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# AUDITING WITH ACCOUNTABILITY: SHRINKING THE OPPORTUNITY SPACES FOR AUDIT FAILURE

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## EXECUTIVE SUMMARY

- i) In recent years a number of high-profile company failures, including those at BHS and Carillion, have raised fundamental questions about the willingness and/or ability of auditors to challenge management and exercise the professional scepticism necessary for the production of robust audits.
- ii) Questions of public accountability are at the heart of audit failures. The purpose of an audit is to verify that financial statements produced by a company's management present a "true and fair view" of a company or group's assets, liabilities, financial position and profit or loss (Companies Act 2006, section 393). We are all affected when that mission fails: confidence in companies disappears - banks will not lend, shareholders will not invest, workers will not commit their labour, suppliers will not transact and consumers will not buy.
- iii) This report is the outcome of a two-month study which analyses why audits are failing their wider public purpose. Our study draws on four main sources: i) a review of relevant academic and policy literature on audit failure, ii) fourteen interviews with prominent figures in media, regulation, academia, civil society and industry with extensive knowledge of audit failure issues, iii) an examination of primary and secondary data on audit failure and iv) a social network analysis of other campaigning organisations as a model for how civil society might organise and respond to audit failure in the future.
- iv) Our public accountability approach began with the following understanding of the problem:
  - Accounting constructs, rather than merely reflects, a financial reality: it is thus prone to manipulation.
  - Auditing is a check on manipulation and so should be understood as a social utility: it performs a vital check on accounting abuse for the benefit of all stakeholders.
  - There is thus a need to address the 'accountability gap': the shortfall between what the wider public might legitimately expect auditors to do and what the audit process currently delivers.
- v) Analytically, we approach audit failure as the outcome of a particular configuration of economic, cultural, regulatory arrangements which create the opportunity spaces within which audit failures take place. The causes of audit failure therefore must be understood in organisational, institutional and historical context. Our emphasis, therefore, is on the *relations and interactions* which lead to audit failures.

vi) Our findings are that:

- The interaction of i) shareholder value linked remuneration structures for senior managers, ii) fair value accounting standards where valuations require some subjective judgement on the part of those managers and iii) IFRS rules which encourage proceduralism over judgement create large opportunity spaces for audit failure. They provide senior managers with the incentive and the means to produce optimistic valuations, whilst the proceduralism of IFRS rules create an ambiguity as to where rules end and judgement begins for auditors, which reduces their incentive to challenge.
- Similarly, the interaction of US fair value rules which are formal and procedural and a UK regulatory system more accustomed to informal, trust-based, qualitative forms of governance leads to role ambiguity and a more conciliatory regime which defers to management.
- The cultures and practices which lead to audit failure long predate the current competitive environment where the Big Four dominate. A focus on competition to the exclusion of all other reform options ignores the documented experiences when there were five or even eight large audit firms. The problems are institutional and cultural rather than market-based.
- Different cultures may co-exist within the same organisation without one imposing on the other. However, the institutional logics which underpin the culture of consulting are incompatible with those of auditing. This leaves auditors compromised when they should feel free to exercise scepticism fearlessly.
- These problems are exacerbated by the partnership system in the Big Four which may promote non-audit services in ways that compromise audit quality.
- However historic attempts to reform the audit industry have disappointed because reformists confront a 'thin political market' (Ramanna 2015): the audit reform process is captured by the interests of the auditing industry because they possess tacit, technical knowledge in a context where audit is of low political salience amongst the general public.

vii) Our recommendations are:

- In order to reassert the proper role of audit practice, the accounting framework should be amended to reinforce the 2006 Companies Act. It should be stated in that framework that accounting rules are subordinate to law, and that the role of auditing is to exercise prudential judgement to prioritise capital maintenance.
- In order to reinvigorate a culture of scepticism and prudence, we recommend that audit and non-audit activities are legally separated, that limited liability privileges should be withdrawn from both audit and non-audit services to reduce moral hazard and that the FRC should be replaced with the Kingman Review recommended Audit, Reporting and Governance Authority (ARGA).
- In order to shrink the opportunity spaces where scepticism is compromised, we recommend a government review into the role of fair value accounting rules in audit failure. Specifically, whether IFRS rules – with their combination of

subjectivity and proceduralism - create an ambiguity as to where rules end and judgement begins for auditors.

- Finally, in order to address the 'thin political market' problem, we recommend the inclusion of civil society representatives in key regulatory bodies and bodies involved in the audit reform process. Furthermore, we see a role for civil society bodies in creating new networked alliances between academics, public intellectuals and seasoned campaigners to 'thicken' the thin political market, and build an effective civil society check on audit failure.

# 1. Introduction

**1.1** The purpose of an audit should be to verify that financial statements produced by a company's management provide a "true and fair view" of a company or group's assets, liabilities, financial position and profit or loss (Companies Act 2006, section 393).

**1.2** Without robust audits, confidence in companies disappears - banks will not lend, shareholders will not invest, workers will not commit their labour, suppliers will not transact and consumers will not buy.

**1.3** In recent years a number of high-profile company failures have undermined taken-for-granted trust. The collapse of companies like Carillion and British Home Stores raise fundamental questions about the willingness and/or ability of auditors to challenge management and exercise the professional scepticism which is essential to the production of robust, socially-useful audits.

**1.4** These individual failures are reinforced by a reported slide in audit quality, as measured by the Financial Reporting Council (FRC) annual review of audit quality. In 2018 the FRC found that just under three-quarters of FTSE 350 audits were either 'good' or 'needed only trivial improvements', implying a full quarter of audits in some of the UK's largest firms required more extensive improvements (Ford & Burgess 2019).

**1.5** In response to these individual and aggregate failings, the Government commissioned two independent reviews: the Kingman Review to look at regulation and the Brydon Review to examine the effectiveness of audit. At the same time the Competition and Markets Authority (CMA) examined competition and resilience in the audit sector. The Business, Energy and Industrial Strategy Committee's analysis, 'The Future of Audit' fed into these reports. Collectively these reports raise questions about audit culture, the problems of market concentration in auditing services and conflicts of interest inside the Big Four accounting firms (BEIS 2018, 2019; Competition & Markets Authority 2019 (CMA); Kingman Review 2019).

**1.6** The purpose of this report is to build on this appetite for reform by offering a perspective that differs in scope in two fundamental respects:

**1.6.1** Our focus is on the public accountability of auditing as a professional practice:

i. We view auditing as a *social utility* that builds trust and legitimacy in firms and organisations. This trust is essential for all stakeholders: creditors, shareholders, workers, suppliers, consumers and the state. Without confidence in a firm's accounting outputs, creditors will not lend, shareholders will not invest, workers may seek alternative employment, suppliers may withdraw their services and consumers may switch to more credible suppliers.

ii. We consequently focus on the *accountability gap* - the shortfall between what the wider public might legitimately expect auditors to do and what the audit

process currently delivers. This is distinct from the more traditional ‘expectation gap’ explanation that emphasises differences between what the public thinks auditors do and what their actual responsibilities are (ACCA, 2019). Too often the latter defaults onto a discussion about the public’s lack of knowledge rather than the behaviours of the audit profession. The accountability gap frame asks: if audit is failing its wider public purpose, what interventions are needed to restore its social utility function?

**1.6.2** Our focus is also on the public accountability of the *audit reform process*. The history of audit reform is littered with good intentions that do not translate into effective checks on bad practice. Reform failure is partly the result of asking the wrong questions, designing the wrong policies or failing to implement or properly enforce new rules after the process has ended. We understand the audit market, following Ramanna (2015) as a ‘thin political market’ open to insider capture in ways that frustrate reform. Consequently, this report will examine how to build a stronger civil society presence in the reform process, to speak for the interests of the wider public and prevent regulatory capture.

**1.7** Our four terms of reference therefore are to:

**1.7.1** examine the extent and form of audit failure in context

**1.7.2** understand the causes of those failures, drawing on the concept of ‘opportunity spaces’ (defined in 1.8)

**1.7.3** locate explanations of failure within the context of the growth of the Big Four accounting firms

**1.7.4** trace the historical obstacles to reform in audit services and to consider the social forces/political agents best placed to advance public accountability reform processes and audit practices

**1.8** By addressing these four questions, we aim to better understand the ‘opportunity spaces’ which lead to audit failures. We define an opportunity space as:

*the room for manoeuvre within a valuation process, where opportunities to overstate accounting items are taken because auditor judgement is compromised or constrained, leading to information asymmetries between the acting party or parties and those seeking accounting accuracy and accountability.*

**1.9** We view opportunity spaces as arising primarily from financial, organisational or institutional relations which produce incentives that compromise or frustrate auditors' ability to exercise prudential judgement. Our recommendations therefore focus on a series of interlocking, mutually-reinforcing institutional measures designed to shrink opportunity spaces, empower auditor independence, reinvigorate prudence and restore the professional status of auditors as the policemen and policewomen of capital.

## 2. Evidence of audit failure

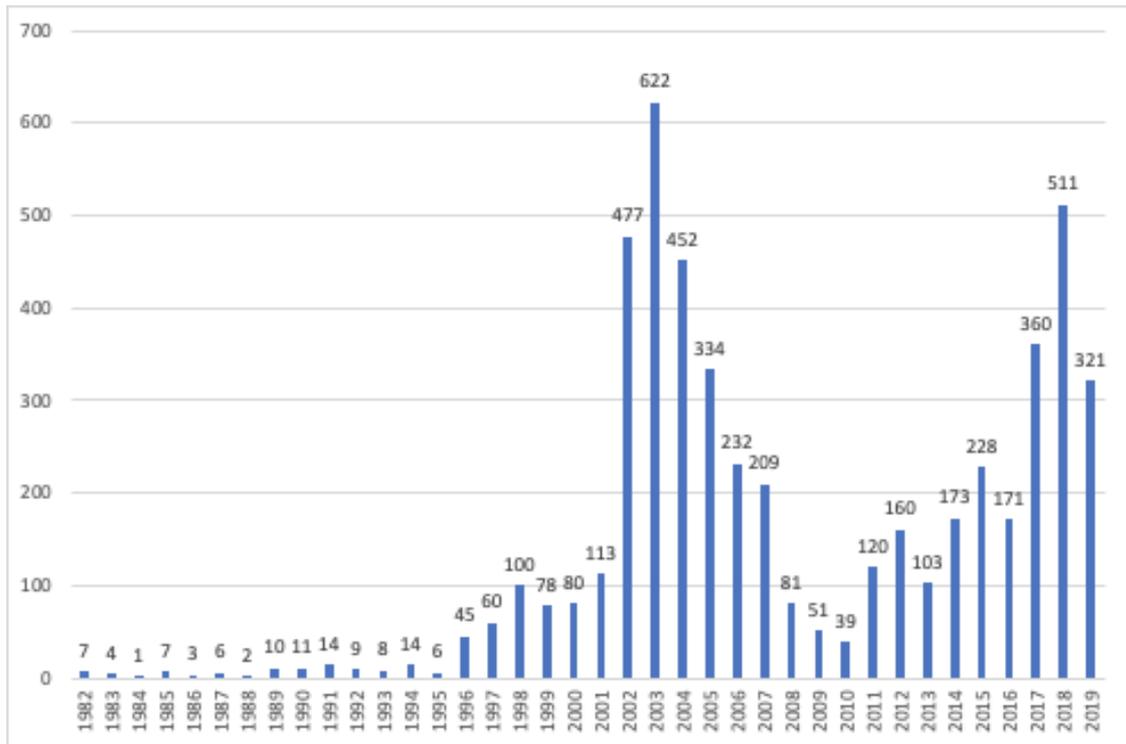
**2.1** Good quality audits are integral to the smooth operation of any modern economy. Firms can expect dire consequences if the perceived legitimacy and quality of reported financial numbers falters. However, auditing confronts a problem. Accounting is not a passive, technical process of mirroring or mapping some objective financial reality that presents itself unambiguously. Accounting is an uncertain valuation process which requires judgements in a context where the application of different principles or rules can lead to very different valuation outputs. Accounting, in this sense, *constitutes and legitimises* a particular financial reality (Hines 1988; Robson 1992) and the task of auditing is to decide whether that process of construction provides a ‘true and fair’ representation of the underlying activity of the firm in question.

**2.2** Weak audits invite senior management to report the accounting numbers that suit them, allowing firms to pay out dividends or hit performance targets which trigger board bonuses. At Carillion, for example, the company was found to have paid dividends out of ‘optimistically booked...unrealised profit’ (BEIS 2019, p.4) and maintained valuations of its goodwill which meant that 80% of its net present value derived from an assumption that the cash flows Carillion expected to generate from its acquisitions would continue ‘in perpetuity’ (BEIS & DWP 2018, p.53).

**2.3** Yet, at the same time, the task of auditing has become ostensibly more difficult. Companies are now more global and subsidiarized. Auditing involves navigating differences in international accounting rules and reporting cultures in a context where the volume of data has increased significantly and deadlines have shortened (Interviewee 2). Accounting rules have also introduced more subjectivity into the valuation of particular items such as contract revenues, goodwill and derivatives, which can make the task of identifying irregularities more challenging. Strong collective commitments to forms of professional regulation that empower such judgements have long-been established in the UK (Robson et al. 1994), but this has intensified in the past decade. The task of auditing may therefore have become more difficult at a time when it has never been more essential.

**2.4** Audit failure is now an important public interest issue, on a scale similar to that of the early/mid 2000s. This can partly be measured by the frequency of audit failure stories appearing in the Financial Times (Figure 1).

