Reward for failure:
The paradox of audit partners' record payouts amidst poor audit quality

The Audit Reform Lab

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Executive summary

The UK's audit industry has faced unprecedented criticism after high-profile corporate collapses - including Carillion, Thomas Cook and BHS - highlighted significant deficiencies in audit practice. This criticism takes place within the context of record partner pay at the large accounting firms responsible for the audits of most of the UK's largest companies. To date these two features - poor performance and high pay - have been analysed separately, rather than as an integrated phenomenon. This report explores the extent of 'reward for failure' in the Big Four empirically, and examines the structural conditions that explain why these two features arise simultaneously.

We analysed the audit reports of the largest 250 publicly traded companies that collapsed between 2010 and 2022 and found:

- Auditors are 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 are required to include this going concern warning if they believe there is a risk that the company may go bankrupt – rather than making a prediction that it will.

- Of the Big Four auditors, EY performed worst – warning of going concern risks for just 20% of collapsed firms. PWC provided warnings in 23% of cases, Deloitte 36% and KPMG 38%. Auditors outside the Big Four performed even worse – providing warnings for just 17% of collapsed firms.

- There are serious concerns that auditors are not challenging enough. Of the 250 liquidated companies, 38 declared dividends in their last set of accounts. Ten of these did so despite making a loss, and two - Entu (UK) PLC and Utilitywise PLC – did so despite reporting a loss and having a negative net asset balance, which is a strong indicator of insolvency risk.

We also analysed partner pay 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.

- In the most recent fiscal year, partners at Deloitte earned over £1 million on average in pay and those at PwC close to £1 million. KPMG and EY also reported their highest ever partner earnings.

- From 2015 and 2022, regulatory fines for poor audits were on average just 0.16% of revenue and 0.85% of profits for Big Four firms. These small fines are not enough to materially affect partner pay – providing an insufficient deterrent, and enabling firms to continue to be rewarded for failure.

- Between 75% (KPMG) and 85% (Deloitte) of revenue at Big Four firms comes from non-audit services. Focusing resources on consultancy rather than audit services in this way could undermine audit quality and create potential conflicts of interest.

Audit is an essential service that ensures the integrity of company reporting, and if done properly, would help to boost confidence for shareholders and other users of company accounts.

However, auditors are currently incentivised to maintain good client relationships, rather than apply the principles of professional scepticism and enforce prudence. The UK's ineffective regulatory, oversight and sanctions system, and the limited liability for audit partners (under the Limited Liability Partnership business structure used by Big Four firms) provides little disincentive for this model to change.

The UK government set out plans to introduce a new audit regulator, but then failed to introduce them. Until the culture of audit is reformed and a new and more effective regulator is in place, partners at audit firms will continue to reap huge financial rewards, despite continued audit failures that harm business confidence and our economy more widely.

Contents

1. Introduction

The performance of the UK audit industry has come under scrutiny after recent high-profile failures. Corporate collapses like those at Carillion, Thomas Cook and British Home Stores were accompanied by claims that audit processes and/or outcomes had been deficient - many of these firms were given a clean bill of health by their auditors, shortly before administration or bankruptcy[1]. This perception of widespread problems in the audit sector has been reinforced by a series of government-sponsored reports designed to probe the causes of audit failure (Brydon 2019; CMA 2019; Kingman 2018), the Financial Reporting Council's issuance of record fines of £33.2m in 2023[2] and their conclusion that 29% of all audits required improvement[3].

At the same time, partner pay at the large accounting firms who audit the majority of the UK's large firms, and who were responsible for some of the audits criticised, have reached record levels. Audit partners oversee the audit process and sign off the audit report, and so bear significant responsibility for maintaining the quality and integrity of audits.

This report will argue that this outcome of high pay for partners and poor audit performance are not separate and discrete phenomena. They need to be understood as different sides of the same coin – they are related to the structural position of large all service accounting and audit firms in the UK economy and the particular LLP legal personality of those same firms. We will argue that a combination of these features creates a layering of positional rents which produce 'reward for failure' outcomes.

To make this argument, this report will first explain what is meant by reward for failure in the context we refer to. We will then examine indicators of failure, then reward, before setting out some recommendations for how to address the problems outlined in the report.

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[1] See, for example, Marriage, M., Ford, J., 2018. The big flaw: auditing in crisis. Financial Times 01.08.2018; Ford, J., 2019. Trust in auditors will be elusive without an overhaul of priorities. Financial Times. 17.02.2019; Mor, F., Conway, L., Thurley, D., Booth, L., 2018. The collapse of Carillion. https://commonslibrary.parliament.uk/research-briefings/cbp-8206/

[2] https://www.accountancyage.com/2024/01/10/frc-imposes-33-2-million-fines-on-audit-firms-amid-crackdown/#:~:text=The%20Financial%20Reporting%20Council%20(FRC,led%20to%20the%20significant%20increase.

[3] O'Dwyer, M., 2021. UK accounting regulator faces calls to publish reports into audit quality. Financial Times 3rd Oct 2021 https://www.ft.com/content/c19ea8f4-a0f8-4e1a-b151-ff903379895b

2.Reward for failure: Definitions

In terms of definitions of failure, for the purposes of this report we focus on the failure of an auditor to warn the users of financial statements of going concern risks – i.e. the risk that an entity will not be able to pay their debts as they fall due within the current accounting year. Warning investors that their capital is at risk is fundamental to the audit process, but such warnings are also essential for lenders, suppliers, customers and the workforce. We acknowledge that this is not the only measure of audit failure, and so we provide evidence on regulatory sanctions and quality reviews, which supplement this analysis.

In terms of definitions of reward, we focus on the payments received by partners of the Big Four. Our reasoning is that audit partners oversee the audit process and sign off the audit report, and so bear significant responsibility for maintaining and overseeing the quality and integrity of audits. Whilst not always directly involved in day-to-day project management, partners are expected to maintain high standards of quality in the firm's services, implementing quality control measures, and addressing any issues of professional misconduct or poor performance. Partners are compensated mainly through profit-sharing arrangements – the residual left at the end of the year once all other costs have been accounted for (although they can also receive bonuses, retirement packages, fixed salaries and other special allocations). Partner income is often driven by more profitable non-audit services rather than audit services. Consequently, through neglect or a desire to maintain good client relations for future non-audit work, partner reward and unsatisfactory audits may go hand in hand.

3.Going Concern: Background

Perhaps the more important measure of failure is the failure to warn the users of financial statements of ‘going concern’ risks. Accounts are generally constructed on the basis that an entity will continue in business for the foreseeable future—i.e. it will continue as a ‘going concern’. The term ‘continue’ here means it has neither the intention, nor the need, to liquidate or curtail materially the scale of its operations, and ‘foreseeable future’ is defined by IAS 1 to be a period of at least 12 months from the end of the reporting period. Under ISA 570 an auditor’s role is to obtain sufficient appropriate audit evidence about the appropriateness of management’s use of the going concern basis of accounting in the preparation of the financial statements, and to conclude whether there is a material uncertainty about the entity’s ability to continue as a going concern (ACCA 2023).

Importantly the inclusion of a ‘material uncertainty’ paragraph does not mean that a firm *will definitely* go bust, or even that it will go bust on a *balance of probabilities.* Rather it signals to users whether there are principal events or conditions that may cast significant doubt on a firm’s ability realise its assets and/or discharge its liabilities in the normal course of business. This paragraph can be included in an audit report even if management’s use of the going concern basis of accounting is deemed appropriate. In this sense, a material uncertainty paragraph is a warning not a prediction and so the threshold for its inclusion should be low – it is better to warn investors of risks even if the firm does not go bust, than it is to provide an opinion that there are no material risks when it transpires that there are. We might therefore reasonably expect going concern warnings for all firms that do go bust, except under exceptional circumstances when important financial information has been withheld or misrepresented by directors, or where unforeseen events lead to the rapid deterioration of a company’s financial condition.

