



Rethinking the rethink

The government may have backtracked on demands on audit reforms, but expect more change than we have ever seen in coming years, says **Jon Moulton**

Very public failures in audit have garnered much criticism in recent years. Generally, this has been when they have had to come clean as the offending company has gone into insolvency.

Politicians have focused on audit in the apparent belief that auditors caused the corporate failure. Of course, they didn't – companies fail mostly because of poor management, or failed or obsolete business models. The worst that a bad audit can do to a company's stakeholders is fail to show poor trading or oversized liabilities, often meaning stakeholder losses are increased as the misled funders of the business advance bad loans, or creditors increase credit limits on the basis of optimistic or fraudulent accounts.

My own experience of audit is doubtless coloured by making numerous investments in troubled companies. However, I have seen a few really bad ones: accounts signed off with substantial differences on intercompany accounts buried in prepayments; a year's credit card expenses netted off 'goods received not yet invoiced'; a public company reporting the bank balance as net cash rather than the much smaller reality of the cash book; very substantial guarantee liabilities not provided; and even one where a fake warehouse with ethereal inventory balances went unremarked. Another clearance meeting came to a juddering halt when I pointed out that the P&L did not add up or agree with the balance sheet.

These examples all featured big-name audit firms. Those war stories aside, audited accounts have always been more reliable than any other source of financial data. But they could, and should, be better.

More than looks

A lot of money has gone to ICAEW from fines – I hope a good chunk of it is spent on increasing the quality of audit rather than reputation management. We should leave that to the politicians, who think they are experts in that field. I'm fairly sure the 17 UN Sustainable Development Goals, adopted

by the Institute, are of less general interest to our members than maintaining a stellar reputation for the quality of work by ICAEW member firms.

Following its consultation, the UK government published some 300 recommendations in around 600 pages, with the aim of improving audit, increasing reporting across a broad range of issues and toughening up corporate governance. But, all that work having gone in, it has largely been dropped off the agenda in favour of more populist policies.

Given the state of the UK economy – and as many of the changes proposed had a cost greater than the potential economic benefits – it probably made sense to drop or defer the proposals. In any case, given the need to improve audit, it's not helpful to add a lot of new stuff to the highly stretched auditor's workload.

For the corporate finance world, pressures for the splitting off of insolvency and corporate finance activities from audit-based firms have grown. And the split is starting to happen. For those of us in corporate finance, there will be an intangible but real effect. An adviser with something of an audit-based culture certainly feels more numerically reliable than one without. Validation of financial accounts in the context of corporate transactions seems likely to be thought more necessary.

Talking to the partners in the firms shows the tensions. 'Taking a view' on less than solid forecasts is something an independent corporate finance firm can more easily do, without an audit culture of low risks constraining activity. The same is apparent in insolvency and tax services. Risks and rewards are different in the different trades, giving rise to understandable tensions as publicised shortcomings in any sector hurt the firm's reputation and profits in all sectors.

Within a few years, I strongly suspect the firms will 'demerge' into specialist firms. It is probably for the better in the round. At minimum, conflicts between audit and non-audit work will be reduced. However, smaller clients will miss the ease of integrated one-stop shopping for audit, tax and advice. But expect more change than we've seen for decades.

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