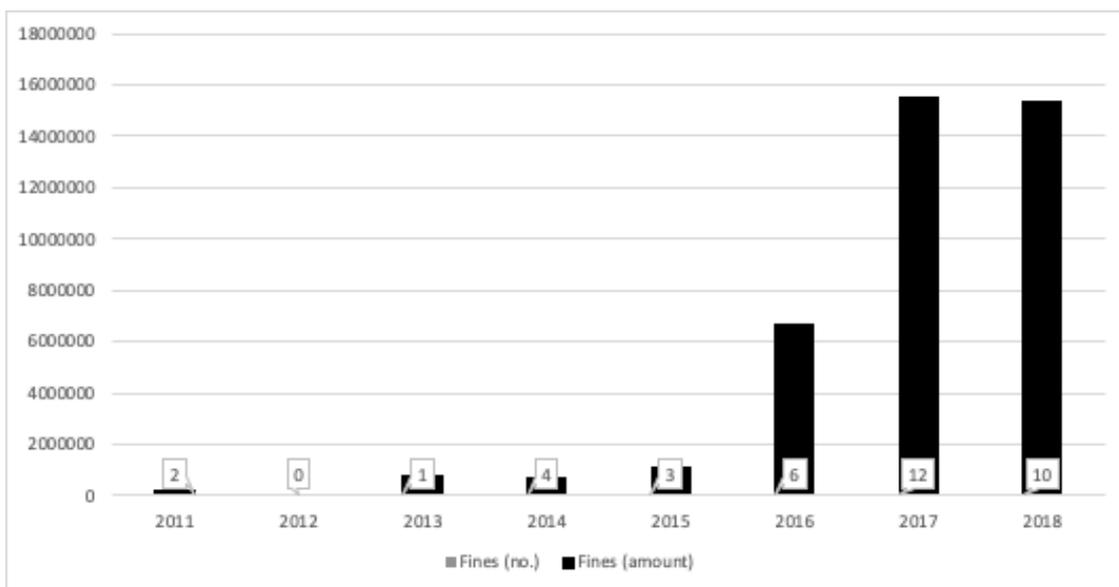
Figure 1: Frequency of auditing failure stories in the Financial Times, 1982-2019



Source: FACTIVA Database · Note: search thread: "audit failure" or "accounting scandal" or "failures in audit" or "auditing failures" or "audit failures" or "accounting irregularities" or "auditing failure".

**2.5** The growing problem of audit failure is also reflected in the FRC's willingness to fine organisations. As figure 2 shows the fines handed out by the FRC to auditors rose from £240k in 2011 to £15.5m in 2017. By July 2018 fines were already at £15.4m, £6.5m of which was a record fine for PWC's auditing of BHS Ltd.

Figure 2: Fines for misconduct and other audit failures, 2011-July 2018



Source: FRC Developments In Audit Report, various years.

**2.6** Fine dates do not necessarily coincide with the dates when audit failures originally took place. Fines are levied only upon the completion of misconduct cases which can take many months or even years. Without pre-empting outcomes of ongoing cases, it is conceivable that this upward trend will continue, when the reviews of Carillion, Mitie, Rolls Royce and the BT Group are concluded.

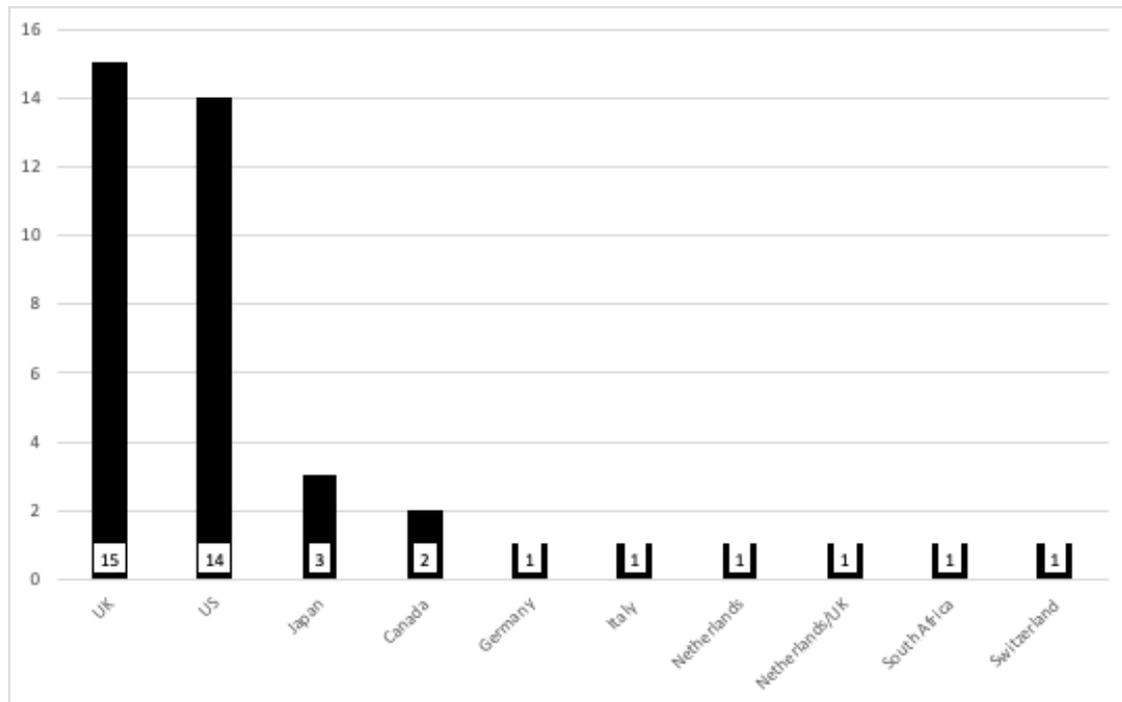
**2.7** Although there are historical examples of audit failure of similar magnitude in other countries (Toshiba in Japan, Parmalat in Italy, Carrefour in France), there is evidence to suggest that the frequency of large audit failures is currently higher in the UK than in other comparatively sized economies. Whilst there is no central database of international audit failure that we are aware of, it is possible through frequency counts of audit failure stories in the Financial Times to provide an indicative picture of the geography of audit failure. The FT is a UK-based newspaper with some geographical bias to their reporting, but it is also a paper where both coverage and readership are global. The UK is also a much larger market for audit services than much of Europe - and so this may also explain why the UK is over-represented in audit failure stories. A list of the 100 firms with the largest number of stories related to audit failure in the Financial Times is provided in the Appendix; no obvious non-UK omissions are evident to the authors. Figure 3 shows that more stories about audit failure are related to UK firms than any other country, whilst figure 4 shows that of the 40 companies that have had the highest number of audit failure stories written about them, 15 were UK based (16, if Royal Dutch Shell are included). This may indicate that audit quality problems are greater in the UK (and US) than elsewhere. Potential reasons for this will be discussed in later sections.

*Figure 3: Frequency of stories about audit failure in the Financial Times, by country of origin of the company involved*

	<b>Region</b>	<b>Document count</b>
1	United Kingdom	1906
2	United States	1545
3	Netherlands	398
4	Japan	391
5	Germany	153
6	China	147
7	South Africa	136
8	France	123
9	Canada	109
10	Italy	100
	Rest of the world	768

*Source: FACTIVA Database · Note: search thread: "audit failure" or "accounting scandal" or "failures in audit" or "auditing failures" or "audit failures" or "accounting irregularities" or "auditing failure"*

Figure 4: The 40 companies with the highest number of audit failure stories in the FT, by country of origin.



Source: Factiva Database · Note: search thread: "audit failure" or "accounting scandal" or "failures in audit" or "auditing failures" or "audit failures" or "accounting irregularities" or "auditing failure"

**2.8** Before we consider causes of audit failure it is important to recognise that not all audit failures are the same. There are outright frauds which involve individuals syphoning money from a business, for example at Polly Peck International in 1991 where the CEO Asil Nadir was eventually sentenced to ten years in prison for the theft of £29m (Box 1). There are situations where audit firms (e.g. Enron [Box 2]) or individual auditors (e.g. Parmalat [Box 3]) have, either through complicity or negligence, allowed management to overstate profits/assets or understate losses/liabilities through the booking of false trades. In those cases, auditors are also at fault for facilitating or failing to constrain managers acting in their own interests to the detriment of shareholders and other stakeholders. There are then examples where rules appear to have been followed, but measurements are incommensurable; and the outcome is thus undesirable from a public accountability perspective (e.g. Goldman Sachs/AIG [Box 4]). In such circumstances accountability failures may lie with the interaction of accounting rules, organisational incentives and institutional factors which encourage weak audits or constrain auditors from exercising judgements which they might, under different circumstances, ordinarily make. Here auditor liability is less clear cut, even though outcomes must still be understood as an accountability failure because the public interest has not been met.

### BOX 1

#### Who?

Polly Peck, a diversified UK firm with interests in textiles, packaging and electronics

#### What Happened?

Polly Peck was a small UK-based textile company which expanded rapidly through acquisition in the 1980s, but collapsed in 1991 with debts of £1.3bn. Accused of fraud, the then CEO, Asil Nadir, fled from the UK to Northern Cyprus in 1993. He later returned to the UK in 2010. He was convicted in 2012 on seven counts of theft from his own company and sentenced to ten years in jail.

#### How?

From 1988, Nadir used fake transactions to boost revenues and profits. Up to £378m disappeared from the company in the form of loans, dubious transactions and the re-registration of Polly Peck's assets under Nadir's name (Partridge 2019). Nadir argued these loans were legitimate and had been repaid. But the evidence presented in court suggested they were mainly used to prop up Polly Peck's share price or were stolen by Nadir. Three accountants - Huseyin Erdal, Ahmet Ozdal and Firuz Fehmi - were found to have supplied audited figures to Stoy Hayward that "bore no relationship to reality". They were required to pay £125,000 towards the joint disciplinary scheme's costs (Treanor 2003). Stoy Howard were fined £75,000 and ordered to pay £250,000 in costs for failing to check the suitability of the company's secondary auditors Erdal & Co, and accepting unsubstantiated explanations about sums held in the company's subsidiary in the Turkish Republic of Northern Cyprus (Perry 2002).

#### Type Of Audit Failure

*Collusion with corrupt management practices:* Erdal & Co were complicit in the fraud (Toms, 2017).

#### References

- Partridge, M., 2019. Great frauds in history: Asil Nadir and Polly Peck. *MoneyWeek*, 20/3/2019
- Perry, M., 2002. Stoy's faces fine and lessons over Polly Peck. *Accountancy Age*. URL <https://www.accountancyage.com/2002/01/15/stoys-faces-fine-and-lessons-over-polly-peck/> (accessed 27.11.19).
- Toms, S., 2017. Fraud Prevention, in: Chew B-L (2017) *Forensic Accounting and Finance: Principles and Practice*. Kogan Page Publishers, 76–93.
- Treanor, J., 2003. Polly Peck auditors fined. *The Guardian* 1/5/03.

### BOX 2

#### Who?

Enron, an energy firm based in Houston, Texas, USA.

#### What Happened?

Enron diversified from being a simple energy pipeline business into a commodities and service trading operation. Throughout the 1990s and early 2000s the company used a variety of accounting mechanisms to inflate earnings and hide liabilities. In 2001, Enron restated their earnings, reporting a \$814m reduction in equity, a \$628m increase in debt, and an additional \$591 million in losses. Enron entered Chapter 11 bankruptcy later that year. In 2006 Enron's CEO, Jeffrey Skilling was convicted of insider trading, fraud, and conspiracy; Kenneth Lay, Enron's previous CEO, was convicted of six counts of fraud and conspiracy and four counts of bank fraud. In 2002, Enron's auditor, Arthur Anderson, was convicted of negligence in its auditing and obstruction of justice for shredding documents related to its audit of Enron. Anderson surrendered its CPA licenses and its right to practice in August 2002, effectively putting it out of business (Healy & Palepu 2003). Although the 2002 decision was eventually overturned in 2005 due to errors in the original judge's jury instructions. Arthur Anderson settled for \$72.5m with Enron's investors in 2007.

#### How?

*Abuse of fair value accounting rules to inflate profits:* Mark to market methods were abused in the measurement of energy contracts and derivatives. For example, overly optimistic model based assumptions were used to value Enron's derivatives, whilst they also realised all expected profits in long term contracts in the present (Bratton 2002).

*Use of special purpose vehicles (SPVs) to hide debt:* Enron used off balance sheet shell companies capitalized entirely by Enron stock to borrow money on Enron's behalf. By 2001, Enron had used hundreds of SPVs to hide its debt.

#### Type Of Audit Failure

Audit *firm* failure: failures were company wide

#### References

- Bratton, W., 2002. Enron and the Dark Side of Shareholder Value. *Tul. L. Rev.* 76, 1275-1361.
- Healy, P. and Palepu, K., 2003. The Fall of Enron. *J. Econ. Perspect.* 17(3), 1-26.

### BOX 3

#### Who?

Parmalat: an Italian company, specialising in dairy and foods.

#### What Happened?

Between 1990-2003 Parmalat were involved in a multi-faceted fraud involving multiple individuals. The fraud unravelled in 2003 when an investigation by PWC uncovered a 14bn Euro black hole in its books, which led the company to collapse almost immediately. Primary auditor from 1999-2003, Deloitte & Touche settled for \$149m in 2007 for failing to pay attention to field auditors' Early Warning Reports & Summary Audit Pleadings (Clikeman 2019). Primary auditor until 1999 and secondary auditor from 1999-2003, Grant Thornton International were implicated in the fraud more directly. Grant Thornton expelled the Italian affiliate from their global network and auditors Mauricio Bianchi and Lorenzo Penca were charged in a Milan court for aiding the Parmalat fraud (Clikeman 2019). Grant Thornton eventually settled with Parmalat for \$4.4m without admitting liability (Parmalat 2015).

#### How?

*Overstatement of revenues through a double billing scheme:* accounts sold on credit to a supermarket; invoices were duplicated (typically in the name of the shipping company that delivered the milk) generating fake sales. The duplicate invoices inflated revenues and created false receivables; the receivables were used as collateral which they pledged against new loans. The loans, then, boosted the cash position of the company (Ferrarini & Giudici 2005).

*Hiding losses using off balance sheet wholly-owned entities:* uncollectible receivables were transferred from operating companies to nominee entities like Cayman Islands subsidiary 'Bonlat'. Fictitious trades/financial transactions were then constructed to offset losses of operating subsidiaries and inflate assets & income.