There are a range of important indicators an auditor might look at to identify a going concern risk. This could include growing competition, falling revenues, failure to reinvest, inability to find lenders to finance its ongoing operations, a growing reliance on short term, higher interest borrowing, delayed supplier payments, or deteriorating cash flow. Paragraph 18-1 of ISA (UK) 570 requires an auditor to take into account all relevant audit evidence obtained, before concluding on the appropriateness of management’s use of the going concern basis or whether a material uncertainty related to going concern exists[4]. If an auditor is satisfied that the information disclosed by directors is adequate, they will issue an ‘unmodified’ opinion. However, where there is an error, a disagreement over a particular matter or a lack of sufficient audit evidence in a particular area of the financial statements, including disclosures, an auditor may provide a ‘modified’ opinion[5]. A modified opinion can be ‘qualified’, ‘disclaimer’ or ‘adverse’ in the auditor's report. A qualified opinion is one where there is either insufficient evidence *on a particular matter*

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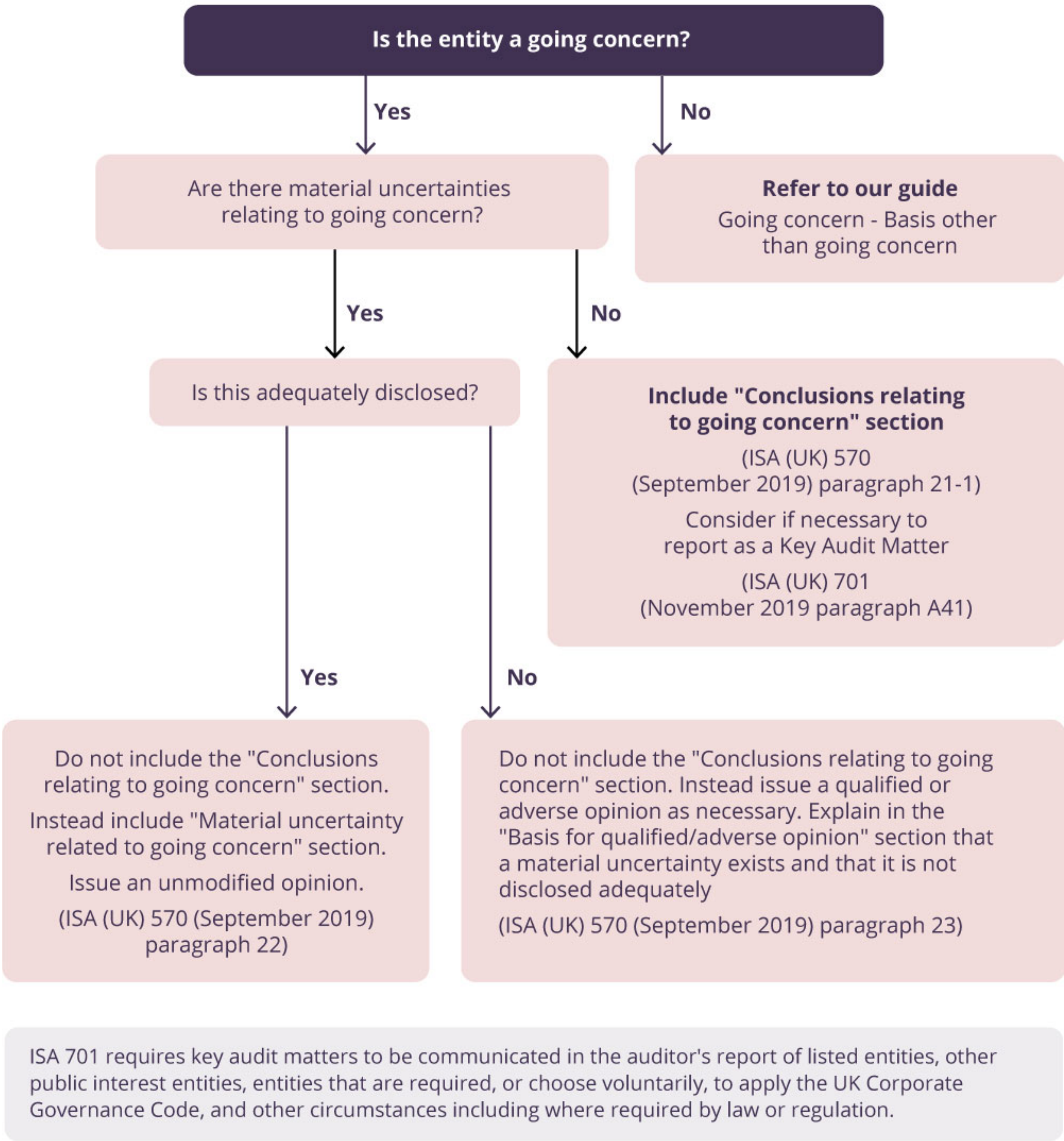
[4] https://www.icaew.com/technical/audit-and-assurance/professional-scepticism/coronavirus-considering-going-concern/how-to-report-on-material-uncertainty-related-to-going-concern-a-guide-for-auditors

5 https://www.icaew.com/technical/audit-and-assurance/audit/reporting-and-completion/understanding-audit-reports

or a *particular material misstatement* which may affect users' decisions. A disclaimer opinion is one where the auditor identifies a *pervasive and material* inability to obtain 'sufficient appropriate audit evidence' in order to form a view as to whether the financial statements give a true and fair view. An adverse opinion is given when an auditor judges, having obtained sufficient evidence, that there is a *material and pervasive misstatement* in the financial statements and that, because of the significance of the matter, the financial statements do not give a true and fair view. The flow chart of auditor decision making in a going concern assessment is outlined below.

Figure 1: Auditor Going Concern Opinion Flowchart



Source: ICAEW (undated) How to report on material uncertainty related to going concern - a guide for auditors, https://www.icaew.com/technical/audit-and-assurance/professional-scepticism/coronavirus-considering-going-concern/how-to-report-on-material-uncertainty-related-to-going-concern-a-guide-for-auditors

The presence or otherwise of going concern opinions in cases of liquidated entities provides a useful measure for evaluating audit quality. If companies go into liquidation without a preceding ‘material uncertainties related to going concern’ paragraph or modified opinion, it could indicate a deficiency in auditor oversight or in diligence and expertise – an ‘audit failure’ in other words. Auditors should be willing to issue these negative assessments as part of their ethical and independent position, even if it contradicts management's own going concern summary, according to ISA (UK) 570 rule, revised in 2016[6] and 2019[7]. Consequently, an analysis of the going concern opinions given to liquidated UK companies in the year prior to their liquidation, offers one compelling indicator of audit failure.

It is quite possible that auditors may not be able to identify or predict all risks that could affect an entity's ability to continue as a going concern. Auditors are expected to rely on professional judgment, experience, and the information available at the time of the audit to review risks related to going concern. However, due to intrinsic weaknesses in auditing, such as the complex and dynamic business environments and lack of predictability of future events, auditors may not be able to predict every risk. Therefore, auditors often set a threshold for recording misstatements. This is referred to in this guide as a ‘clearly trivial threshold’. In determining the amount of this threshold, auditors use professional judgement, taking into account their experience of the entity including, for example, the past history of misstatements detected during the audit and their assessment of audit risk. In practice, auditors generally consider an amount based on a range of up to 5% of overall materiality to be appropriate. The position within the range, or whether an amount beyond the range can be justified, depends on the auditors’ judgement[8]. Any failure to do so can be considered as an audit failure.

