The madness of audit independence

As the CMA announces sweeping proposals for audit reform, Clive Viegas Bennett, CEO of MGI Worldwide, says the way the industry works is fundamentally flawed

Author
Clive Viegas Bennett
CEO of MGI Worldwide

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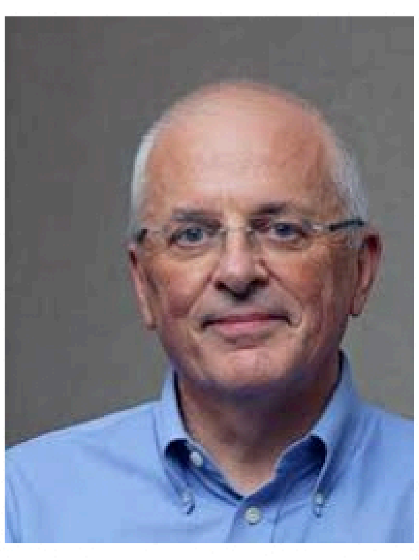

Independence from the company you are auditing is the heart of audit methodology. Yet, best management practice aims to maximise mutual dependency in customer relationships. So, auditing a client is contradictory and the very basis of audit today is fundamentally flawed.

Without independence, audit as currently understood would be meaningless and untrustworthy. Independence is driven by the critically important professional traits of objectivity and scepticism.

All 118 pages of the International Ethics Standards Board for Accountants *Code of Ethics* which relate to audit are about independence. Auditors are taught that ethical conduct and independence are synonymous.

And, boy, does the IESBA code go to town. The minutiae of the acceptable limits to receiving gifts and hospitality, financial interests in clients, non-audit services, and so on, run page after page, all focused on threats to the delicate flower that is independence. Ethical auditors are exhorted to take into account not just the facts of independence but also the *appearance* of independence.

Auditors and networks of audit firms such as ours then have to live by these byzantine rules.

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Unfortunately, the huge independence edifice is built on quicksand because auditors are paid directly by the companies they audit. The extraordinary fact is that companies pay experts to pronounce publicly on their probity and viability. On top of that, the paying company is usually not even the constituency needing the audit. Shareholders and wider stakeholders depend on the reliability and transparency of financial statements but, unless the company is owner managed, get no effective say in the choice or control of auditors.

We would never travel with an airline that paid inspectors to issue its safety certificates, so why, other than habit, do we entrust our financial safety to auditors paid for by the companies they audit?

This is not only about money; it is about culture. The assumption is that audits can be made of such high quality that auditors will never fail to call out unsustainable or corrupt businesses. But the client-supplier relationship, the antithesis of independence, is at the core of any firm – great companies in all sectors rightly put their customers' interests at the heart of their strategy.

The many auditors I know are decent, highly-trained professionals who take their ethics as seriously as any surgeon or judge. They want their reports to be useful and, well, independent. They know that important decisions, indeed whole slices of the economy, ride on the reliability of company accounts.

Only human

Auditors are only human. Admonishing clients, let alone disciplining or firing them, when they represent a good percentage of fee portfolios, not to mention bonuses, is commercial torture. Auditors are not corrupt, their silence is not bought by evil clients: the significant independence they honestly achieve is, rather, a heroic stand against business logic. Obsessively detailed independence rules are made mockery by the most basic maxim – he who pays the piper calls the tune.

Auditors are terrified of putting a client at risk by publicly questioning the reliability of accounts with a "qualified" or "adverse" audit opinion or the future viability of a client company with a "going concern disclosure". They worry that even hinting at such issues will cause a catastrophic crash in the client's share price or creditworthiness or be a self-fulfilling prophecy and destroy its future. Such commercial considerations should never be the concern of an independent auditor – as they would not be for an air safety inspector – yet they frequently are.

So, in audit, the deepest foundation of independence is not just made of sand, it does not exist. It truly is madness. It is *dangerous* madness because the ever-growing thousands of pages of regulation give a false sense of security to investors and stakeholders.

The elephant in the room

Outrage and regulatory frenzy explode after any auditing scandal. In the wake of shocks such as Carillion in the UK, Colonial BancGroup and General Electric in the US and Gupta in South Africa, all sorts of astonishing solutions are being discussed.

Yet the critics still tiptoe around the elephant in the room.

As former Arthur Anderson Counsel, Jim Peterson, emphasises in his excellent book *Count Down: The Past, Present and Uncertain Future of the Big Four Auditing Firms*, it is absurd to be concerned about audit firm dependence created by taking fees from clients for non-audit business when the same clients pay them for the audit itself. The proposed UK solution of separating out the audit operations of the Big Four will make them more, not less, dependent on audit clients.

My aim is to critique an unsustainable status quo. I do not here offer any specific solutions. These could involve passing the entire responsibility of contracting auditors to investors (the user pays) or scrapping independence requirements and allowing firms to offer any services within their skills, which is one of Peterson's suggestions. I have no doubt that open-minded and committed experts could work out an effective, practical answer to the paradox.

Back in the real world, the mess will be fudged by regulators with no teeth and governments who just want to do "something". The next audit scandal, perhaps the next collapse of a Big Four firm, will result from that lack of resolve.