

# CIVIL SOCIETY INITIATIVE ON AUDIT REFORM

## Scoping Study, May 2020

### Executive summary

#### 1 | Introduction

The next few months present an exceptional opportunity for civil society to influence audit reform in the UK. This is of tremendous importance to making the economy work on a more inclusive, responsible and sustainable basis. These behind-the-scenes rules determine whether financial reports are reliable and meet the needs of all stakeholders, or are unduly influenced by the interests of management and the audit industry. Unreliable audit was a critical cause of the 2008 crash and will play a crucial role in the transition to a sustainable economy as part of a recovery from the coronavirus crisis.

This opportunity will only last a few months from now. The current government is committed to reform processes that present a powerful entry point. Without substantial civil society input, these reform processes are likely to drive no more fundamental change than previous efforts. The government is expected to launch a final consultation on audit reforms later this year, building on previous consultations on the Kingman, Brydon and CMA reviews, having delayed it from May 2020 due to the coronavirus pandemic.

This paper presents an analysis of how the opportunity can be seized. It looks at the potential objectives of a civil society initiative on audit reform in the UK, considers the context in which the current reform process is taking place (including a stakeholder analysis and a discussion of the potential impact of coronavirus), and then weighs up the options and pros and cons for a range of models, with more detail on the recommended option.

The study has been funded by the Joffe Charitable Trust. Its remit was 'to engage a range of stakeholders to scope the potential objectives, approach and activities of a civil society initiative focused on audit reform in the UK'. It builds on a research study into public accountability and the audit profession, *Auditing with Accountability*. That study was funded by Luminate and published in March 2020. Luminate remains interested in further work in this area.

A large number of stakeholders has been involved in developing the analysis so far. A small group of experts met in April to review this scoping study. They agreed that the initiative was of great importance and should be pursued urgently, and provided advice on how best to do that. They emphasised that further work should be pursued in dialogue with organisations who could shape and take ownership of the initiative. All that is needed now is a group of people who are willing to take up the work and make it happen.

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<sup>1</sup> See <https://luminategroup.com/posts/blog/reforming-audit-in-the-public-interest> and <https://www.sheffield.ac.uk/crafic/auditing-with-accountability>

## 2 | The need for audit reform

The functioning of market capitalism depends on confidence in companies' financial reports, and by extension, on confidence in audit and auditors. But this confidence has declined in recent years, as the BEIS Select Committee noted in *The Future of Audit* in 2019:

*"Questions around competition, resilience, conflicts of interest, regulatory weakness and the nature of audit itself have contributed to a crisis of trust in the industry. None of these problems are new; but previous attempts at reform have not delivered necessary improvements."*

The effectiveness of audit is undermined by accounting rules that do not prioritise capital maintenance and by issues of scope. The firms that audit large companies also provide significant advisory and consulting services, leading to conflicts of interest and questions around transparency. Regulation has been criticised as being inadequate. There are questions about the levels of competition, resilience and accountability in the audit market, raised by issues such as the dominance of the FTSE 350 audit market by the big four firms and the limited impact of existing sanctions on the quality of subsequent audits.

*Auditing with Accountability* (2020) found, among several key conclusions, that civil society action in this field was necessary to protect and advance the public interest.

## 3 | Proposed civil society initiative

The scoping study considers key issues from the perspectives of multiple stakeholders. It reviews related initiatives and previous civil society attention in the field of audit reform. Based on this analysis, the report presents a number of approaches that civil society could take. With further dialogue, a single preferred option has emerged of a time-limited coalition, in the first instance, to engage with the current government-led audit reform process. This section sets out the preferred option in more detail.

### **Recommended objective**

To ensure that current government-initiated audit reform processes in the UK deliver substantial changes, and thereby increase confidence that the audit industry acts effectively in the public interest

### **Recommended model**

This study recommends the establishment of a coalition of organisations and individuals with shared support for an ambitious agenda for audit reform (e.g. a *Coalition for Audit Reform*). It would act as a home for experts from a range of relevant disciplines, representing a range of sectors and perspectives. It would be politically non-aligned, with the agreed approach of aiming to engage across the political spectrum. It would reach across the public, private and voluntary sectors, but would not engage directly with the audit industry. It would aim to become the 'go-to' place both for journalists and for policymakers seeking engagement on policy proposals.

Substantive research, policy, advocacy, campaigning and communications work would be done by coalition members, with a single co-ordinator (employed by a host organisation) building and managing the coalition itself. Initially, this coalition would be set up as a time-limited effort to make the most of live opportunities to achieve meaningful policy reform in the UK. At the end of the current reform period (e.g. in late 2021), it would review whether there is an appetite to continue the work. If so, it would review its potential objectives, structure and approach for the second phase of its existence.

### **Recommended goals**

To build an independent coalition of organisations and individuals who share this objective to make and defend the case for audit reform, to increase public awareness of and support for reform, and to contribute to the reform process. It should promote the following reforms:

- Stronger regulation through the creation of a new Audit, Reporting and Governance Authority (ARGA) with a revised remit, greater powers, more independence, stronger governance and a more transparent and aggressive approach to investigations, sanctions and enforcement
- Reduced incentives for weak auditing through the structural separation of audit (and associated compliance and accounting) services from advisory services, and more frequent audit rotations
- Revised accounting rules that require adherence to restrictions on distributions out of capital and prudent accounting for realised revenue and foreseeable losses and liabilities

### **Recommended activities**

- Building political pressure for change by developing narratives about the impact of poor auditing on people's daily lives, and working with journalists and campaigners to raise public awareness of and engagement with the issues and to uncover and communicate examples of poor practice (leading eventually to the development of educational campaigns)
- Building and co-ordinating a network of practitioners, academics, public intellectuals and business representatives who can provide independent expert input into reform and consultation processes, undertake research, policy and advocacy work as needed, and support politicians and other influencers who are well-positioned to champion our reform agenda
- Providing an independent voice through civil society representation on key regulatory bodies and coordinating civil society responses to media stories and public enquiries

## 4 | Possible next steps

- A. Convene a core group to drive the early development of a civil society initiative, made up of people with technical accounting and audit expertise, knowledge of the UK audit market and regulatory environment, and expertise in advocacy and campaigning
- B. Urgently reach out to a broader set of groups who seek to influence economic reform in the UK, to encourage them to incorporate audit reform into their analysis and agenda, as well as to other relevant groups
- C. Start recruiting allies, including organisations and individuals representing a range of sectors and those with the capacity and willingness to do research, policy, advocacy, communications and campaigning work in support of the coalition's objectives, as well as those which might play a more passive role but will lend their support and networks
- D. Identify a host organisation to employ a coordinator and manage relevant grants (e.g. a UK-based NGO or think tank with a relevant remit and located in the political centre ground) and encourage them to apply for funding to hire a co-ordinator to build and manage this initiative (e.g. someone with technical knowledge of the issues, who also has campaigning experience and is a good networker and communicator)
- E. Agree detailed policy objectives with a view to responding to the BEIS committee inquiry by 31 July 2020 (<https://committees.parliament.uk/work/222/delivering-audit-reform/>)

[ENDS]

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