6 https://www.frc.org.uk/getattachment/8eab510c-17a7-4ac5-a91a-fc590bb3d7dd/ISA-(UK)-570.pdf

7 https://www.frc.org.uk/getattachment/13b19e6c-4d2c-425e-84f9-da8b6c1a19c9/ISA-UK-570-revised-September-2019-Full-Covers.pdf

8 https://www.icaew.com/-/media/corporate/files/technical/iaa/materiality-in-the-audit-of-financial-statements.ashx

4. Methods

To gather data about the going concern opinions of liquidated firms, we sourced the annual reports from the Companies House website, while additional data for some listed companies was derived from the Audit Analytics (Europe) database. The largest 250 publicly traded companies (based on their latest disclosed revenues) that entered liquidation between 2010 and 2022 were selected. We then analysed the auditor going concern opinion and audit report category (unmodified / modified / disclaimer of opinion) in the final year of their audited financial statements (i.e. the last set of reports before the company ceased to be a going concern). Going concern opinions were obtained from the Audit Analytics database for listed companies, and from financial statements filed with Companies House for other entities. These opinions were expressed either as "material uncertainty related to going concern" or through "emphasis of matter" paragraphs. We also examined the net income and net asset position of these failed firms in the final year of their accounts, to assess whether signs of financial stress were already visible to auditors.

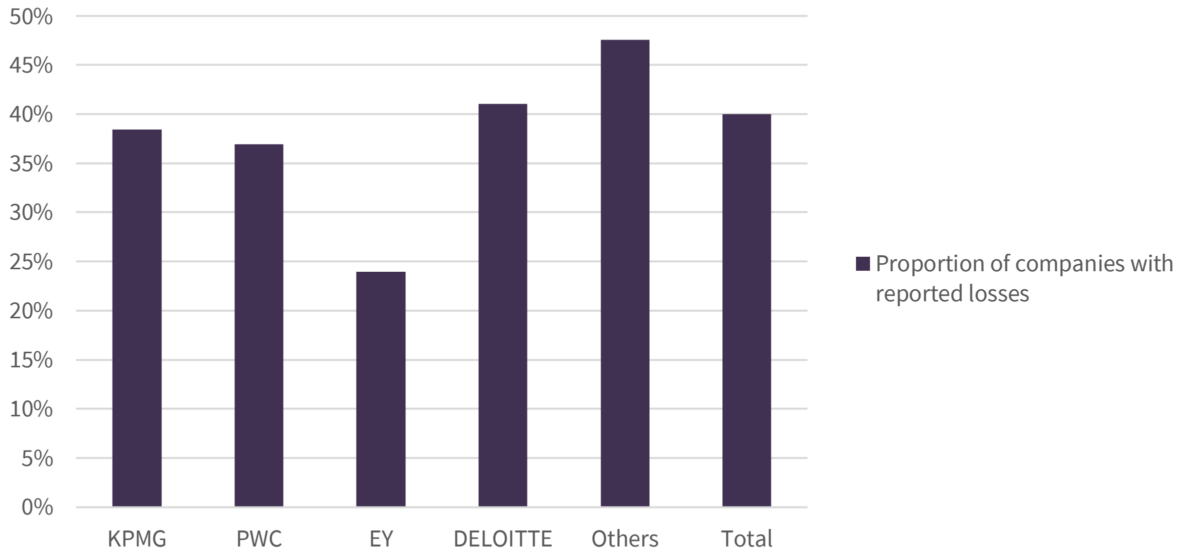
5.Findings

5.1. Indicators of failure

5.1.1. Going Concern Risks

Figure 2 shows the proportion of companies that reported losses in their last available accounts before liquidation. Loss making does not automatically indicate a going concern risk, but is one important component of it. Forty percent of the firms in our sample of failed firms reported losses in their last available company accounts. Among the companies audited by Big Four firms, Deloitte had the largest proportion of firms reporting losses while less than a quarter of the firms audited by EY audited firms reported losses.

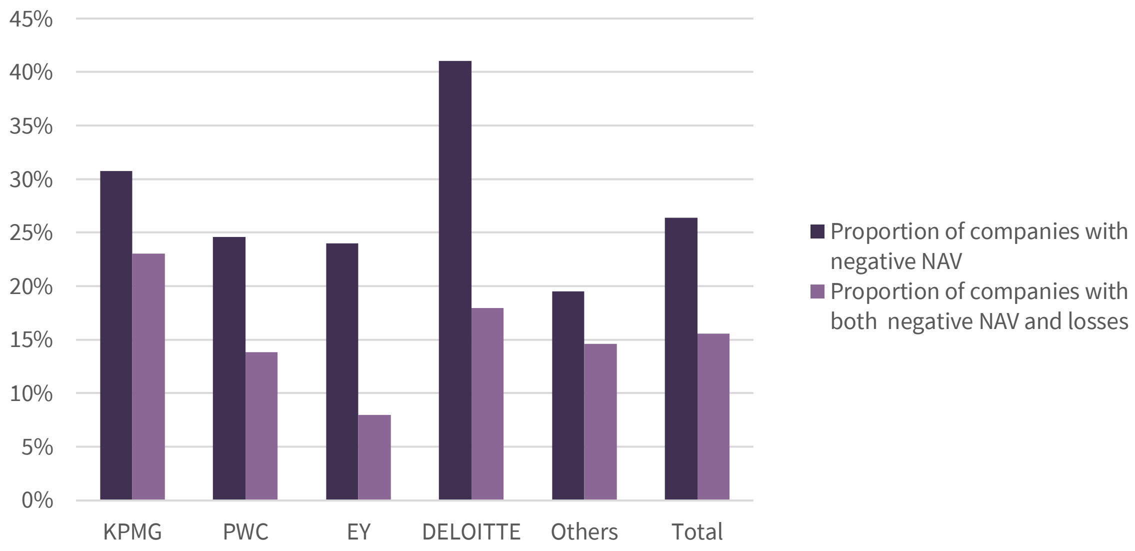
Figure 2: Proportion of companies with reported losses



(Source: Annual reports of liquidated companies in Companies house website)

Figure 3 shows the proportion of firms in our sample of liquidated entities that reported a negative net asset position in their last posted company accounts. A negative Net Asset Value (NAV) in a company's financial statements implies a balance sheet insolvency, and so normally requires extra vigilance in the assessment of going concern risks. In our sample, just over a quarter of firms that failed reported a negative net asset value in the final year of their accounts before going bust. Over 40% of the firms audited by Deloitte reported a negative net asset value compared with 24% at EY. The combination of both negative net assets and net income losses in the accounting year should increase scrutiny of going concern risks further. Fifteen percent of firms in our sample had both negative NAV and negative net income in total; with approximately 23% of the companies audited by KPMG exhibiting these two financial features, in contrast to only 8% for those audited by EY.

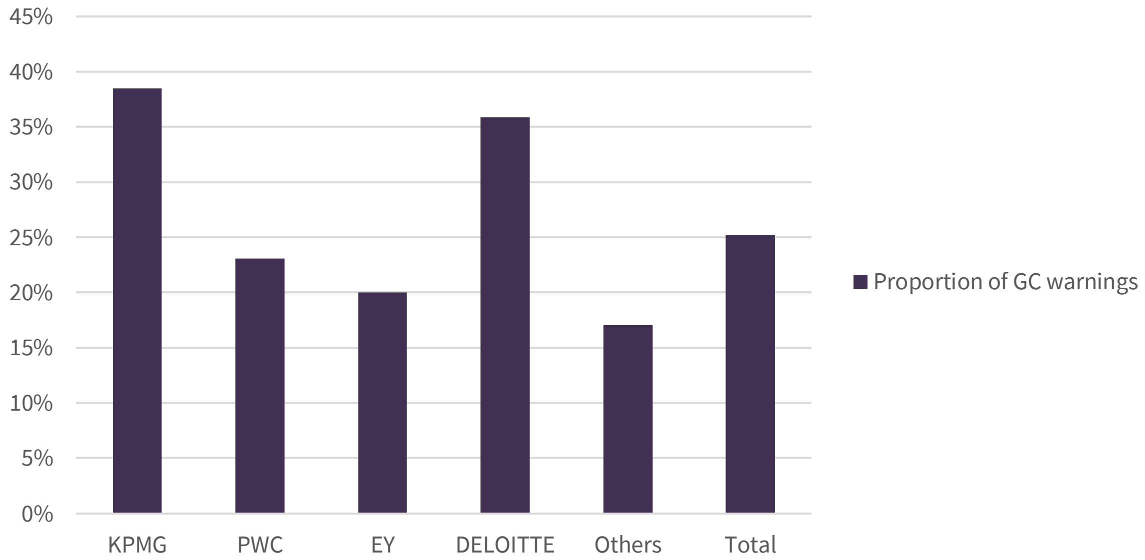
Figure 3: Net asset position of the companies



(Source: Annual reports of liquidated companies in Companies house website)

Figure 4 shows that auditors have a very patchy track record of being able to warn the users of accounts about liquidation risks. Only a quarter of the firms that entered liquidation proceedings received ‘material uncertainty in relation to going concern’ paragraphs (or equivalent in ‘emphasis of matter’), or modified opinions. Given the data on profits and net asset positions outlined above, that such a small fraction of firms received this warning is surprising. More worrying yet, this lack of a warning could rarely be attributed to a lack of information provided to the auditor. In only 8 audits out of the 250 reviewed did the auditors provide either qualified, disclaimer or adverse opinions, attributable to the lack of sufficient corroborative evidence. Of the 66 enterprises with a negative NAV, a mere 26 received Going Concern (GC) warnings. More worryingly, only 20 firms out of 39 firms that reported both a negative NAV and losses, were classified as going concern risks by their respective auditors, shortly before going bust.