*Understating liabilities:* recorded non-existent bond repurchases; sold 'non-recourse' receivables to remove liabilities; debt reported as equity; debt not reported at all.

#### Audit failure type?

*Individual auditor* failure - Bianchi & Penca, (then of Grant Thornton International)

#### References:

Clikeman, P., 2019. *Called to Account: Financial Frauds that Shaped the Accounting Profession*. London: Routledge.

Parmalat (2015) Press Release: Settlement Between Parmalat And Grant Thornton. [http://www.parmalat.com/attach/content/4858/2015\\_10\\_30\\_ENG.pdf](http://www.parmalat.com/attach/content/4858/2015_10_30_ENG.pdf)

### BOX 4

#### Who?

American International Group (AIG) a US insurance company  
Goldman Sachs, a US investment bank

#### What Happened?

Throughout the mid 2000s Goldman Sachs bought insurance on the senior tranches of their sub-prime mortgage backed Collateral Debt Obligations (CDOs) to add a layer of security (see Englen et al. 2012). They did this by buying insurance contracts known as credit default swaps (CDSs) from AIG. By late 2007, as many households began defaulting on their mortgages, Goldman Sachs argued that AIG owed a \$5.1bn insurance payout on these contracts, based on a probabilistic estimate of the underlying loans defaulting. AIG, however, argued that it owed no more than \$1.5bn, which allowed it to continue recording quarterly profits (Ford & Marriage 2018). PricewaterhouseCoopers was the auditor for both companies and allowed each firm to record these different exposures, even though they were involved in a bilateral contract where one company's gain should equal the other party's loss. This divergent valuation was only reconciled later when the US government agreed to bailout AIG.

#### How?

Derivatives like CDSs are 'level 3' assets valued on a mark-to-market basis. However because of their bespoke nature, there is often no external market referent against which values can be 'marked'. For this reason values are imputed through proprietary

economic models, which are sensitive to the assumptions and inputs used. The two different estimates thus emerge from differences in the way exposures were calculated. The auditor PWC allowed both to be booked initially, although pressure was later put on AIG to recognise its obligations.

#### Type of Audit Failure

*Rule-stretching/'calculative inconsistency'.*

#### References:

Engelen, E., Ertürk, I., Froud, J., Johal, S., Leaver, A., Moran, M., & Williams, K., 2012. Misrule of experts? The financial crisis as elite debacle. *Economy and Society* 41(3), 360-382.

**2.9** Frauds like those in Box 1 require a complicit auditor and could happen at any time, in any country, under any accounting regime. But generally, cases similar to those in Box 4 are more complex because auditors may confront a number of competing pressure or imponderables. They may confront a hierarchy problem (do you follow Company Law principles or the letter of accounting rules?), a threshold problem (have accounting rules been broken or merely stretched?), an empowerment problem (even if rules are deemed to be stretched not broken, is it correct to exercise judgement in the interest of prudence?), a commercial incentive problem (will the insistence on greater prudence affect client relations?) and an organisational incentive problem (will the exercise of judgement affect my reputation internally?).

**2.10** To take a contemporary example, in 2011 the Thomas Cook parent company released £1.46bn of its merger reserve into its retained earnings to account for an impairment to the value of its subsidiaries (see Box 5 for a full description of the case). This effectively meant releasing unrealised and thus undistributable profits into an account for realised, distributable profits. The Thomas Cook parent company then paid out £99.2m as dividends which would not have otherwise been legal without this merger reserve release, despite recording a loss for the year of £1.52m. The case is salient because:

**a)** it implies that a company can increase their distributable reserves because they have been financially weakened as a result of a large impairment<sup>1</sup>. In this sense, writedowns which reduce capital maintenance become an opportunity to pay out more dividends, further diminishing equity buffers.

**b)** Thomas Cook entered liquidation proceedings in September 2019 after a goodwill writedown could not be absorbed by its equity buffers, and creditors could not reach agreement on a refinancing package.

**2.11** This raises a number of issues for an auditor. The 2006 Companies Act is given as the rationale for the treatment of the impairment, but the Act does not mention ‘merger reserves’ at all. Paragraph 612 refers to merger *relief* from the share premium account; but it does not outline a process for releasing merger reserves into distributable retained earnings. The Companies Act does outline a process for releasing reserves from the share premium account (another undistributable reserve) into retained earnings, but the bar is high: for a public company it requires a special resolution, 75% support in a vote by the membership, and court approval. However, the ICAEW (2010) 02/17BL technical guidance on merger reserves and distributions suggests this treatment of merger reserves is legitimate and there is no mention of the need for special resolutions and court approval (para 39 f (iv)).

**2.12** There is thus an ambiguity or tension between the principle of capital maintenance enshrined in the Companies Act and the actions of Thomas Cook which nevertheless appear to be consistent with ICAEW guidelines. How should auditors act in such a situation? Should they follow the principle of company law and exercise judgement to encourage prudence, or

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<sup>1</sup> *Distributions can only be made from “profits available for the purpose”, those being “accumulated, realised profits... less accumulated realised losses” (Companies Act 2006). Distributable reserves set the legal limit on what can be distributed.*

should they follow accounting rules strictly and allow a substantially weakened company to convert unrealised profits into realised profits to pay out a dividend? Hierarchy, threshold, empowerment, commercial and organisational factors all apply in such circumstances.

#### BOX 5

In 2011 the Thomas Cook parent company (Thomas Cook Group PLC) took a £1.43bn impairment to the value of its subsidiaries, resulting in an overall loss for the year of £1.52bn. That loss was a problem because it meant the parent had to take an equivalent reduction on the liability side because of the double entry principle. At that point in time the parent company had retained earnings of just £199.2m, which would have put their retained earnings at -£1.32bn, excluding other adjustments. The Thomas Cook parent avoided reporting negative retained earnings using two mechanisms (see 'Company statement of changes in equity' for reference):

i) they 'released' £1.46bn of their merger reserve, which is an *undistributable* reserve into their retained earnings, which is a *distributable* reserve. They claimed, 'following the impairment of the Company's investment in subsidiaries during the year, the Company has, in accordance the Companies Act 2006, relieved the impairment loss through a transfer from the merger reserve to retained earnings' (Thomas Cook 2011, p.130). The report to the audit committee noted this treatment is 'consistent with that adopted by other listed Groups' (p.8). Other groups using this accounting treatment – e.g. Greene King in 2010, DSG International in 2010, J Sainsbury in 2010 – refer to para.612 of that act in justification (Company Reporting 2011).

ii) the parent company received £402.9m dividends from their subsidiaries, whilst simultaneously increasing its loans to those subsidiaries by £386.8m.

Those two adjustments *increased* distributable reserves at the Thomas Cook parent from £199.2m to a level where they could afford to pay a £99.2m dividend in 2011 and still have £446.8m of distributable reserves left over, despite reporting a £1.52bn loss for the year.

### Company statement of changes in equity

For the year ended 30 September 2011

	Share capital £m	Share premium £m	Merger reserve £m	Capital redemption reserve £m	Translation reserve £m	Retained earnings £m	Own shares £m	Total £m
At 1 October 2009	57.7	8.9	3,051.3	8.5	1,126.3	347.2	(13.1)	4,586.8
Loss for the year	–	–	–	–	–	(63.7)	–	(63.7)
Other comprehensive expense	–	–	–	–	(243.5)	(0.7)	–	(244.2)
<b>Total comprehensive expense for the year</b>	–	–	–	–	(243.5)	(64.4)	–	(307.9)
Equity credit in respect of share-based payments	–	–	–	–	–	8.1	–	8.1
Purchase of own shares	–	–	–	–	–	–	(0.2)	(0.2)
Dividends paid	–	–	–	–	–	(91.7)	–	(91.7)
At 30 September 2010	57.7	8.9	3,051.3	8.5	882.8	199.2	(13.3)	4,195.1
Loss for the year	–	–	–	–	–	(1,522.9)	–	(1,522.9)
Other comprehensive expense	–	–	–	–	5.9	–	–	5.9
<b>Total comprehensive expense for the year</b>	–	–	–	–	5.9	(1,522.9)	–	(1,517.0)
Equity debit in respect of share-based payments	–	–	–	–	–	(3.2)	–	(3.2)
Issue of equity shares net of expenses	1.5	20.3	–	–	–	–	–	21.8
Release of merger reserve	–	–	(1,463.3)	–	–	1,463.3	–	–
Dividends paid	–	–	–	–	–	(92.5)	–	(92.5)
Dividends received	–	–	–	–	–	402.9	–	402.9
<b>At 30 September 2011</b>	<b>59.2</b>	<b>29.2</b>	<b>1,588.0</b>	<b>8.5</b>	<b>888.7</b>	<b>446.8</b>	<b>(13.3)</b>	<b>3,007.1</b>

The merger reserve arose on the issue of shares of the Company in connection with the acquisition of the entire share capital of Thomas Cook AG and MyTravel Group plc on 19 June 2007 and represents the difference between the nominal value and the fair value of the shares acquired. Following the impairment of the Company's investment in subsidiaries during the year, the Company has, in accordance the Companies Act 2006, relieved the impairment loss through a transfer from the merger reserve to retained earnings.

The share premium arose in connection with the issue of ordinary shares of the Company following the exercise of MyTravel executive share options.

At 30 September 2011, the Company had distributable reserves of £446.8m (2010: £199.2m).

Details of the own shares held are set out in note 28 to the Group financial statements.

Company Reporting, 2011. Emerging Issues: Share Premium And Elimination Of Authorised Capital. <https://www.companyreporting.com/sites/default/files/emerging-issues/11.01-share-premium-authorised-capital.pdf>

Thomas Cook 2011. Annual Report.

**2.13** This example raises questions about the organisational and institutional context within which audit practice is conducted and how this may create opportunity spaces for audit failure. This focus helps us to understand the unevenness of audit failures. IFRS was adopted across Europe in 2005, yet examples of rule-stretching appear on the surface to be more common in the UK. Similarly, accountability problems cannot be explained by audit market concentration in isolation because the Big Four are also dominant in countries with lower levels of audit failure. This could, for example, reflect differences in board composition where greater staff or union representation may introduce dissenting voices that act as a check on managerial rule-stretching. It is important therefore to focus on the *embeddedness* of the Big Four within national regulatory structures, corporate governance regimes, market dynamics and accounting rules to better understand the UK's particular vulnerability to audit failure. All of these factors compose the opportunity space within which audit failure proliferates.

### 3. Explanations of Audit Failure

**3.1** To better understand the problem of public accountability in the audit industry, we sought opinions from academics, journalists, civil society representatives, regulators and industry/ex-industry figures. We conducted 14 semi-structured interviews, each between 40 minutes and an hour long, asking a standard set of questions which we provide in the Appendix.

**3.2** This chapter is an attempt to understand why the UK is so prone to audit failure by examining the particular way accounting standards, corporate governance incentives and regulations interact in the UK case to create opportunity spaces for weak auditing practice. We subdivide this analysis into two sections: the first focuses on the 'lost mission' of auditing, examining the opportunity spaces for unaccountable audit practice when the UK's shareholder value culture meets fair value accounting standards. The second examines problems of institutional incompleteness when US shareholder-focused accounting regimes meet UK light-touch regulatory systems.

#### *A. Fair Value Accounting Standards and 'Opportunity Spaces' For Unaccountable Audits*

**3.3** The role or 'mission' of audit is plainly described in Section 393 of the 2006 Companies Act, which states that:

(1)The directors of a company must not approve accounts for the purposes of this Chapter unless they are satisfied that they give a true and fair view of the assets, liabilities, financial position and profit or loss—

(a) in the case of the company's individual accounts, of the company;

(b) in the case of the company's group accounts, of the undertakings included in the consolidation as a whole, so far as concerns members of the company.

(2)The auditor of a company in carrying out his functions under this Act in relation to the company's annual accounts must have regard to the directors' duty under subsection (1).

**3.4** However what constitutes a 'true and fair' view is the subject of almost existential debate. It is rarely explicitly defined, and so has the capacity to summon quite different understandings of the purpose of accounting and auditing. If accounting is understood as a 'rationally consistent set of principles' (Walton 1993, p.50) which become codified in rules, then true and fair assessments by auditors should assess the extent to which those rules have been faithfully adhered to at the aggregate by management (see FRC 2014, for example). If accounting is understood as a 'set of pragmatic responses to measurement problems' (Walton 1993, p.50), then auditor assessments of true and fair are established through the exercise of *judgement* - a higher objective formed independently of accounting

rules (see LAPFF 2015). The tendency to interpret ‘true and fair’ in the former rather than the latter is viewed by many interviewees as a core reason audit quality has declined:

*[Audit currently] depends on an architecture of rules around how you calculate what profits a business is making. This creates an architecture of yes/no answers about whether rules are followed, and has nothing to do with what audits are supposed to be, which is to make judgements about the sustainability and real health of the business. So you can have accounts presented that show lots of capital for a business that has none at all. And therefore the basic function of an audit, to give assurance, is confounded, and investors and wider public has no knowledge about the business at all. (Interviewee 12)*

**3.5** Others argue that auditors' ability to apply the ‘eyeball test’ to dubious management estimates have been compromised by IFRS accounting rules. They note that IFRS rules have reduced auditors' capacity to use judgement and exercise professional scepticism, creating a power imbalance between management and auditors:

*Accounts don't answer to most stakeholders, since IFRS it's not answering the most important questions. Changes to accounting rules means that accounts have become subjective, diminishing the role of the auditor... Unrealized losses go unreported, so profits are overestimated. When the rules say it's OK; then accountants say it's OK. (Interviewee 6)*

*The reason why they have lost sight of it is that superimposed on this task is a lot of extraneous stuff, irrelevant stuff, the sort of thing that you find with the accounting standards which had been designed with a different thing in view, that accounts should give people good information on the value of the company... My fundamental concern is that we are seeing cases where it's fairly clear that managers are using the rules and the system to game things and to take a very aggressive view... A rules based system is problematic because a prudent auditor might ask to delay the recognition of income, but managers say ‘No! This is the rule – we are sitting within the standards’. The only option the auditor has is to confirm the accounts because it is within the rules. Managers shelter behind the rules. (Interviewee 12)*

**3.6** Others note a slightly different problem - that the rules themselves are difficult to justify on a public accountability basis, and that (some) auditors are unnecessarily beholden to them. A broader decline in a culture of challenge is key for some interviewees, one which transcends questions of market concentration that we discuss later in the report. The implication is something deeper than an ‘expectations gap’. One interviewee implied this was a more fundamental problem of accountability – that there is an ‘accountability gap’. For example on the principle of ‘going concern’:

*The problem is with accounting standards, they do not relate to the real world. They need to be tested against public opinion. For example “foreseeable future” is not 12 months anywhere else. If changed to a 5-year definition that would already be a huge change (Interviewee 4)*

**3.7** The claim that fair value accounting leads to audit failure gains some support from our analysis in section 2; the shift from historic cost to fair value does seem to coincide with a greater incidence of audit failure. Even in some of those large failures before 2005, when IFRS was adopted across the European Union, fair value was a cause. Enron's valuations of its contract profits and derivatives valuations were, for example, made on a mark-to-market basis (Giroux 2008).

