entities must be available on public record so that all those stakeholders who might conceivably be impacted by the activities of that entity might be able to appraise the risk that they face because of them. It is on the basis of this logic that we make many of the suggestions included in this Audit Briefing and the other Audit Briefings in the series of which it is a part.

The [Briefing is some 22 pages long](#), and clearly cannot be reproduced here. This summary does, however, indicate the conclusions drawn:

We propose a replacement definition of accounting in this Audit Briefing that rejects most of the assumptions made as to purpose and limitation of scope adopted by IFRS and puts in their place a stakeholder focus to accounting. The aim is to ensure that the need of the reasonably anticipatable stakeholder of a PIE to secure the information that they need to satisfy the purpose that they have for making enquiry of that entity is met.

One over-arching theme of the analysis of needs that follows on from this suggested purpose for accounting is that the data required by stakeholders about any PIE is as likely to relate to its activities locally and within specific subsidiary entities as it is within the PIE as a whole. The time when it was presumed that the consolidated accounts of a homogenous parent entity which never actually undertakes the selected range of transactions that its accounts report could meet all stakeholder need have long gone. Even the suppliers of capital to a company, whether they be the shareholders or providers of loan finance have obvious need for local and subsidiary data which they are too often denied at present. Other stakeholders usually have local concerns about the PIE, all of which do, however, have to be understood within the context of that interest being framed by the activity of the PIE as a whole. What this makes clear is that the understanding that the accounts of a PIE are singular is no longer true: if the PIE is to account for its activities reporting at multiple levels is required.

Another recurring theme is that the data required by many of the stakeholders of accounts has little to do with the financial return due to the providers of capital. The model of accounting that the IFRS Foundation has chosen to adopt that makes this need paramount is wrong. It does, however, also fail some of the most basic needs of those users. When in most PIEs the relationship between the entity and the shareholder is transient at best the only basis for its perpetuation is the expectation of a future dividend stream. That is in turn dependent upon the availability of realised distributable reserves and yet IFRS accounts do neither disclose the technical availability of such reserves or the practical ability of the group parent entity of the PIE to access them within its subsidiary companies. As such at this most basic level IFRS accounts fail. Because IFRS accounts also fail to disclose the location and extent of the security available to loan financiers they also fail at that level as well. When it comes to other stakeholders these failings are compounded.

In that case the new definition of accounting that we propose is, we suggest, required. That suggestion is that:

The purpose of accounting is to provide the stakeholders of a reporting entity with financial statements that include relevant, reliable and sufficient information which allow them to make informed decisions.

It is worth briefly speculating as to what this might mean in practice. First, the emphasis on reliability might well require a review of the use of fair value reporting in financial statements. This use has resulted in the accounts of most PIEs being dominated by data that has no relationship with any actual transaction ever undertaken by the reporting entity. That makes those accounts inherently unreliable.

Second, we suggest that there will be a much greater emphasis on subsidiary and jurisdictional reporting within those accounts.

Third, we believe that stakeholder reporting will refocus the whole process of accounting so that the needs that we note in this Audit Briefing are met.

Useful financial statements will as a result look very different from those that we now have.

That, at least, is the hope.