Figure 4: Companies in liquidation that had previously received a 'material uncertainty' in relation to going concern or modified opinions from auditors since 2010



(Source: Annual reports of liquidated companies in Companies house website)

Within the cohort of 250 liquidated firms analysed, approximately two-thirds were audited by the Big Four audit firms. Within this cohort, KPMG emerged as the most prolific issuer of Going Concern (GC) warnings, accounting for 38% of such notices, closely followed by Deloitte at 36%. In contrast, EY issued fewest going concern risks: only 20% of their liquidated clientele received such an opinion, a figure marginally surpassed by PwC's 23%. Only 17% of non - Big Four auditors gave their clientele a material uncertainty opinion prior to liquidation. Caution should be taken when interpreting these figures. Deloitte and KPMG have audited weaker companies in our sample, measured by negative NAV and net income. It might therefore be expected that they issue a higher proportion of material uncertainty in relation to going concern opinions relative to PWC and EY. The performance of non-Big Four auditors should be a sobering finding for those who believe that audit quality could be improved simply by introducing more competition to the market, or by introducing more shared or joint audits.

Auditors' material uncertainty related to going concern opinions are also important for creditors. Of the 250 liquidated companies in our sample, 38 declared dividends from their profits in their last set of accounts. Ten of those 38 companies reported an operating loss in their final year, although only six were identified as going concern risks. Two companies – Entu (UK) PLC and Utilitywise PLC – paid dividends despite reporting both a negative NAV and net income losses. A more prudent audit could have flagged a going concern risk which may have prevented this distribution. There are instances where risks in whole sectors have been ignored. Our previous report on liquidated energy suppliers showed that only two out of 15 received a negative 'going concern' opinion from their auditors[9].

Our concerns about the auditing of going concern are mirrored in the FRC's thematic review of the viability and going concern reporting of UK companies. The review examined 20 companies and conducted a limited review of an additional ten. The sample included companies in different industries for the accounting period ending between December 2020 and March 2021. The report found that, in some cases, the assessment period was either not distinctly identified or the associated information within going concern disclosures was not consistent throughout the accounts. There were cases where the chosen going concern period ended before an important liquidity event, such as a large scheduled debt repayment, or before a debt covenant test was performed. A significant number of companies did not acknowledge their dependency on the Covid Corporate Financing Facility Limited (CCFFL). Numerous companies in the sample entered into transactions after the year's end but before the accounts were authorised for issue - affecting the company's liquidity - yet failed to highlight these post-balance sheet events in their going concern disclosures. This exclusion of information concealed the companies' liquidity status at that time. Besides failing to disclose material uncertainties, several instances were identified where considerable judgement was exercised to determine whether there was a material uncertainty related to going concern. A note related to this subjectivity was not provided.[10] These findings reinforce our own and are indicative of widespread audit failures.

5.1.2. Financial sanctions

Financial sanctions imposed by the Financial Reporting Council (FRC) provide another indicator of audit failure that go beyond going concern because they signal the presence of other substantive deficiencies, irregularities, and non-compliance within audit processes. Typically, sanctions are levied when audit firms fail to uphold the requisite standards of diligence, accuracy, and professional scepticism, compromising the integrity and reliability of financial statements. Sanctions imposed by FRC as a result of audit failures typically involve initial financial penalties that may be subject to reduction for admissions and prompt resolution, accompanied by a publicly issued severe reprimand. Additionally, the audit partner or manager held accountable for the failure incurs a financial penalty and receives a reprimand. Depending on the gravity of the cases, certain individuals may face exclusion from the register of their respective professional accounting bodies – although this is rare.

The following chart illustrates the monetary fines imposed by the FRC, quantified in millions of British pounds, starting from the year 2015. From 48 enforcement results during this period, the FRC has administered a cumulative total of £170.75 million in financial penalties. Figure 5 reveals the sanctions imposed on the leading audit firms in the UK by year. Since 2015 KPMG and PWC amassed the largest total fines of £67.3m and £49.9m respectively. KPMG were fined over £15m in 2019, 2021 and 2022. Only Deloitte have been fined over £15m in one single year (in 2020).

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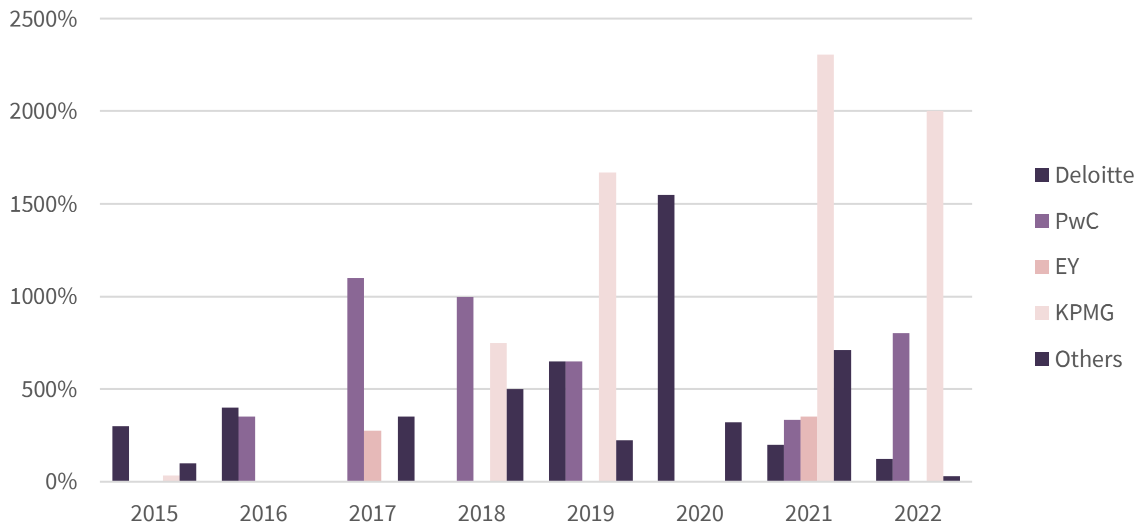
[9] https://auditreformlab.group.shef.ac.uk/audit-failure-in-the-uk-energy-supply-industry/

[10] https://www.frc.org.uk/getattachment/2b213ba8-b950-49e4-838d-d919cbcbd6e6/Going-Concern-and-Viability-Review.pdf

Figure 5: FRC financial sanctions



(Source: https://www.frc.org.uk/auditors/enforcement/enforcement-outcomes)

Table 1 lists the 10 largest financial sanctions linked to audit failure in Big Four firms to date. KPMG faced significant financial consequences linked to their audits of Carillion[11] and Regenersis, initially around £20 million, but reduced to £14.4 million in recognition of the firm's self-disclosure, cooperation, and acknowledgment of shortcomings. KPMG incurred a penalty of £13 million for its audit of Silent Night, Deloitte £15 million for its involvement in the audit of Autonomy Corporation, and PwC £10 million in relation to its audit of the Tavern Group, which included the audit of BHS. EY is currently being investigated by the FRC for its Made.com audit.