**3.8** It is worth noting some dissenting voices to this argument. Some point to the role of IFRS in standardising reporting across countries, and the improvement this should make to the task of audit. Standardisation allows auditors to compile the group and parent accounts of complex multinationals with multi-jurisdictional subsidiaries more easily and accurately, thus improving the audit function (Interviewee 8). Others note that the ultimate client of the audit are the shareholders, and that shareholders require forward looking information which auditors should assess robustly. If there is a problem with the audit process, then new mechanisms should be sought to improve accountability by making Big Four partners more responsible for weak audits or by improving competition in the audit market (Interviewee 2). A third view maintained that fair value was part of the solution because banks and other financial services firms could game historic cost accounting by holding derivatives at their transaction value even though market prices suggested they were worthless. Auditors just needed to enforce those rules more robustly (Interviewee 1).

**3.9** The relation between audit quality and accounting standards is therefore not clear cut. On balance, it could be said the emphasis on the consistency afforded by IFRS is overstated when there is considerable discretion and subjectivity involved in the compilation of accounts on a fair value basis which leads to variance. Similarly, although accounting rules may try to standardise, those rules are often differently interpreted and applied in different national or organisational contexts; they are refracted through institutions and the cultures they nurture. It could also be said that forward looking information means little to shareholders or other stakeholders if it is too open to manipulation by managers who are themselves responding to perverse organisational incentives.

**3.10** This emphasises the importance of avoiding mono-causal explanations, and instead identifying how different elements interact to create the opportunity spaces within which audit failures are more likely to occur. In the UK case there is a risk of *unwanted institutional isomorphism* when board remuneration is linked to short term shareholder value creation and IFRS rules provide room for discretion in the reporting of those items which underlie shareholder value creation. The two have the capacity to reinforce each other if shareholder value creation becomes both an incentive for, and outcome of, poor accounting practice, unless checked by auditors exercising judgement.

**3.11** However auditors often perceive the adherence to IFRS rules as the best way to evaluate 'true and fair' representations. Feedback from ex-auditors in our interviews suggests this creates an ambiguity about where rules end and judgment begins, which can lead auditors to defer to managements' presentations. This can lead to a circularity which allows poor accounting practice to flourish. The risk is that the isomorphism of shareholder value pressures, remuneration structures, reporting discretion and audit role ambiguity is potentially one source of the opportunity spaces which diminish accountability. **Serious**

**consideration should be given to the way audit becomes compromised when fair value measurement discretion meets UK shareholder value corporate governance.**

**3.12** Critics could point to the role of historic cost accounting in other scandals, such as the Savings and Loans (S&L) crisis which involved avoiding the booking of losses on underwater assets (see Young 1995 for discussion). Others could point to the continued use of GAAP in the US where audit scandals are still commonplace. More research is needed to examine the role of fair value accounting on audit failure, in particular whether IFRS rules hand management too much *discretion* in the reporting of accounting items; whilst also encouraging an over-proceduralisation of the audit process at the expense of auditor judgement, creating a circular logic - that true and fair assessments of company accounts produced within IFRS rules, are judged on the extent to which they comply with those rules. Whatever conclusion that research draws, it is imperative in principle that IFRS rules are subordinate to Company Law, and thus that auditor judgement can override accounting rules. This point was raised by BEIS (2019, p. 24):

*Because accounts are prepared in accordance with accounting standards, and auditors review the accounts against these standards, the Companies Act 2006 requirements are not necessarily met - a case of company law following standards, rather than the other way round.*

*B. Institutional incompleteness: US rules without US enforcement*

**3.13** The lost 'mission' of auditing has also been attributed to regulatory failure. One concern raised by some of our interviewees was that the UK regulator lacks the willingness or ability to enforce those rules when they are abused.

**3.14** The limits of the UK's current regulator, the Financial Reporting Council (FRC), were noted in both in the BEIS (2019) Future of Audit report, and was the specific focus of the Kingman Review (2019). The Kingman review provides a far-reaching critique of the remit and practices of the FRC. The report criticised the FRC's 'excessively consensual approach' (p.8) and 'perceived closeness to those it regulates, its reliance on recruiting from the major audit firms, and an associated concern that the FRC has an ingrained cultural sympathy towards the accounting profession' (p. 52).

**3.15** Kingman advocates the establishment of a new public regulator to replace the FRC: the Audit, Reporting and Governance Authority (ARGA). It would have a clear statutory base, enhanced enforcement powers, lines of accountability to parliament, and funding via a statutory, rather than voluntary levy (p. 60).

**3.16** We agree that voluntary funding arrangements are unlikely to produce a sufficiently robust regulatory relationship; and that revolving doors between the Big Four and the regulator should be countered with re-tooled, formal recruitment procedures. We also endorse a shift from proceduralist verification to professional judgement via an enhanced market intelligence function, upgraded viability tests and graduated findings, with the latter providing room for the expression of auditor opinion on management estimates and judgements in accounts, and a venue for the communication of the rationale for audit outcomes (p. 52).

**3.17** However, we are concerned that the UK's problems emerge out of a form of *institutional dissonance* that may not be resolved by a Kingman-like proposal. In many ways the current regulatory structure is reminiscent of the legacy of 'club government' described by Moran (2003) - a less rule bound, more consensual approach which relies on discussion within trusted networks to ensure best practices are followed. The UK therefore has something of a hybrid system where the different parts do not work well in tandem: UK regulatory systems are generally more qualitative and informal, which means the UK has tried to accommodate the US rule-bound proceduralism of fair value accounting standards without the US rule-focused regulatory governance approach. This can reinforce the tendency outlined in 3.11 for there to be ambiguity at regulatory (and auditor) level as to where rules should end and judgment begins. This can be disempowering, encouraging uncertainty and thus a more conciliatory approach which can lead auditors and regulators to defer to management. As Interviewee 9 put it, this is 'the worst of both worlds'.

**3.18** The US system, in contrast, has greater symmetry between its accounting framework and regulatory architecture. It operates a stronger rules-based regulatory approach where good and bad practice are determined by formula which make the division clearer; with less ambiguity. That has not stopped malpractice, but may have encouraged a more stringent approach to failures. Entities like the Public Company Accounting Oversight Board (PCAOB), Securities and Exchange Commission (SEC) or the Federal Deposit Insurance Corporation (FDIC) in finance are better resourced and possess greater statutory powers to sanction poor auditors. The lesson here is not necessarily to 'be more like the US', but rather to think about the institutional complementarities between accounting standards, regulatory structures and audit purpose/auditor role which reduce opportunity spaces for audit failure. That may imply changing accounting rules to empower the exercise of prudence and judgement which better fit our system, rather than conforming with US regulatory structures.

**3.19** These problems of institutional dissonance emerge in our interviews with European actors. While the UK has previously been seen as a good model, reform efforts in other European countries are now looking in different directions.

*The UK market is regulated fundamentally the same as in the EU but obviously there are differences. The funny thing is we always looked at the UK as a fairly well regulated market and now this has all been put into question. When we looked at the FRC and how they dealt with audit regulation, we looked at it as a model, now we have to change that. That's apparently not what we should have thought. But it is still one of the best performing regulators in Europe, maybe that says something about what needs to be done in other countries... the whole focus [of reform] in the Netherlands is on audit quality, and the UK are much more focused on audit market. Although the issues may be similar, the way people look at them are different and potentially the solutions are different. The solutions in the UK are market driven, in the Netherlands the issues they have already made were more focused on remuneration of partners, focusing on quality and linking that to remuneration and have this accountability much better fleshed out. (Interviewee 5)*

## 4. Role of The Big Four in Audit Failure

**4.1** Poor audit practices thrive when organisational and institutional incentives are misaligned with the public interest. It is therefore important to consider the relation between the market dominance of the Big Four accounting firms and the opportunity spaces for audit failure that have been observed recently.

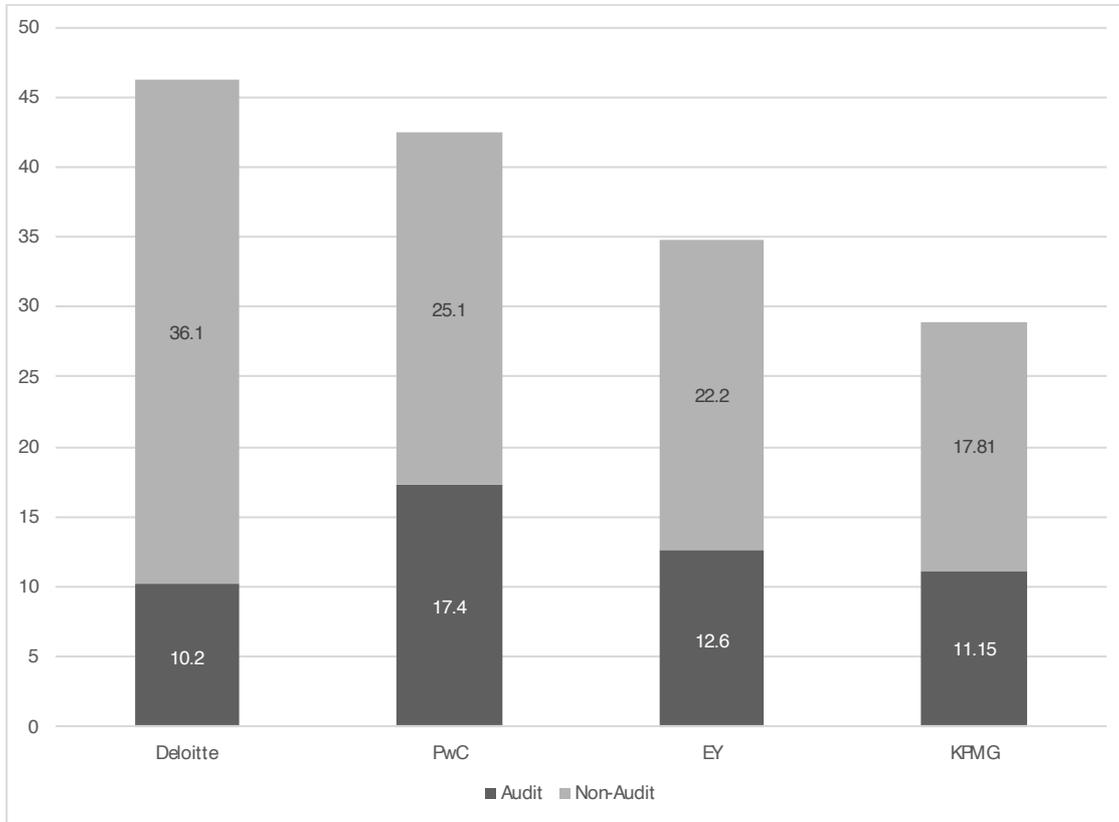
### *Market Dominance*

**4.2** By any reasonable measure the Big Four are highly concentrated and wield market power. The Big Four are not only the largest players in the audit market, but dominate the lucrative audits of larger firms. Of the S&P500 the Big Four audit 495 companies. Adding their other services, their relationships with the largest firms are even more comprehensive. For illustration, PwC publishes how many firms out of different company indices they service. Of the FTSE100, PwC service 60% with non-audit work and audit 30 % - leaving just 10% of companies with which they have no commercial relationship. For S&P Europe the breakdown is 59% non-audit, 34% audit, and just 7% with no relationship. The pattern is replicated for the other three firms. The Big Four have strong consulting or auditing relationships with almost all of the largest companies in the world – a point raised by a number of interviewees.

*Big Four are an oligopoly and they are extremely big and extremely powerful, and they are commercial organizations primarily even though as auditors they have regulatory responsibilities and duties, they are extremely conflicted in terms of their interests. The partner incentives and culture of these organizations is a real problem in my view. (Interviewee 10)*

**4.3** This dominance generates large profits, particularly from non-audit service lines. The global revenue for these firms varies from USD 29 billion to USD 46 billion for the latest fiscal year (PwC 2019, KPMG 2018, EY 2018, Deloitte 2019). Auditing work represents about a third of income for the Big Four. The more lucrative activities are tax consulting, advisory and business consulting.

Figure 5: Big Four Revenue, US\$bn, 2018



Source: Company Accounts, 2018

**4.4** Globally, the Big Four employ over a million people. In EY and PwC, more than half of employees are in non-audit service lines. However, an estimate from 2017 suggests that within Europe, the Big Four employ 64,789 people in the UK and 209,554 in the rest of Europe. The UK has the largest concentration of Big Four employees (Murphy and Stausholm 2017). Their size in the UK is several times bigger than any other country in Europe, and almost twice as large as in Germany, their second largest national market.

