The Audit Reform Lab

Auditors failed to warn about 3 out of 4 largest 250 publicly traded companies that collapsed between 2010-2022

- New Audit Reform Lab analysis reveals scale of problem in audit industry and how partners at Big Four firms are rewarded for failure.
- Regulatory fines are just 0.16% of revenue - too small to materially affect partner pay, which has skyrocketed by 31% over three years.
- Auditors are failing to perform their core function. The industry is plagued by conflicts of interest, poor standards and weak regulation, and in spite of repeated calls for reform little has changed.

Why audit reform matters

Time and time again, irresponsible company directors have misrepresented company finances or taken excessive risks. When firms like Carillion, Thomas Cook and BHS go bankrupt, it's ordinary people that pay the price - through expensive government bailouts, job losses right across a supply chain, and costly disruption that affects households as consumers and taxpayers. It's the job of auditors to check companies' financial health, and publicly flag potential risks. However, a first-of-its-kind report from the Audit Reform Lab shows auditors are routinely failing to do this.

Problems in the audit industry

The audit industry is plagued by poor standards, a toothless regulator, conflicts of interests and weak sanctions for malpractice. Auditors are failing to show independent judgement or professional scepticism, or provide adequate warnings when a company is in a risky financial position or directors are behaving recklessly. The Big Four enjoy an oligopoly position: Deloitte, KMPG, PwC and EY earned 96% of FTSE 350 audit fees in 2022. In spite of a number of high-profile, government backed reviews over the past few years, including the Kingman and Brydon reviews, which the government endorsed and promised to act on, little has been done to address systemic failings in the sector.

Findings of the new report

The Audit Reform Lab, based at Sheffield University, analysed the audit reports of the largest 250 publicly traded companies that collapsed between 2010 and 2022 and found:

- Auditors are routinely failing to perform their core function. Three in four audit reports failed to raise the alarm that the collapsed company could go bankrupt, by providing a 'material uncertainty related to going concern' paragraph or warning in the year prior to the collapse. Auditors must provide this warning if they think there is a risk that the company will go bankrupt - they do not need to be certain it will.

- Of the Big Four auditors, EY performed most poorly – warning of going concern risks for just 20% of collapsed firms. Auditors outside the Big Four were even worse – providing warnings for just 17% of collapsed firms on average.

The Lab also analysed pay, revenue and profits at Big Four firms and the fines issued by the Financial Reporting Council (FRC), the audit regulator, and found:

- From 2020 to 2022, the average pay for partners at the Big Four firms rose by 31%, reaching £872,500. Average pay for Deloitte partners reached over £1 million.
- From 2015 to 2022, regulatory fines for poor audits were on average just 0.16% of revenue and 0.85% of profits for Big Four firms. These are too small to materially affect partner pay or change behaviour.
- Between 75% (KPMG) and 85% (Deloitte) of revenue at Big Four firms comes from non-audit services. Firms having the vast majority of revenue come from consultancy rather than audit creates conflicts of interest and risks undermining audit quality.

Recommendations

The next UK government should introduce systemic and far reaching reforms, aligned with those set out in the Kingman, Brydon and CMA reviews, to improve the regulation and culture of the broken audit sector. This should include:

1. **A new regulator**: they should follow through on plans to replace the Financial Reporting Council (FRC) with the Audit, Reporting and Governance Authority (ARGA). The new regulator should have enhanced enforcement and sanction powers, lines of accountability to parliament, and funding via a statutory, rather than voluntary levy.
2. **A new mission** for audit, provided by the new regulator. Auditors should exercise independent judgement and professional scepticism, rather than follow a box-ticking exercise.
3. **Reformed culture** within the audit industry, separate from accountancy and consultancy. The Audit Reform Lab recommends the legal separation of audit and non-audit services to help counter conflicts of interest; new auditor-specific qualifications, skills, and training; and greater coordination between the professional body and universities to create accredited educational pathways.
4. **Greater partner accountability** for audit failure. Currently partners receive the benefit of audit and non-audit revenues, but too little of the risk. We recommend a reformed sanction regime to target partner incomes, and the removal of limited liability privileges.

About the Audit Reform Lab: The Audit Reform Lab is the UK's only think tank focused on addressing our urgent financial transparency and accountability problems. It is hosted by the Centre for Research on Accounting and Finance in Context (CRAFiC) at the University of Sheffield.

To view the full report, visit: https://auditreformlab.group.shef.ac.uk
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