[11] The FRC has issued two final settlement decision notices under the Audit Enforcement Procedure after the data collection period (on 12th October, 2023), amounting to £30m before discounts that reflect the firm's co-operation and admissions. https://www.frc.org.uk/news-and-events/news/2023/10/sanctions-against-kpmg-llp-kpmg-audit-plc-and-two-former-partners/

Table 1: Top 10 audit enforcement outcomes (ranked by financial sanctions)

No	Name of the entity	Auditor	Financial sanctions	Date of sanction	Individual partners sanctioned	Sanctions
1	Carillion plc[4] and Regenersis plc	KPMG	£20.0m	30/05/2022 11/01/2022	Peter N Meehan Stuart P J Smith	£250,000 £150,000
2	Autonomy Corporation Plc	Deloitte	£15.0m	24/08/2020	Richard Knights Nigel Mercer	£500,000 £250,000
3	Silentnight Group Limited	KPMG	£13.0m	12/07/2021	David Costley-Wood	£500,000
4	Taveta Group (which included BHS Limited)	PwC	£10.0m	12/06/2018	Stephen J Denison	£500,000
5	Babcock International Group Plc & Devonport Royal Dockyard Limited	PwC	£7.5m	03/01/2023	Nicholas C Lambert H Ancient	£200,000 £65,000
6	Redcentric plc	PwC	£6.5m	22/05/2019	Jaskamal Sarai Arif Ahmad	£200,000 £200,000
7	Serco Geografix Limited ("Serco")	Deloitte	£6.5m	20/02/2019	Helen George	£150,000
8	Equity Syndicate Management Limited	KPMG	£6.0m	01/02/2019	Mark Taylor Anthony Hulse	£100,000 £100,000
9	RSM Tenon Group plc	PwC	£6.0m	20/07/2017	Nicholas W E Boden	£150,000
10	Galliford Try Plc	PwC	£5.5m	31/03/2022	Jonathan Hook	£150,000

(Source: https://www.frc.org.uk/library/enforcement/enforcement-cases/outcomes/)

5.1.3. FRC's Audit Quality Review (AQR) results

Another indicator of audit quality is the annual FRC Audit Quality review, although it has received various criticisms. For example, the FRC's reviews showed an improvement in audit quality up until 2017, and it was only after the Carillion collapse that significant problems in the audit regime were 'discovered'. Additionally, the reviews do not disclose which companies' audits require improvement, meaning it becomes impossible to check the quality of those quality reviews if - for example - a contemporary example of audit failure shows up as a clean audit in the FRC's previous reviews. Finally, the FRC has changed its audit quality targets. It previously set an audit quality target of 90% of FTSE 350 audits as being reported as 'good' or 'requiring limited improvements'. Later they claimed that from 2020/21 onwards, 100% of audits inspected should require no more than limited improvement (Stephen Haddrill, FRC CEO in 2019).[12] However the FRC no longer talks about this audit quality target after 2019 in their AQRs.

The audit quality reviews conducted by the FRC show that over 20% of all audits require some form of improvement, with a number requiring significant improvements (Figure 6). AQR's audit monitoring activity is based on the review of a sample of audits each year, supported by related audit quality (firmwide) procedures at individual audit firms focused on internal quality monitoring, engagement quality control reviews and independence and ethics.

Figure 6: FRC audit quality inspection results- Tier 1 (7 firms)

(Source: https://media.frc.org.uk/documents/Tier_1_Firms__Overview_2023.pdf)

The AQRs conducted by the FRC show a deterioration in audit quality up until the 2019/20 period, among the Tier 1 audit firms that comprises 7 audit firms – Deloitte, EY, KPMG, PwC, Grant Thornton, BDO and Mazars who collectively handle over 90% of FTSE350 companies' audits. Since 2020/21, the FRC have reported marginal improvements to the number of audits considered good or requiring limited improvements. In the 2020/21 period, approximately 71% of audits were considered good or required limited improvements; followed by 75% in 2021/22 and 77% in

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[12] https://www.frc.org.uk/news-and-events/news/2019/07/latest-frc-audit-inspections/

2022/23. Despite ongoing investments in audit systems, methodology, and training by firms, further improvements are hindered by inconsistencies in audit execution. Inspections reveal disparities in methodology application, management challenge, evidence quality, resource capability, and review procedures effectiveness[13].

A slightly different picture emerges from the FRC's "Key Facts and Trends in the Accountancy Profession" (August 2023) which indicates that, from 2020-2022, ACCA deemed less than 5% of audit work sufficiently scoped and devoid of significant deficiencies, establishing a reasonable foundation for audit opinions. Approximately 75% of files were deemed to have minor deficiencies and about 25% revealed serious non-compliance or deficient audit evidence, posing a notable risk of undetected material misstatements. ICAEW data shows that 11-16% of files raised some, albeit not significant, concerns regarding audit evidence sufficiency, audit judgement appropriateness, or widespread documentation weaknesses, and flagged other significant concerns. Moreover, 3-9% of files showcased significant issues concerning audit evidence or audit judgments' appropriateness and/or other very substantial concerns[14].

5.2. Indicators of reward

In recent years, there has been a notable escalation in audit fees. This has been primarily attributed to the rise in audit cost drivers due to the introduction of new audit standards and regulatory demands for enhanced documentation[15][16]. The audit fees paid by the UK's top 500 companies increased by 14% over the past year, climbing from £1.12bn to £1.27bn in total[17]. FRC data shows that the distribution of audit and non-audit fees varies across different firms for the year 2022.

5.2.1. Pay Structure

There has been recent media interest in headline partner pay at the Big Four.[18][19] However, pay structure in the Big Four and its relation to profit is rarely discussed. Each Big Four member has a slightly different way of determining partner reward. Big Four firms like KPMG and Deloitte divide profits into two: members' profit shares charged as an expense and profit available for discretionary division among members. PwC and EY profits do not have such classification but partners receive a distribution out of the profits of the LLP after adjusting for their obligations to make annuity payments to certain former partners and other equity adjustments. The partner payment in all Big Four firms are adjusted based on the partner contribution towards equity partnership, drawings made, etc.

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13 https://media.frc.org.uk/documents/Tier_1_Firms__Overview_2023.pdf

14https://media.frc.org.uk/documents/FRC_Key_Facts_and_Trends_in_the_Accountancy_Profession_August_2023.pdf

15 https://news.bloombergtax.com/financial-accounting/kpmg-increased-uk-partners-pay-to-717-000

16 https://www.thetimes.co.uk/article/audit-fees-could-rise-by-up-to-half-warns-bdo-3gsw3gc3s

17 https://www.accountancytoday.co.uk/2023/08/08/top-500-audit-fees-rise-14-to-almost-1-3bn/