4.5 However, it is important to consider whether audit failure problems result from market concentration or reflect institutional problems about organizational incentives and culture. This raises a fundamental question: have the Big Four shaped the culture of auditing through their dominance, or have they emerged from, and merely institutionalised, a longer-standing culture that preceded them? The former presumes that market interventions can provide resolution - that breaking up the competitive grip of the Big Four would lead to a transformed audit sector; the latter requires a more complex consideration about the place of auditing within the Big Four and the mechanisms and architectures required to usher in a more publicly accountable audit sector.

#### *Historical Development*

**4.6** It is important to avoid teleology. Understanding the rise of the Big four in historical context is essential. This does not imply that the current levels of concentration in the

industry are somehow unavoidable, that there was no other historical path the industry could have taken (Carruthers and Espeland 1991). It is possible to acknowledge path dependency whilst also recognising that paths are always shaped by the topologies they confront. Paths can also be diverted, split or even stopped. Hence, to understand the power of the Big Four now, we must understand its history, whilst also accepting that change is still a matter of will and mobilisation.

**4.7** The history of audit is relatively well known. Audit dates back to medieval times, but only came into prominence as trading and manufacturing companies multiplied in the eighteenth century. In the nineteenth century, industrialization created the need for financing, which in turn created a need for incorporation. Incorporation created the need for financial reporting verified through the process of audit (Matthews 2006): compulsory audits were introduced in the 1844 Companies Act, scrapped by the 1856 act, then re-established in the 1900 Companies Act (Watts & Zimmerman 1983).

**4.8** It is also well known that accountants were core to the development of auditing, assuming professional control over the audit role. This was not pre-determined: there were other agents who performed audits in the 19th century, most notably shareholder auditors. However, through the development of more extensive techniques, full service provisioning, and by professionalising, chartered accountants displaced shareholder auditors as the primary actors in the auditing sector (Jones 1995). This dominance was consolidated through the formation of the Institute of Chartered Accountants in England and Wales (ICAEW) in 1880, their professional body which represents their interests (Matthews et al. 1998: 60). Recurring access to audit work underpinned the growth of the UK accountancy profession and its claims to independence in the exercise of professional practice (Sikka and Willmott 1995).

**4.9** The close relations between audit and non-audit services such as consulting long predates the emergence of four large accounting firms. However, the firms that now constitute the Big Four are embedded in this particular history. For example, public accountants like William Deloitte made their name in the mid to late 1800s by providing both auditing and advisory/ accounting services to railway companies, helping develop alternative accounting systems after large frauds had taken place (Jones 1984: 58). This norm is deeply institutionalised. Many founding fathers of the Big Four firms were also presidents of the ICAEW in the late 19th and early 20th Century, including Arthur Cooper, Frederick Whinney, William Deloitte and Sir William Peat. The proximity of accounting and auditing functions is thus an outcome of a historical institutional process which the Big Four have shaped and been shaped by.

**4.10** There has always been unease about the proximity between accounting and auditing functions dating back to the 19th Century, and an expectation that there should be a clear separation between the responsibilities of the manager to prepare the accounts and auditors to verify them. Subsequent Companies Acts formalised this demarcation: they prescribe a clear distinction between the directors' responsibility to produce a balance sheet and the auditors' job to give an opinion on it (Edwards and Webb 1985: 177).

**4.11** The challenge of keeping audit and non-audit activities separate is identified as an enduring problem; as are the conflict of interests that arise when the financial incentive to maintain good client relations meets the public interest responsibility to challenge management presentations robustly. But these issues are institutionalised and long predate the current competitive environment (Suddaby and Greenwood 2006). Critical work on the auditing industry, for example, illustrates long standing conflicts of interest, despite the presence of greater competition. These conflicts are a constant, whether we look at the Big Four, the Five Brothers pre-Enron (NEF 2002) or the Big Eight of the 1980s (Brooks 2018). For example, this was the conclusion of the 1976 Committee on Government Operations, United States Senate, which is worth quoting at length:

*This study finds that public doubts concerning the performance of independent auditors of major corporations are well founded. Moreover, the problems causing an erosion of confidence in the “Big Eight” accounting firms and other independent auditors are inherent in their present system of practice, the procedure by which they are chosen, and their relationship to standard-setting bodies. Restoration of public confidence in the independence and competence of such auditors depends upon reforming the manner in which they perform their responsibilities.*

*The most important requirement of independent auditors is that they be regarded by the public as truly independent from the interests of their clients. The “Big Eight” firms have seriously impaired their independence by becoming involved in the business affairs of their corporate clients, and by advocating their clients’ interests on controversial issues. It appears that the “Big Eight” firms are more concerned with serving the interests of corporate managements who select them and authorize their fees than with protecting the interests of the public, for whose benefit Congress established the position of independent auditor.*

*The management advisory services provided by “Big Eight” firms are intended to aid corporate managements in operating their businesses, and necessarily involve “Big Eight” firms in the business affairs of their clients. Such involvement creates a professional and financial interest by the independent auditor in a client’s affairs which is inconsistent with the auditor’s responsibility to remain independent in facts and in appearance’. (Committee on Government Operations, United States Senate, December 1976, p.7)*

**4.12** The historical analysis and quote above suggest that market-based solutions – the introduction of more competitors – are unlikely to resolve problems of culture and practice that are historically and institutionally engrained. Market concentration certainly does create problems on market-based terms. For example, in some circumstances the choice of auditor is reduced to one if a firm has bought particular non-audit services from three of the Big Four companies (Interviewee 2). However, the majority of interviewees were sceptical that ‘more competition’ would solve the more central problem of audit failure:

*Fundamentally the problem [of audit] is insufficient scepticism, which is about culture, rather than competition or the integration of firms (Interviewee 4)*

Most focused instead on the partnership system and the incompatible cultures of audit and non-audit.

*The Partnership System & Organisational Culture*

**4.13** Non-audit services accounted for 79 per cent of the Big Four's total revenues in 2018, and the percentage of profits was even higher (BEIS 2019). Non-audit profits therefore flow into the bonus pool of audit partners, who receive a share of the overall profits of the firm. This creates incentives for audit partners to care more about firm performance at the aggregate, the majority of which comes from non-audit services (CMA 2019).

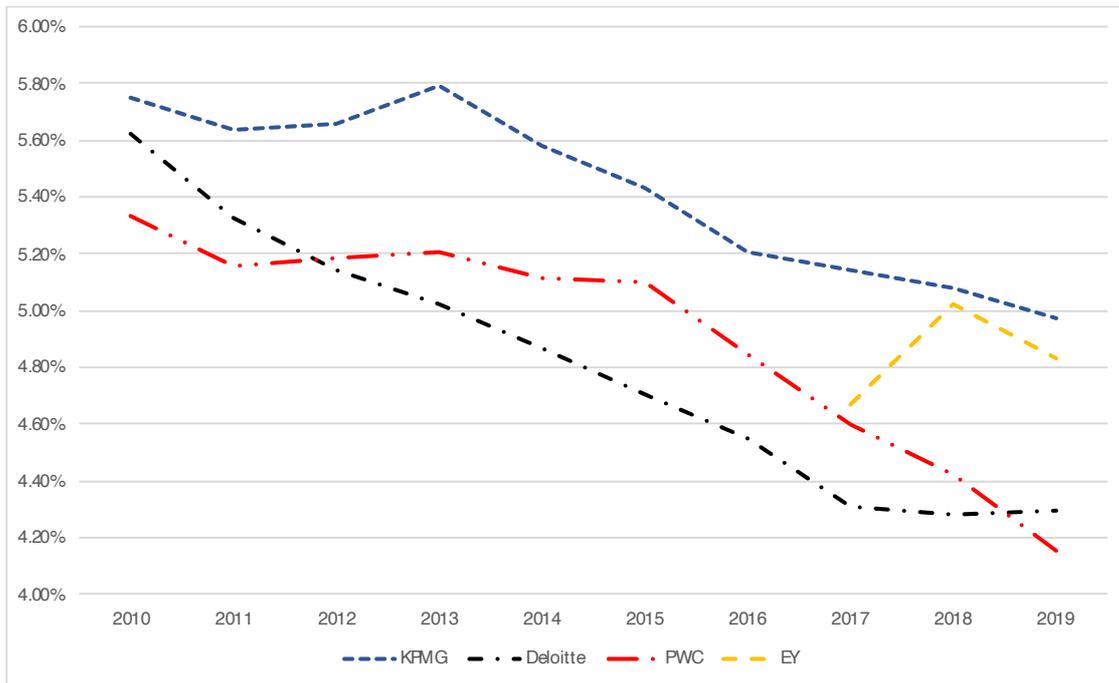
**4.14** This general incentive needs to be understood in the context of the overall legal status and partner-driven business model of the Big Four firm. Partners are paid on a profit share basis. However, since the Limited Liability Partnerships Act (2000), the partnership model has changed from one where each individual partner was jointly and severally liable for claims against the partnership, to one where the corporate entity is granted limited liability privileges, reducing the individual exposure of partners to their capital contribution to the firm (Competition Commission 2011). According to the Competition Commission (2011) report on liability, insurance and settlements, the Big Four then use 'captive' (i.e. in-house) insurers, with the risk partly or wholly reinsured in the commercial market, to mitigate negligence claims. This creates, as Richard Brooks observes, the conditions for 'sports-star level incomes for men and women... taking no personal or entrepreneurial risk' (Brooks, 2018, p.8). Last year Deloitte's 699 UK partners took home an average of £882,000 each. In 2018, PwC's UK partners received an average of £712,000, EY's UK partners an average of £693,000, and KPMG's UK partners an average of £601,000 (Kinder 2019).

**4.15** In a context of limited liability protection where audit is compulsory for virtually all companies and non-audit services are practically essential for any firm of modest size, the partnership system may assume a rentier-like structure. Partners secure high incomes by exercising a form of organisational closure, leveraging the efforts of an ever larger Big Four workforce: average partner share of aggregate employment at KPMG, Deloitte and PWC<sup>2</sup> declined from 5.56 per cent in 2010 to 4.43 per cent in 2019 (figure 6). The risk is that this creates perverse incentives for aspirant juniors in audit roles who may wish to be partner at some future point. Audit may be compromised in a context where partner profits derive largely from non-audit services, and existing partners exercise organisational closure over future partner positions.

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<sup>2</sup> We could not put together a consistent dataset for EY's partners, hence they are excluded from this calculation

Figure 6: Number Of Partners As A Percentage Of The Total Workforce 2010-2019 (EY 2017-2019)



Source: Statista Database

**4.16** These institutional pressures may mean that the culture of audit - which should be objective, sceptical, prudent, and confrontational when required is compromised by or subordinated to the culture of consulting - which is client-focused, pragmatic and ‘can-do’ (BEIS 2019) in order to maintain good client relations. Ex-auditors or those working closely with the industry explained how this client-focused culture seeped into the auditing process:

*If my client (audit) doesn't go well, ...; even though there is not technically a reason to say they might have a going concern issue, but longer term you cannot convince yourself they will make it, ... the auditor has a very difficult time to say to a client "I will consider you not as a going concern". That is an absolute clash with your clients (interests). (Interviewee 5)*

**4.17** Under such circumstances, some question the extent to which professional norms which have traditionally governed the practice are currently working as they should:

*Professional norms are wholly unsatisfactory (Interviewee 4)*

*There is a culture of familiarity. They have forgotten how not to have too close relationships, and take clients wining and dining instead. (Interviewee 6)*

*The awareness within the profession that it is definitely not only about serving the interests of your clients has grown. And it is continuing to grow. I am not saying it is where this should be but it has changed and I think it has changed in the right direction... Is the profession able to keep up as the wider public or civil society would wish? Potentially not, but I think there is more and more thinking about it. They are, more and more, trying to do this. But they seem to always be a little behind. and it is something that is difficult to actually grasp because I would*

*say there are a lot of conflicting asks of the profession, and it is also linked to accountability and quality - there is a clear link. (Interviewee 5)*

**4.18** It should be noted that some respondents saw this as a problem of individual auditors, rather than being solely related to the internal culture or market power of the Big Four:

*There will always be audit failures because there are always things that go wrong. Everybody makes misjudgements, but sometimes people are also potentially not doing the right thing. (Interviewee 5)*

*Financial instruments have been extremely innovative in the last three decades, driven partly by regulatory arbitrage... (but) Carillon, Thomas Cook, Patisserie Valerie were not complicated financial products, it's just that the auditors did not do a good job. (Interviewee 10)*

**4.19** However most highlighted organisational problems, specifically the denigration of the status of audit as an activity and occupation within the average Big Four company:

*In a fundamental way audit is not in the interest to the Big Four firms. They are interested in audit as a foot in the door to the boardroom and a regular income. But this idea of challenge or scepticism, there is so much evidence of failure of this. Audit has become a very friendly enterprise, not a challenging one at all. (Interviewee 10)*

*Too few people see audit work as a career, it's a stepping stone for a better paid job. (Interviewee 7)*

**4.20** Finally, others highlighted the political clout of the Big Four, and the strong links between them and policymakers:

*Big four are enormously powerful in policy making implementation and they tend to bring an ideological side to that, so they promote both their own interests and the interests of their clients, and the type of elite financial capitalism that serves as creating a bigger market for them – there is an indirect conflict of interest to them. They are feeding their longer term interest. We know that all sorts of corporate sectors are very effective lobbyists, big pharma or tobacco etc. ... a type of “insider lobbying” (Interviewee 13)*

*Governments increasingly depend on the Big Four for consulting. They are advising not just on completing audits, but also how to do audit, which means there is a conflict in the advice they give and the function they execute. We also see this with tax loopholes. (Interviewee 3)*

**4.21** In terms of what should be done, some felt that client-based conflicts of interest meant that other actors should appoint auditors:

*'Insurers should appoint auditors' (Interviewee 9).*

Others thought there were pros and cons to increasing intervention in the commissioning process:

*Changing the commissioning of the audit seems like a blunt instrument, what if you get a too small or a bad auditor? ...(However) auditors of local government asked difficult questions when they were appointed by the Audit Commission for example. (Interviewee 4)*

Some suggested the greater problem was partner liability:

*The invention of limited liability partnerships means they can think “How much do we have to bother” (Interviewee 4)*

*Greater clarity is needed on the role of audits, who they serve, to whom auditors are accountable and liable when things go wrong, and what consequences they face in such circumstances -- the absence of skin in the game (for example, in the form of unlimited liability) means that penalties are often minimal due to the difficulty involved in proving a failure of duty of care (Interviewee 7)*

**4.22** There was some disagreement about whether the state or the market should moderate these pressures. Some interviewees believed the main problem was moral hazard which could be better resolved by making partners liable for weak audits. Emphasis here was placed on the introduction of limited liability in the Big Four and how this distorted incentives:

*Traditionally Big Four were partnerships with unlimited liability. Now, that liability is limited. So that has significant influence on the culture of the firm and on the attitude and behaviour of audit partners. We also know insurance partners are unwilling to provide professional indemnity to audit partners, so they are self-insured. There is no way of establishing exactly how, but my research shows it is through buying into the political process and having enough political connections to make sure in the event of scandal they do not get sued. (Interviewee 10)*

**4.23** On a similar tack, others suggested fining partners individually for poor audits (Interviewee 13). Ramanna (2019), in his report on how to reinvigorate a culture of challenge in auditing advocates the use of independent, external remuneration committees to more robustly intervene on partner bonuses, to make partners more accountable for audit failure.