18 https://www.ft.com/content/3ea72fc7-ea96-45d4-979b-ae67a1b40e89

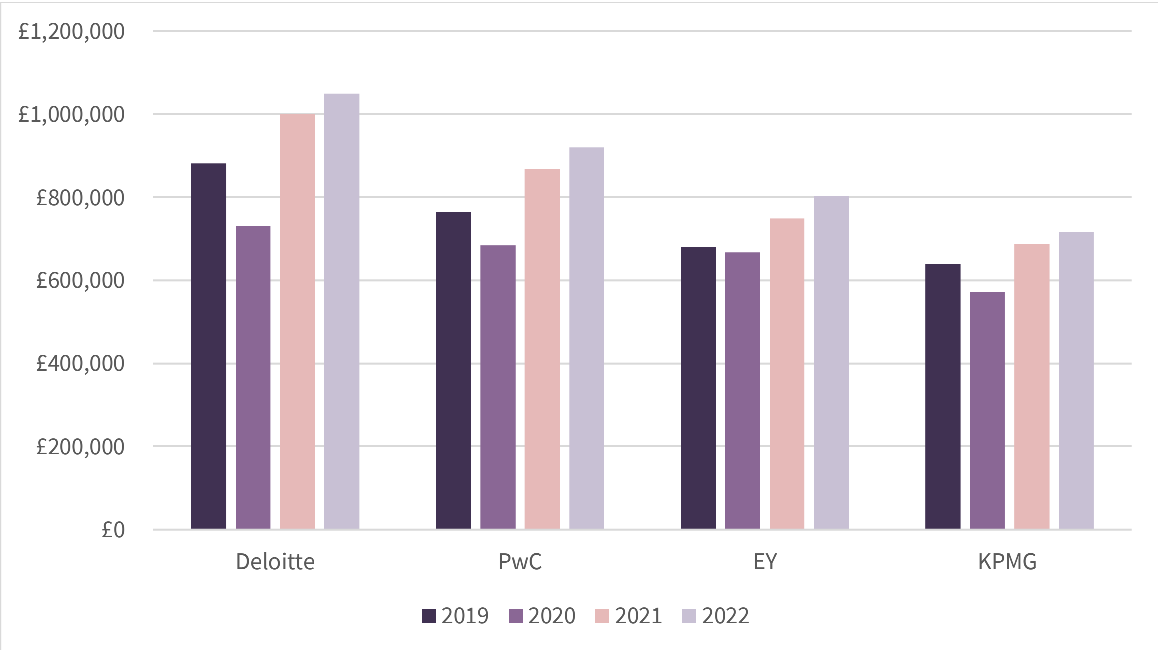
19https://www.theguardian.com/business/2022/jul/07/pwc-partners-to-earn-1m-each-as-firm-sets-new-pay-records

The Big Four also encourage partners to commit for the long term by offering attractive pension packages, which typically vest upon retirement and are calculated based on the duration of service. PwC's retired partners shared £100m windfall through the firm's annuities system in 2019 according to a report by Financial Times[20]. The same article also notes:

> "The recent payments at PwC eclipse those made by its main rivals. KPMG's latest annual report showed it expected to pay £4m in annuities to former UK members within 12 months of its 2018 year end, while EY's most recent results showed the provision for annuity obligations would be £6m within one year. Deloitte also has a scheme that pays retirement annuities to members with a minimum of 10 years' service."

Figure 7 shows the average partner pay in Big Four firms from 2019 to 2022: between 2020 and 2022 average partner pay at Big4 firms rose by 31% to £872,500. Partners at Deloitte earned more than £1m and PwC close to £1m in pay for the latest financial year, while KPMG and EY also recorded the highest partner pay ever. The recent increase in profit is attributed to the boom created by a flood of corporate mergers and acquisitions along with the revenue from consultancy services including business digitisation, advising on sustainability reporting, etc.

Figure 7: Average partner pay for Big4 firms



(Sources: News articles and press releases)

5.2.2. Risk

The risk/reward experience of partners is shaped by the particular legal structure of the Big Four. The Big Four are set up as Limited Liability Partnerships (LLPs). As a consequence, they retain the disclosure benefits of partnerships - they are, for example, not required to submit audited

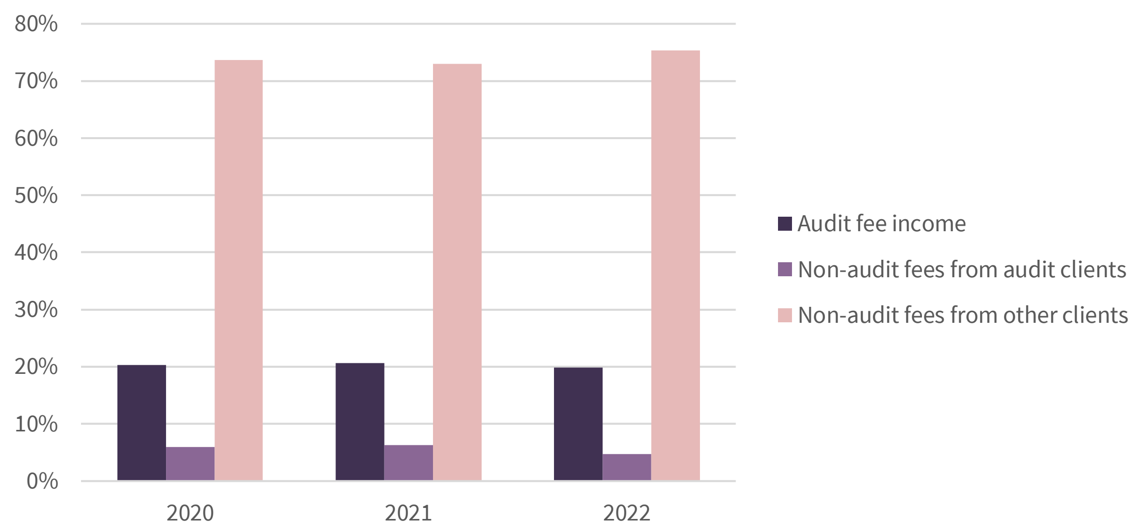
[20] https://www.ft.com/content/d679ceee-ec33-11e9-85f4-d00e5018f061

financial statements, but instead report on the basis of their own partnership agreement. They thus benefit from diminished reporting requirements, with implications for transparency and accountability. But at the same time, they benefit from limited liability protection and so are not individually or collectively responsible for the costs of any negligence claims, whereas prior to 2000 partners assumed joint and several liability. In this sense, the limited liability partnership structure acts as a ‘shield’ against external scrutiny and acts as a buffer for partner interests if there is any large claim.

The remuneration structure, as noted above, works on the principle that partners take a residual of profits generated by the organisation. This can be sizable, as noted, partners at Deloitte received more than £1m and partners at PwC received close to that in the latest financial year. The partnership structure also allows partners to pass adjustments on to non-partnership employees in a downturn through disemployment or lower discretionary payments. In this sense, the partnership does not receive a residual which is vulnerable to the vicissitudes of the market; rather it becomes a kind of guaranteed flat rate with the option of even higher income in boom years.

As figure 8 shows, partner pay appears to be resilient to market conditions or audit quality performance. Average partner pay has gone up virtually every year in our database, despite this being a period of controversy in terms of audit performance – whilst recognising that audit is a minor part of the Big Four’s revenues.

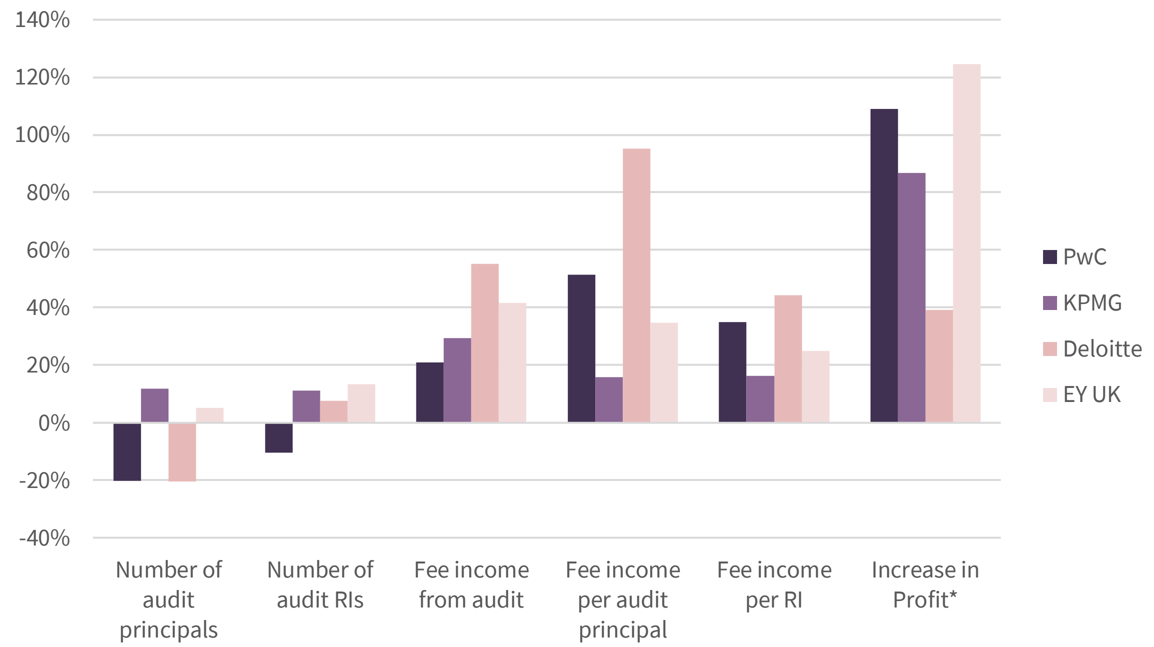
Figure 8: Proportion of total fee income for the Big4 firms, 2020-2022



(Source: https://www.frc.org.uk/getattachment/6bb377d8-a26d-4084-81b8-829c70e37347/Key-Facts-and-Trends-in-the-Accountancy-Profession-_August-2023.pdf)

Figure 9 is prepared from the FRC's 'Key Facts and Trends in the Accountancy Profession'[21]. It shows that although the Big Four have substantially increased fees generated from audits, individual firms pursue different strategies. PwC cut principal and RI (Responsible Individuals) staff numbers which significantly improved fee ratios for each category. Deloitte appears to have increased its fee income but has shifted responsibilities to an increased number of RIs whilst cutting the number of audit partners leading to the doubling of fees attributable to each partner to over £6m. EY UK and KPMG have both increased their staff numbers but whilst these have significantly improved income per principal in EY UK, KPMG lags its peers. This may well be a result of increasing scrutiny from the press on KPMG in particular following recent audit scandals. These findings point towards an intensification of fee generation per audit principal as well as an increased workload and accountability. Alongside all these changes, the overall profitability of the Big Four has increased at a faster rate than fee income from audit for all firms but EY, suggesting that firms seek to optimise their profitability.

Figure 9: Development of key audit personnel, audit fee income and Big Four profit 2017-2022



* Profit after tax and before members' profit share charged as expense (Source: Authors analysis of FRC data published in FRC publications "FRC Key Facts and Trends in the Accountancy Profession" 2018-2023)[22]

Because audit firms derive a significant portion of their revenue from non-audit services, as shown in Figure 8, it creates a skewed risk-return dynamic. KPMG partners generate the highest percentage of their revenue from audit services at 25%, whereas Deloitte secures only 15% of its revenue from audit services. In other words, non-audit services are the primary revenue driver.

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[21]https://media.frc.org.uk/documents/FRC_Key_Facts_and_Trends_in_the_Accountancy_Profession_for_2023.pdf

[22] Principals are partners or members of an LLP; Statutory Auditors/ Responsible Individuals (RIs) are those individuals who are registered to sign audit reports and can include Audit Principals and Employees.

Notably, as audit accounts for less than 25% of revenue for major audit firms, there has been a tendency to shift focus towards the more financially rewarding consulting engagements. This shift can divert vital resources from audit responsibilities, potentially undermining the audit quality. Given that partners might be more attracted to the higher returns from consulting, they could prioritise it over essential audit functions. Such prioritisation risks the primary mandate of audit firms: delivering unbiased, quality-assured audit reports. Compromising this core responsibility, lured by greater profits elsewhere, can threaten the firm's reputation and erode public trust. However, the data suggests that, given its notable income-per-staff, the audit sector has the potential to be self-sustaining even if it operates separately from the consultancy arm.

5.2.3. Ineffectual Sanctions

Most sanctions are issued many years after an audit failure is identified because the enforcement procedure is complex and long. When those sanctions arrive, they are rarely significant enough to deter repeat offending. The benefits of the consultancy services gained often outweigh the downside of the fines (eventually) received.

The maximum individual fine received by a Big4 equity partner is £500,000 for David Costley-Wood (KPMG) for the audit of Silentnight followed by £250,000 for Peter Noel Meehan (KPMG) for audit of Carillion.[23] These maximums are less than an individual partner might be expected to earn in a year from these firms. The fines charged can also be discounted - for aggravating and mitigating factors, for admissions and early disposal, and also based on the level of co-operation during enquiry. Only a handful of partners are excluded from the professional body membership or banned from accounting/auditing practice. Most of the partners who are sanctioned by regulators are often fired by their firms or retire themselves as in the case of the above two.

Despite an increase in fines in recent years, they remain small compared to revenue and profits: on average between 2015 and 2022, fines for poor audits were just 0.16% of revenue and 0.85% of profits for Big Four firms. Figures 10 and 11 show how inconsequential financial sanctions are. Financial penalties never reach 1% of total fee revenues in any given year, and only on rare occasions exceed 2% of profits. The largest fine as a percentage of profit was KPMG’s 5.72% in 2019 – hardly an important deterrent.

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23 New sanctions issued on 12th October 2023. https://www.frc.org.uk/news-and-events/news/2023/10/sanctions-against-kpmg-llp-kpmg-audit-plc-and-two-former-partners/

Figure 10: Fines as a percentage of fees revenue of Big Four firms

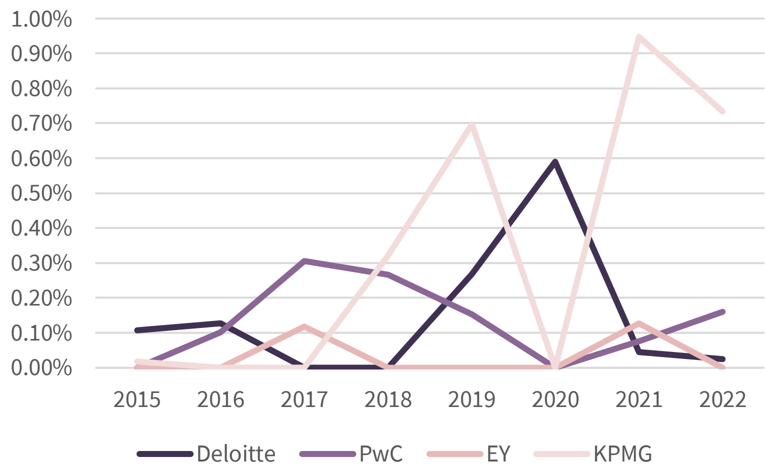
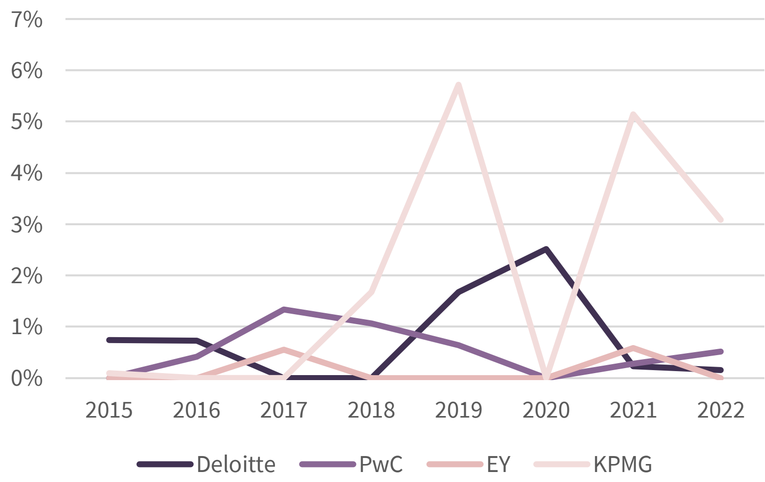


Figure 11: Fines as percentage of profit for the year of Big Four firms



(Source: FRC enforcement outcomes and annual reports of audit firms)

Calculating fines as a proportion of audit fees (rather than total revenue) generated by Big Four firms does not alter the picture significantly: Figures 12 and 13 shows that the highest fines paid by KPMG and Deloitte make up only 3.6% and 3.1% of fee income generated from audit functions. Information on the profit generated by audit functions is not available publicly.