## 5. The Role of Civil Society

**5.1** The concerns about audit failure raised by recent government reports detail multiple suggestions for deep, structural reform of the auditing sector. Such demands are not new. There have been multiple attempts to reform the audit market. Calls for reform followed corporate failures in the 1930s (Royal Mail Steam Packet Company), 1970s (London and Country), 1980s (DeLorean), 1990s (Barings Bank) and 2000s (Enron, great financial crisis). These calls all highlighted repeated problems about auditor independence, competition, governance and regulation (BEIS 2019). Despite repeat failures, these problems persist.

**5.2** Why do these problems persist and why is effective reform so difficult to achieve? One persuasive answer is that audit reform is a ‘thin political market’ (Ramanna 2015), characterised by: *i.* incumbents’ tacit or implicit knowledge of technical detail, generated by experience, so that there is a coalescence of interests and arcane expertise in the bodies involved in the reform process and *ii.* a generally low political salience of these issues with the general public. These conditions make regulatory capture more likely, and also allow big players (or special-interest groups) to capture reform processes.

**5.3** The “thin political market” problem can be seen in the background documents to public consultations which emphasise the lack of civil society input into the audit reform process. The charts below (figures 7-9) show the categories and numbers of respondents to Financial Reporting Council public consultations, detailing the last three consultations under the category of ‘audit’ to which the FRC received responses.

**5.4** The dominance of the audit profession in discussions of audit reform and regulation is notable. The second most dominant group are users of financial statements, those who commit capital to firms. The third are preparers of financial statements. Academia has minimal presence and public authority voices are few and far between. Despite the importance of audit as a ‘social utility’, voices that inform debate represent a narrow set of interests. Civil society is all but absent.

**5.5** The 2019 ‘Revision to Ethical and Audit Standards’ consultation addressed the need for trust and confidence between the users of audited financial statements and company directors. In the same year the ‘Proposed revision to the CASS standard’ consultation addressed the proposal for revisions to the Client Assets Assurance Standard. This provides requirements and guidance for auditors reporting to the Financial Conduct Authority (FCA) on an entity’s compliance with FCA’s CASS Rules pertaining to firms that hold or control client money or assets. The 2015 ‘Review of UK Audit Firm Governance Code Feedback statement and proposed revisions’ invited input on the FRC code which is intended to provide a benchmark of good governance practice against which firms that audit listed companies can report for the benefit of shareholders. FRC consultations can be accessed here: <https://www.frc.org.uk/actuarities/asorps/past-consultations>.

Figure 7: Responses to 'Review of UK Audit Firm Governance Code Feedback statement and proposed revisions' 2015

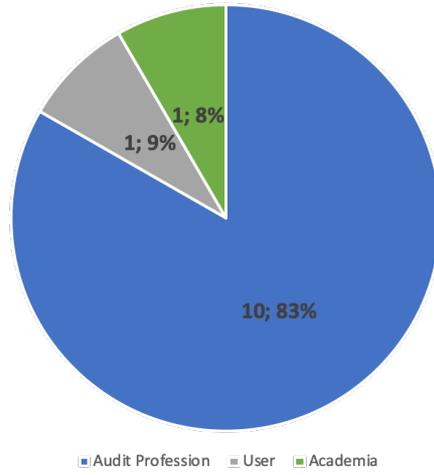


Figure 8: Responses to 'Proposed revision to the CASS standard' 2019

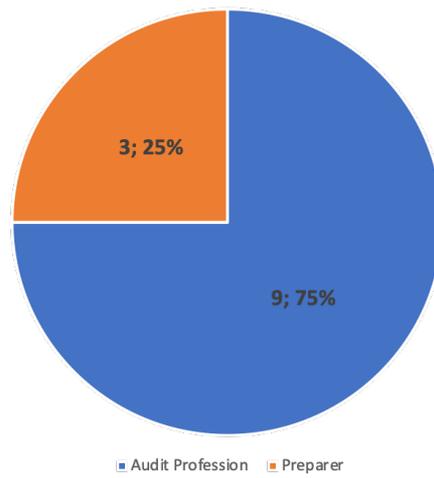
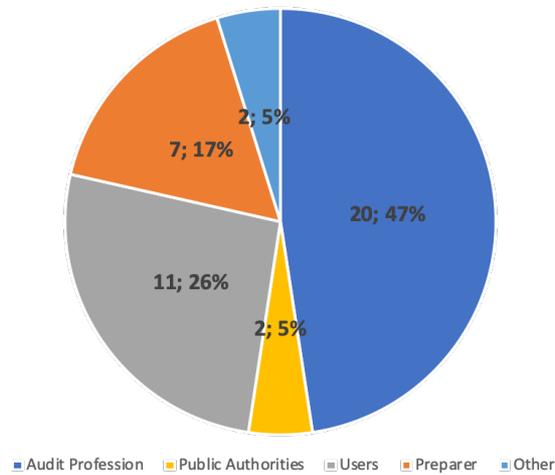


Figure 9: Responses to 'Revision to Ethical and Audit Standards' 2019



**5.6** The lack of diversity in discussions of audit is replicated outside the UK. In 2010 the EU published a Green Paper, 'Audit Policy: Lessons from the crisis' to invite discussion of a range of issues. These included the supervision of the auditors, the structure of the audit market and the governance and independence of audit firms. 688 comments were submitted with 407 (59%) coming from the audit profession, 145 from preparers, 22 users, 57 public authorities, 9 audit committees, 28 academia and 20 categorized as other. The European Commission reports that of 'other' the majority came from private individuals (EC 2011).

**5.6** Respondents from the UK were more consistent in opposing reform proposals than respondents from any other country. Of interest in terms of identifying change coalitions, the 213 responses that came from small German auditors and firms strongly supported reform proposals (Böcking et al. 2011). Subtracting these respondents from the audit profession category shows that large audit firms almost unanimously opposed reform. '... (M)ost of the stakeholders did not see a necessity for fundamentally changing the status quo. This result prevails even more when, in a separate analysis, we treated identical statements by several German small practitioners as a single response' (Böcking et al. 2011: 1). Auditors, financial statement preparers and users dominate discussions on audit reform in support of the status quo. Civil society is silent.

**5.7** The silence of civil society on the important matter of audit reform is a public accountability problem. As Ramanna notes, 'a relatively higher awareness among the public of [these issues] induces intermediaries such as politicians or the media to act as safeguards for the public interest' (Ramanna 2015, pp.7-8). The challenge is how to energise civil society to become involved in the reform process, when for many this is simply a boring, technical activity with little connection to their own lives.

**5.8** The absence of a civil society voice in audit reform and the challenge this poses to public accountability was a concern for many interviewees. Some commented that the purpose of audit should be reframed to include a wider range of stakeholders, and argued for a civil society with capacity to speak for those interests in the reform process.

*Cultural change and pressure is needed. Businesses should be accountable not just to shareholders, they should bring externalities [such as the environment] into accounts. (Interviewee 6)*

*Company structure and dividend focus is part of the problem. In the UK and US there is recent debate (Business Roundtable) about businesses should have a purpose, but this hasn't been given life. Civil society could impact responsible shareholders. (Interviewee 4)*

*It should be a multi stakeholder consultation, everyone in the same room. The profession at large is open for that. If the profession could have a method in which they contribute and there is discussion. But not new regulation and new demands every year, it seems to be a never ending struggle. (Interviewee 5)*

*Civil society could be publishing, actively promoting, ensuring accurate description. How much money are they getting and where from. Influencing public opinion, engaging with government and regulators, and independent analysis of the more technical elements. Providing a mechanism for young auditors and provide them with a different point of view, help them coalesce into a constituency that could be influential. An area where there is leverage is on graduate intake. There could be a different view presented to students on what the firms offer and what their impact is in society, have them think about questions to ask in interviews. (Interviewee 13)*

**5.9** Interviewees suggest that there are challenges in constructing a broader public sphere around audit and making the issue a topic of mainstream political debate. Several suggest that one way of making the risk of audit failures clear to the public is to focus on the risk to employees.

*It is possible to involve civil society but might be hard to see how – what stakes do civil society have in the governance of for example Sports Direct? (Interviewee 3)*

*In the case of Thomas Cook, the customers are getting saved, but not employees. This is the human face of auditing risk. (Interviewee 4)*

*All audit stakeholders (employees, creditors, investors) should have a statutory right of access to audit files, working papers, etc, and should be able to question the outgoing auditors on their statement of circumstances (Interviewee 7)*

**5.10** Thickening this thin political market by involving civil society in the reform processes of the auditing sector is essential. However, improving transparency may be another way to provide the public with access to information so that it may better understand the audit process is another. This would allow the public and the press to act as a more effective check on or bulwark against conflicts of interest:

*Auditors should be required to fully disclose the full set of relations they have with their clients, and to comment on what steps they take to avoid conflicts of interest arising between audit and (say) consulting advice on an M&A project, or on tax structuring. A statement should be appended to the annual report of a company clarifying all related party transactions. Outcomes of discussions between outgoing and incoming auditors should be filed on public record at Companies House so that all stakeholders have access to this information. (Interviewee 7)*

**5.11** However this vision of a more active and effective civil society check on audit failures will require the development of new public knowledge and capabilities which require organisation. Civil society activism on audit failure confronts high levels of complexity and thus high barriers to entry.

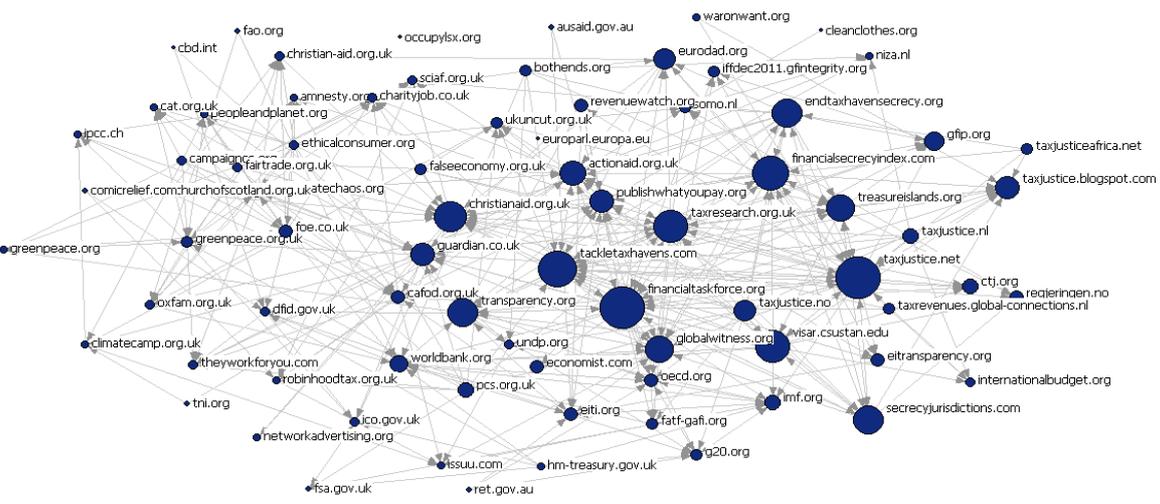
*[Civil society needs] to really understand structure, money flows, everything about the firms. Secondly, understand the technical parts of reform proposals. And thirdly understand campaigning. Proper strategic insights into developing things that work. Smart strategizing... Anyone who has been previously a partner or is on the route to being a partner in the Big Four would have a conflict of interest. (Interviewee 13)*

**5.12** Building civil society engagement on issues often considered boring and technical is challenging. Although there are some signs of encouragement. The work of financial journalists at the Financial Times have increased the public prominence of this issue through their coverage of detailed accounting failures and of Big Four culture, for example. But the readership of the FT is relatively eclectic and well-written exposes alone will not automatically lead to civil society momentum on audit issues. That requires organisation, and the key problem is that there are few organisations campaigning about audit failure.

**5.13** Tax is a case in point. It provides precedent of another campaign issue that was deemed arcane and captured by vested interests and technocratic barriers to entry. Tax justice has despite this history of insulation from public contention, increased in salience with new regulatory tools such as Country by Country Reporting (CbCR) originating in civil society and now adopted in policy (Seabrooke and Wigan 2016). The Tax Justice Network has been at the fore here and provides some clear pointers on direction of travel.

**5.14** Figures 10 and 11, below, provides an issue crawler depiction of the organizational websites involved with tax justice issues for 2012 and 2016. Issue Crawler (issuecrawler.net) is a network mapping software that captures outlinks from specified sites and ‘crawls’ along them to establish issue linkage from website presence (Marres and Rogers 2005). It permits a visualization of existing links between organizations based on the issue, such as tax justice. This technique locates links between websites and is an established method for locating agenda setting in transnational networks (Carpenter et al., 2014). Researchers in this team conducted Issue Crawler searches on tax justice issues in 2012 and 2016. Figures 10 and 11 show the betweenness centrality of nodes (websites) in the network, with the size of the nodes a reflection of the number of times it acts as the shortest bridge between two other nodes.

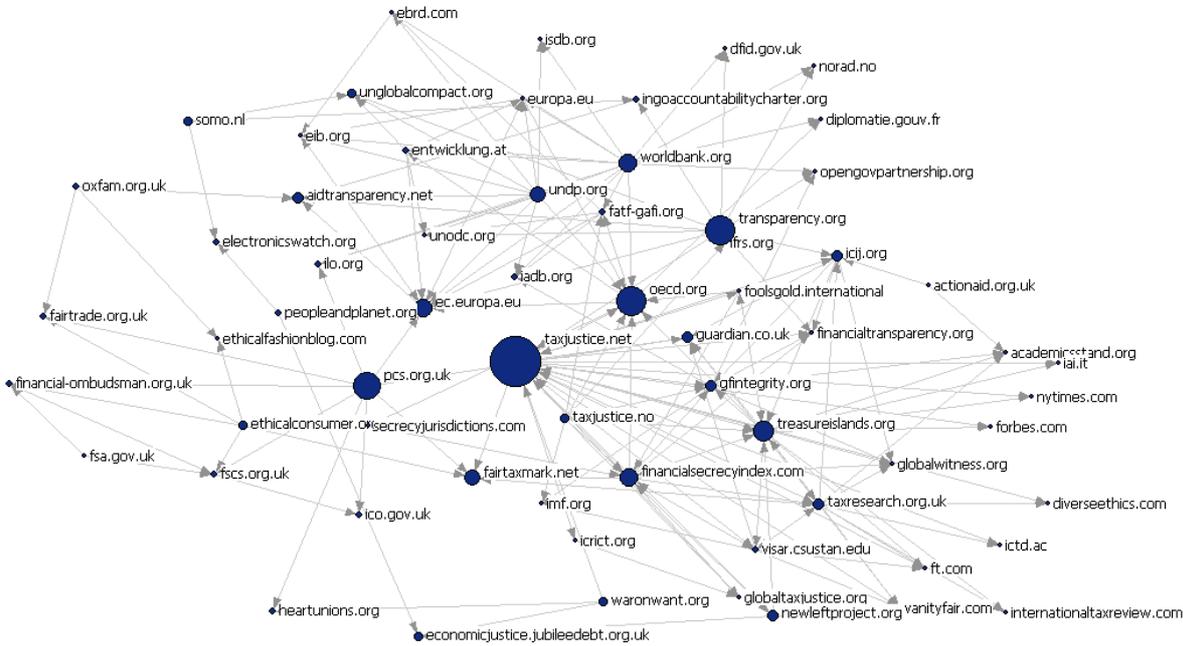
*Figure 10: Tax Justice Issue Crawler Network, 2012.*



**5.15** Figure 10 shows the tax justice issue space in 2012. By this time the tax justice issue had been well-established and given a significant boost with post-financial crisis moral outrage about tax abuses and bailouts. Tax Justice Network had led this charge since 2003 as an

informally assembled expert-based NGO (Seabrooke and Wigan 2016). Tax Justice Network (taxjustice.net) is located to the southeast of the diagram, and the Financial Action Task Force and Christian Aid are also prominent towards the center of the image. What is interesting about this network depiction is that the nodes dotted around taxjustice.net are tied together. This includes TJN branches but also different websites that speak to different audiences. For example treasureislands.org is a website for a popular 2012 book on tax havens written by a journalist affiliated with TJN (Shaxson 2012). taxresearch.org.uk is Richard Murphy, a key driving force behind CbCR and the FairTax Mark, a prolific blogger on economics issues, and now director of the Corporate Accountability Network. financialsecrecyindex.com refers to the Financial Secrecy Index produced by TJN and affiliates, which provides a unique methodology to measure the extent of financial secrecy provided by a jurisdiction (Cobham et al. 2015). This benchmark is aimed at the policymaking community, deliberately seeking to move attention away from the idea of ‘tax havens’ as tropical destinations getting away with daylight robbery and placing emphasis on corporate and elite tax avoidance within the core of the OECD member states (Seabrooke and Wigan 2015). In Figure 10 there are some ties to intergovernmental organizations like the Financial Action Task Force, the World Bank, and the UK Department for International Development, but this network is mainly populated by NGOs, including large players like Transparency International. At the time NGOs were competing for attention on the tax justice issue and signalling to each other, creating the dense network depicted above.

Figure 11: Tax Justice Issue Crawler Network, 2016.



5.16 Figure 11 provides the network for 2016. taxjustice.net is by far the most dominant node. We can see the thinning out of NGOs compared to only four years earlier, but the rise of direct ties to intergovernmental activity, such as with the OECD, the European Commission, a range of development banks, and large NGOs like Transparency International. There are also substantive links to groups such as the Public and Commercial Services Union,

as well as direct links to journalists (ICIJ). By 2016 it is clear that tax justice issues like CbCR had moved from the periphery into formal decision-making circles backed by agents that could apply significant public pressure.

**5.17** One known way to create momentum on technical issues is through the creation of benchmarks and indices. Civil society organizations can engage ‘reformist’ benchmarking by calling on experts to assess and analyse practices within accepted industry standards. So called ‘expert activists’ can push forward ‘revolutionary’ benchmarks by offering alternative standards against which practices can be assessed. Here one can expect significant opposition from entrenched interests (Seabrooke and Wigan 2015). Both reformist and revolutionary forms of generating civil society engagement on technical issues have their positives and negatives. Pursuing auditing with accountability requires some similar choices to be made on how to best engage activists, authorities, and broader civil society.

**5.18** The demand for a noisier politics on audit and audit reform is on the rise. While demand is growing, institutional supply lags. As noted in regard to the politics surrounding the City of London and a ‘finance curse’ that the City nourishes (Christensen et al. 2016), where institutional supply is absent and unlikely to spontaneously emerge, it must be strategically and purposively orchestrated (Baker and Wigan 2017). It is important that such efforts are not only UK-based but also transnational, since professional practices, including auditing, are developed and affirmed through transnational communities (Free et al. 2019). However, efforts can be seeded in the UK as a practical starting point. And reforms in the UK may have international implications, by demonstrating what change is possible.

## **6. Recommendations**

**6.1** Our examination of audit failure and our interviews reveal ongoing concerns about the decline of judgement and scepticism in the audit process, the conflicts of interest between consulting and auditing roles within the Big Four organisations, and – more broadly – the location of auditing within an architecture of impoverished checks and balances which create the opportunity spaces for poor practice.

**6.2** Audit is a social utility: it should serve all stakeholders, whether shareholders, creditors, employees, suppliers, or consumers. Audit failure therefore is a public accountability failure.

**6.3** Our recommendations are therefore guided by the following principles:

- The importance of reasserting the proper *role* of audit practice: to exercise judgement to ensure that accounting information provides the best approximation of underlying economic activity.
- The importance of reinvigorating a *culture* of scepticism and prudence in the audit process
- The importance of *closing down the opportunity spaces* where scepticism may be compromised and poor practice may proliferate.
- The importance of mobilising a *civil society bulwark* against the thin political markets which lead to insider capture of regulation and the reform process.

With those principles in mind, our recommendations are:

*A. In terms of the role of audit:*

**6.4** We acknowledge the importance of accounting rules as a mechanism for standardising reporting practice, allowing investors and other stakeholders to make commensurable comparisons between firms. But there is a legitimate concern that the move to IFRS has led to an over-proceduralisation that has reduced audit to an architecture of yes/no debates around whether rules are fulfilled or not.

**6.5** Audit has lost sight of its mission, enshrined in the 2006 Companies Act which is to form a judgement about the sustainability and health of a business by providing a true and fair view of its assets, liabilities, financial position and profit or loss.

**6.6** In recent times an ambiguity has emerged, both in the FRC's (2014) interpretation of 'true and fair' (see LAPFF 2015) and in auditors' own view that their role is to implement IFRS rules. It is not.

**6.7** Similarly the concept of prudence was removed from the IFRS 2010 Conceptual Framework for financial reporting.

**6.8** We therefore recommend **a rewriting of the accounting framework** to ensure greater symmetry with the 2006 Companies Act about the role of auditing: that whilst rules should standardise the process of constructing financial reports, the role of audit is to verify them by providing a true and fair view of its assets, liabilities, financial position and profit or loss. Accounting rules should be subordinate to the law, and the law demands the exercise of independent judgement and professional scepticism by auditors to encourage prudence. We do not want to be overly-prescriptive about which body or bodies should be charged with this rewriting process, but in principle those bodies should be intellectually plural and include civil society representatives to prevent industry capture.

*B. In terms of the culture of audit:*

**6.9** We recognise that a restatement of the role of auditing is a necessary prerequisite for changing audit practice, but is unlikely to change practice on its own.

**6.10** Our history of auditing has shown that the conduct of audit and audit's relationship to other practices are often shaped by informal rules which play at the edges of what might be deemed legitimate; and that new rules may simply enshrine and legitimise informal behaviours that have been long practiced.

**6.11** This has often led to conflicts of interest between audit and non-audit functions when those activities are carried out within the same organisation.

**6.12** Such conflicts may also lead to a compromising of audit quality if maintaining a good client relation with management becomes an important commercial concern.

**6.13** This culture did not start with the Big Four. Similar problems are noted when there were 'Five Brothers' (NEF 2002; Suddaby and Greenwood 2005) or even eight large accounting and audit firms (Committee on Government Operations, United States Senate, December 1976, p.7) This culture has long structural and institutional origins.

**6.14** It is rather the case that the Big Four represents a continuation and consolidation of that culture. For that reason we do not think there to be any natural mechanism through which the introduction of more competition of similarly integrated accounting and audit combines would resolve this fundamental cultural problem.

**6.15** However we do believe the culture of scepticism and challenge necessary to conduct robust audits is often sublimated to the optimistic problem-solving culture of consulting. Auditors must be fearless. And, they are only able to be so if there is a separation between the two activities. **We therefore support a structural and legal separation of those activities, rather than a softer governance or operational (ring-fencing) separation.**

**6.16** We note that this is politically practicable. The industry responses given in the BEIS (2019) report suggest that many within the Big Four believe this may resolve some of their accountability problems, and that this is the direction of travel they are moving in, in any case. Audit is similarly no longer a major profit centre, and so would be a tolerable loss. We also note that some coordination will always be required in complex audits, but that this could be managed through more sophisticated information systems.

**6.17** However, we note some risks associated with this separation. First, the separation of low-profit audit services from high profit non-auditing services raises legitimate questions about the financial viability of audit post-separation. Audit costs will have to rise and those costs will likely be passed on to consumers. Second, the risk of capture by clients may be more pronounced if the audit market fragments and smaller auditors become dependent on a handful of large audit contracts to survive. Third, there may be information asymmetries if the audit sector fragments whilst non-audit services remain at their current level of concentration.

**6.18** On the first risk, there is a strong case that audit failure has now got out of hand and that higher audit costs are a social price worth paying for more robust, accountable audits. There may be efficiency enhancing outcomes which offset some of these costs (see para 6.33 below). Similarly, those higher upfront costs should lead to a smaller number of corporate failures, the costs of which are, in many cases, already socialised. On the second and third risks we believe the rentier problem outlined in para 4.15 could be ameliorated through the **withdrawal of limited liability** privileges in both audit and non-audit services. That would incentivise prudence in audit and more caution in non-audit. Partners are not suppliers of risk capital in the classic sense and so it is unclear what purpose limited liability serves other than protecting partner privilege. Limited liability in this situation is a moral hazard that helps privatise gains and socialise losses, and so needs to be withdrawn.

**6.19** This withdrawal of limited liability privilege should be coupled with Kingman's recommendation for **an enlarged Audit, Reporting and Governance Authority (ARGA) which replaces the FRC**. This organisation should be willing to levy significantly larger fines on audit firms who engage in poor audit practice. Fines should be charged to the bonus pool and must be significant enough for partners to 'feel it' in their pay packets: for example the record £15.4m of fines the FRC levied on all Big Four firms in 2018 is less than the pay received by just eighteen of Deloitte's 699 UK partners, calculated at the average profit share of £882,000 they received.

**6.20** We believe this market-based intervention is more in-keeping with the fabric of UK institutional arrangements. But should these interventions not work, a more interventionist approach might be necessary. Withdrawing firms' ability to choose auditors might be another step: audit could be financed by an annual levy on firm revenues, with auditors allocated by ARGA on 5-7 year contracts - long enough to build knowledge and prevent the eviction of challenging auditors, but short enough to prevent the formation of strong social ties (see Geiger and Raghunandan 2002 regarding problems of short term audit contracts).

*C. In order to shrink opportunity spaces:*

**6.21** A risk associated with legal separation of audit and non-audit is the risk that information asymmetries affect auditors' ability to conduct meaningful audits. If large corporations continue to work with large non-audit advisory services firms, then a smaller, more diffuse audit sector may struggle to engage with the detail of accounting innovation. Similarly, the extrication of auditors from the Big Four may encourage an even more carnivorous culture to flourish in the firms they leave behind.

**6.22** Our analysis of audit failure suggests that fair value accounting provides a large opportunity space for such information asymmetries to emerge. We therefore recommend a **government review into the role of fair value accounting rules in audit failure**. That review should consider within its remit whether moving back to historic cost as the legal statutory form of reporting would vastly simplify the accounting regime, reducing the returns to the information asymmetries that can arise under fair value (e.g when using proprietorial models to value level 3 assets like derivatives). There are legitimate concerns that the move to IFRS has blunted auditor judgement (see, for example, Economic Affairs Committee 2011, para.113), reducing assessments of true and fair to an architecture of tick box, yes/no discussions about whether IFRS rules have been followed or not. This may lead to an over-proceduralisation of auditing which creates an ambiguity as to when rules end and judgement begins. This can lead auditors to defer to management's accounting presentations.

**6.23** Auditors should be free to exercise judgement, but judgement would benefit from a more verifiable accounting regime with a stronger evidential basis. Historic cost may provide one crucial way of handing power back to auditors and diminishing returns to the gaming of accounting rules in non-audit. This would not stop firms producing fair value accounts if they believed it would benefit shareholders. That would be at their discretion to do so.

**6.24** The legal separation of audit and non-audit activities, the removal of limited liability, a revived mission of auditing and a review of the impact of fair value on audit quality may not of themselves change audit culture, particularly if auditors carry the cultures from their old employers with them. Currently the FRC lacks the resources, power and authority to uphold the mission of auditing – that is the conclusion of both Kingman & BEIS reports. This is another reason to support the Kingman recommendation to introduce a new Audit, Reporting and Governance Authority (ARGA) regulator.

D. In order to mobilise a civil society bulwark against the thin political markets

**6.25** The Accounting Profession has been described as a ‘state within a state’ (LAPFF 2015, p.2). Its basis of authority is narrow, resting on mastering an arcane and esoteric language and technical skills held by initiates. That authority is rarely contested.

**6.26** It is thus important we do not take for granted the ability of the accounting profession to wrestle control of the reform process away from public actors. Past attempts to reform the industry have failed because they have brought influence over i) problem definition ii) planning & design of solutions iii) implementation, in a context where there is little countervailing force from civil society.

**6.27** This can be explained through the idea that auditing is a ‘thin political market’ (Ramanna 2015), characterised by:

- i. incumbents’ tacit or implicit knowledge of technical detail, generated by experience
- ii. a general low salience of these issues with the general public.

These conditions make regulatory capture more likely, and also allow big players (or special-interest groups) to capture reform processes. Yet, ‘a relatively higher awareness among the public of this possibility induces intermediaries such as politicians or the media to act as safeguards for the public interest’. (Ramanna 2015, pp.7-8)

**6.28** Civil society must play a more active role as a political agent in applying pressure on regulators, auditors, government and other intermediaries to ensure that regulation is accountable and that the reform process is less prone to capture. This will require a programme of engagement and education, which draws on the following principles:

**6.28.1** To construct audit as a public interest issue, there needs to be a focal point; so that audit becomes a prism through which people understand aspects of their own lives. The link between lost jobs, inequality and audit failure needs to be made.

**6.28.2** There also needs to be a stronger public sense of the proper role of auditing, as the police men/women of the economy, underwriting stable jobs. This would be the basis from which to ask questions about whether auditors are holding companies to account.

**6.28.3** There also needs to be a basic and accessible political economy analysis of auditing. Low political salience can be combated through a greater public understanding of the industry (its structure, role of partners, pay norms, importance of consulting etc) in order to highlight how it can go wrong.

**6.28.4** The public also require a better technical understanding of accounting as an activity that constructs rather than maps our economy - to emphasise the importance of prudence, scepticism, judgement.

**6.28.5** An understanding of how to mobilise knowledge, to build organised civil society bodies that develop internal capacity and external networks

**6.29** In order to do that, there will need to be educational fora, training programmes, idea-building events etc. The goal would be to create a greater number of citizen-intellectuals/civil society experts. A political case would be made for their representation in the new ARGA and in discussions of accounting reform as a civil society check on the problem of thin political markets.

**6.30** This would also require the construction of new organisations which act as advocates for change and new networks of academic/public intellectuals, seasoned campaigners and public representatives to act as a check, balance and social force driving the reform process through the three stages of problem definition, plan/design and implementation.

**6.31** Hybrid networks will not emerge in spontaneous response to audit failure; in financial markets, for example, failure creates demand but institutional supply is not automatic (Baker & Wigan 2017). Civil society activism on complex economic issues requires specific, and relatively scarce capacities. A corporate accountability public sphere calls for strategic planning to harness linkages between academia and professionals. New organisations will also require resources to pay for the hard graft of advocacy and campaigning.

**6.32** If civil society is to act, there must also be greater transparency, so that a more educated, knowledgeable public body may hold the industry to account. Transparency featured prominently as one way of building a civil society bulwark, in our interviews:

*When auditors resign they seldom provide clear reasons for their action. Being taciturn or economical with material information prevents stakeholders from understanding the true state of a company or enterprise - in some cases it appears that outgoing auditors may withhold information from stakeholders at the request of directors / management, which strikes me as a dereliction of duty to stakeholders (Interviewee 7)*

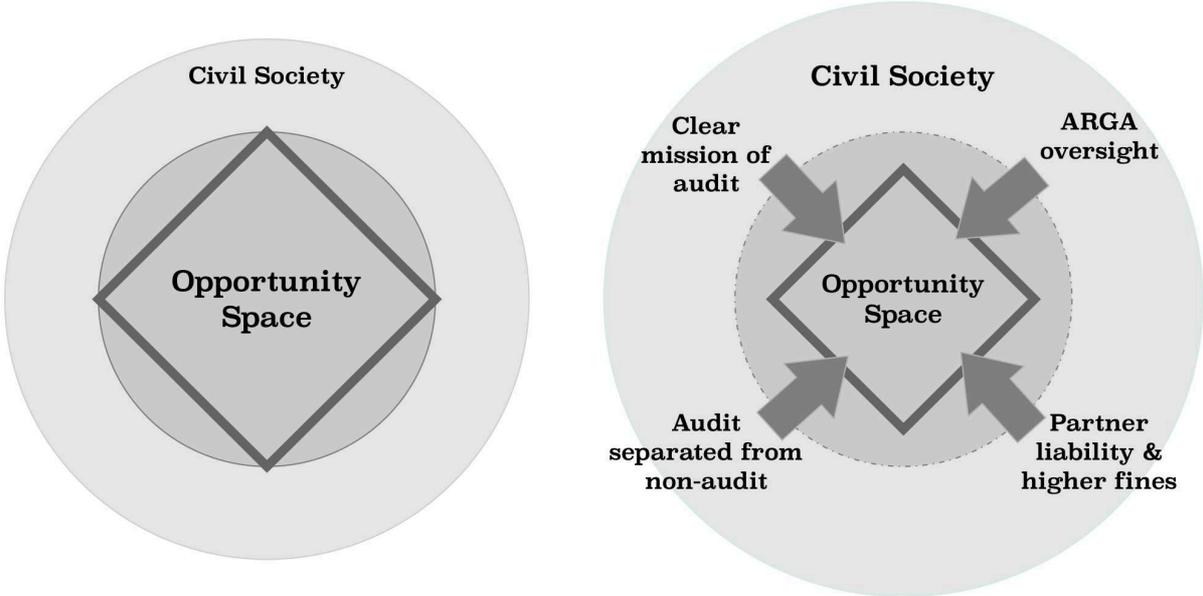
*We are seeing the backlash from the Big Four firms [against the proposals from CMA report] so we will have to wait and see. They are very powerful organizations who have been capable of determining their own regulation and enforcement for very long. (Interviewee 10)*

**6.33** However, all regulatory change should be assessed on the basis that there are financial trade-offs. Our recommendations may be normatively justified, but may be challenged on the new financial costs they would impose. On this we believe more research is needed. The

costs of accounting restatements as a result of audit failure stretch into the tens, if not hundreds of billions of pounds. But more than that - there is an opportunity cost basis which should also be considered in any financial calculation. A more publicly accountable audit market might have unanticipated and benign spin-offs. For example, when shareholder returns can be generated through accounting manipulation in ways that exceed those expected from productive investment, senior managers may allocate greater time and resource to the former, often at the expense of the latter. In other words weak auditing may encourage 'satisficing' behaviour in managers, who may switch their efforts from the 'difficult' stuff of improving firm competences to the 'easy' stuff of creative accounting. This may 'crowd out' investment, leading to falling productivity. Consequently, more robust audits may weed out weak managers who rely on accounting manipulation and help promote more genuinely entrepreneurial managers who are willing to invest and are better able to spot real investment opportunities.

**6.34** Returning to our discussion of unwanted institutional isomorphism (para.3.10) and institutional dissonance (para. 3.17), we view these recommendations as institutionally complementary; they would work in a mutually reinforcing way to shrink opportunity spaces. The separation of audit and non-audit would remove the cultural and commercial pressures on auditors to temper their professional scepticism. Auditors would then be guided by a clearer, restated mission for audit to uphold Company Law; whilst the removal of limited liability would apply incentives to audit partners to ensure that principle was adhered to. All of these processes would mutually reinforce each other, and be overseen by and embedded in an enlarged civil society sphere, empowered through increased transparency to hold organisations and processes to account.

*Figure 12: Shrinking the Opportunity Spaces for Audit Failure*



## APPENDIX 1: 100 largest audit failures by story frequency in the FT

Company	Document Count	Company	Document Count	Company	Document Count
Koninklijke Ahold Delhaize N.V.	378	Versailles Group PLC	31	Rhodia SA	16
Tesco PLC	204	Bristol-Myers Squibb Co	27	Bain Capital, LLC	15
Steinhoff International Holdings N.V.	176	Carillion PLC	27	Verizon Communications Inc.	15
Toshiba Corp	169	Royal Bank of Scotland Group PLC	26	Boosey & Hawkes Ltd	15
MCI Inc	129	Warner Media, LLC	25	KKR & Co. Inc.	15
BT Group PLC	115	Qwest Communications International Inc	25	Lehman Brothers Holdings Inc	15
Fannie Mae	113	Royal Dutch Shell PLC	24	Rite Aid Corp	15
Patisserie Holdings PLC	100	Cadbury plc	23	Sony Corporation	15
Freddie Mac	98	Ford Motor Company	22	Berkshire Hathaway Inc	14
American International Group Inc.	87	Fuji Xerox Company Limited	22	Deutsche Telekom AG	14
RSA Insurance Group PLC	87	Mayflower Corp PLC	22	Aptiv PLC	14
Nortel Networks Corp	74	TransTec PLC	21	Elan Corporation plc	14
PricewaterhouseCoopers LLP	71	Johnson Controls International PLC	21	Mpac Group PLC	14
Enron Creditors Recovery Corp.	67	iSOFT Group Plc	21	Bundesanstalt für Finanzdienstleistungsaufsicht	13
Olympus Corporation	67	SK C&C Company Limited	21	Carl Fischer	13
Wirecard AG	63	Speedy Hire PLC	20	Refco Inc	13
KPMG International	61	JPMorgan Chase & Co.	20	UBS Group AG	13
Bausch Health Cos Inc	55	Encompass Health Corp	20	Britax International plc	12
Citigroup Inc.	49	Citigroup Japan Holdings Corp.	20	Merrill	12
Avis Budget Group Inc.	47	Wickes Ltd	20	Noble Group Ltd	12
Xerox Holdings Corp.	46	Banco Espirito Santo SA	19	Asia Resource Minerals Ltd	12
Ernst & Young LLP	45	Carrefour SA	19	International Consolidated Airlines Group S.A.	11
HP Inc	45	Allied Carpets Group plc	19	Powerscreen International Plc	11
Thomas Cook Group PLC	42	Zurich Insurance Group Ltd	17	Cisco Systems Inc	11
Autonomy Corporation plc	39	Barclays PLC	16	Hillshire Brands Company	11
Deloitte Touche Tohmatsu Limited	39	CA Inc.	16	Samsonite International S.A.	11
Adecco Group AG	36	Deloitte LLP	16	Interpublic Group of Companies Inc.	11
The Goldman Sachs Group Incorporated	33	Fujifilm Holdings Corporation	16	Pearson PLC	11
Healthcare Locums Plc	33	ISS A/S	16	Rolls-Royce Holdings PLC	11
Andersen	32	Glencore PLC	16	Senior PLC	11
Parmalat SpA	32	Bank of America Corporation	16	Booker Group Plc	10

## APPENDIX 2: Interview questions

### Accountability challenges

- what, if any, would you say are the main accountability issues in the sector?
- what, in your view, are the main causes of some of the audit failures we've seen in recent years?
- how unprecedented would you say that the current spate of audit failures (Carillion, Patisserie Valerie etc), are?
- do you see these recent cases as isolated incidents, or do you think they highlight a broader problem in the auditing industry?
- would you say that problems - when they arise - are concentrated within a particular country or countries, or are there general/international problems? (i.e. do they arise only in a particular national context, or are problems evenly geographically dispersed due to the international footprint of the Big 4 accounting firms)
- have changes to accounting rules (from historic cost to fair value) increased or decreased accountability challenges?

### The Big 4

- In your view, do the Big 4 do an adequate job of auditing large firms?
- Is market concentration demand driven - do large companies require large multi-functional, global auditing firms to conduct their audit?
- Would the auditing function be improved through more competition? If so, how could that be implemented?
- Is the concentration of the Big 4 in London a problem? If so, how?
- Are there conflicts of interest between the auditing and consulting arms of the Big 4 accounting firms, or do you think those conflicts are overblown?
  - If the former, what is the nature of those conflicts?
  - Are professional norms working as they should, and do they act as a sufficient check on conflicts of interest?

### Regulation

- Is government regulation of the auditing industry adequate? If not, what do you think should change?
- Is there a sufficient balance between formal regulation and oversight and self regulation in the sector?
- Should government or its regulatory agencies try to intervene in the market structure of auditing?
- Should government or its regulatory agencies separate the audit and consulting functions of the Big 4?
- What other reforms could be implemented that might alleviate some of the recent concerns about the industry?

### Reform

- There have been many historic attempts to improve the auditing industry: what, in your view have been the successes and failures?

- Do you think they addressed the most relevant problems and underlying causes?
- What could be improved, both in terms of design and general approach?
- What, in your view, have been the most significant obstacles to reform?
- Which constituents/actors should be involved in the process of reform?
- Could civil society initiatives play a role in supporting a reform process/could civil society play a role in monitoring the industry?
  - If so, what skills or knowledge would a civil society organisation need in order to be effective in monitoring the industry or challenging its power?

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