Figure 12: Fines as a percentage of fee income generated by Big Four audit functions

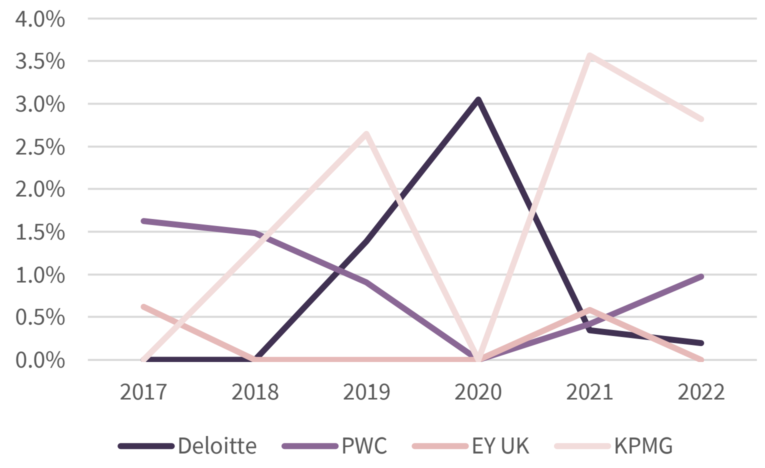
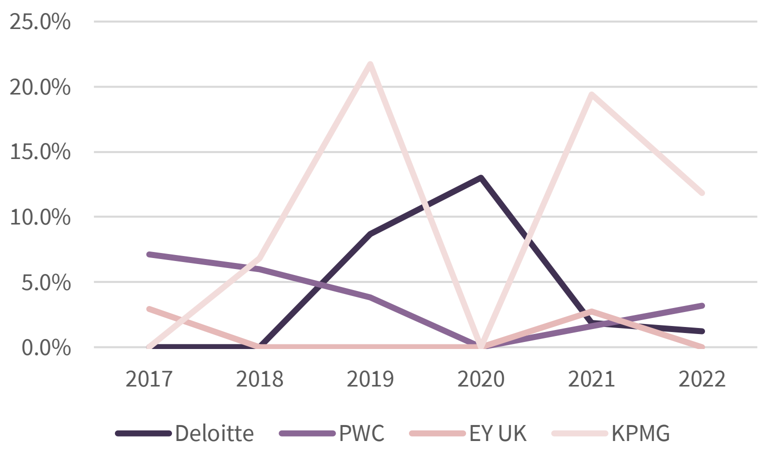


Figure 13: Fines as a percentage of estimated profits generated by Big Four audit functions*



*this approximates the profitability of the audit function by taking into consideration overall profitability of the firm and applying this to the fee income generated by audit as published by the FRC
(Source: Authors analysis of annual reports of audit firms, FRC enforcement outcomes and FRC data published in FRC publications “FRC Key Facts and Trends in the Accountancy Profession” 2018-2023)

Sanctions therefore fail to offer a compelling motivation to improve audit quality. Moreover, the threat of financial penalties are diminished when they are subject to discounts of between 25-35% and can take 5 years or upwards to materialise.

6. Discussion: Reward for failure as a structural problem

In any other context, the appearance of declining quality and increasing pay would lead to claims that an industry exhibits ‘reward for failure’ characteristics. But in the audit industry that narrative has rarely appeared: failure and pay are instead approached as separate and discrete phenomena. Understanding their joint causes requires some elaboration.

All large firms must, by law, have their accounts audited; only firms classified as ‘small companies’, some smaller charities and some subsidiaries are exempt from full audits. Consequently, companies have no choice other than to pay fees to an audit firm to have their accounts scrutinised. There creates a structural gatekeeping position within the economy.

Gatekeepers hold powerful structural positions. Auditors could use their position as gatekeepers to raise standards, but when the incentives are wrong, those positions can be misused to extract rents whilst doing little about audit failure. In recent years audit fees have increased substantially. According to the Quoted Companies Alliance, audit fees for London stock exchange-listed companies increased by 75 per cent over the past five years, from an average of £397,000 in 2017-18 to an average of £694,000 in 2022-23[24].

In a context where large, sprawling international corporations dominate the FTSE350, audits require particularly advanced skills, resources and experience; external stakeholders also expect those firms to be audited by large audit firms with global experience. This creates a natural oligopoly - the Big Four – who are the main gatekeepers occupying those fee-receiving positions: Deloitte, EY, KPMG and PwC earned 98% of FTSE 350 audit fees and 90% of Public Interest Entity (PIE) audit fees in 2022.

However, the Big Four are large, multi-service providers who generate most of their profits from non-audit fees where maintaining good client relations is the *sine qua non* for future income. Audit services are provided on a ‘client-pays’ basis. Thus, there may be strong fee-based disincentives against providing robust audits which may upset clients and damage future non-audit business.

In such a context auditors are failing to use their structural position as gatekeepers to exercise prudent checks and balances on those they scrutinise. Unchecked by proper regulation and other accountability measures, they may simply imposing, what Veblen (1904)[25] called, tollbooth ‘rents’ on corporate and public activity: i.e. they may benefit from returns that accrue to an extractive position within an economic system, where the social benefits and risks taken are low relative to

[24] Foy, S., 2024. Audit fees for UK-listed companies up 75% since 2018, study finds. Financial Times 26.02.2024.

[25] Veblen T. (1904). The Theory of Business Enterprise New York, NY: Charles Scribner’s Sons, available at: https://brocku.ca/MeadProject/Veblen/Veblen_1904/Veblen_1904_03.html.

the fees charged. Although Arthur Anderson's audit of Enron provides an important counterweight, the costs of audit failure for the industry remain low.

The industry tends to organise as an oligopoly, where market mechanisms to displace incumbents are weak. Fines continue to amount to a small fraction of revenues. Whilst many individual auditors may from time to time experience regulatory scrutiny and reputational risk, the firms they work for rarely suffer reputational damage to the extent that their own solvency is put at risk.

This market-based tollbooth may be overlaid with an organisational one. The partnership structure of large audit and accounting firms creates a second positional rent that produces large differentials of reward and experience within the audit workforce. Audit partners are paid from partnership residuals, which accrue mainly from non-audit income, whilst benefitting from limited liability protection. Given partners are responsible for the oversight of audits, this may create a conflict of interest which opens up additional 'opportunity spaces' for audit failure. This risks creating a 'Russian Doll' effect: that the corporation is able to extract tollbooth rents from the economy, and partners are able to extract tollbooth rents from their corporation. Large all-service accounting companies may, therefore, simply take tollbooth rents from audit positions without performing the vital economic role of policing bad accounting practice.

This situation suggests legal separation of audit and non-audit functions would be the starting point for future reform. The conflicts of interest that arise from a client-pays model, likewise, create problems. Both, however, will be politically difficult to execute. Some audit failure might therefore be mitigated by an audit culture guided by a strong mission, embedded in systems of education, training and professional representation. These are currently deficient. The mission of audit is confused - it is too focused on whether arcane and loophole-laden accounting rules are being followed, whilst ignoring whether the outputs of those rules amount to a true and fair representation of corporations' economic position. This is allied to a box-ticking approach which works against principles of professional judgement and the necessary scepticism needed to enforce prudence. Auditing, to a greater or lesser extent, has become a form of administration which diminishes the professional status of auditors. Education systems in universities haven't helped. They, similarly, teach students the principles of accounting and how they should be applied in theory; but provide very little guidance on what to do when they are applied differently in practice. Training systems do not teach the real-world problems facing many auditors – such as how juniors acquire the confidence to stand up to, and challenge, powerful directors. Professional bodies, who represent both auditors and accounting consultants, are failing to instil a culture which emphasises the importance of auditor judgement in exercising challenge, professional scepticism and prudence.

Some of these problems could be mitigated by a stronger regulator with the tools and responsibilities to enforce better audits. But the current regulatory arrangements are insufficient. The FRC has no statutory base, weak disciplinary powers, and an unsatisfactory voluntary funding model. Similarly, CEOs and CFOs are not held responsible for the effectiveness of internal controls over financial reporting and the legality of dividends - companies are not compelled to disclose their distributable reserves. Sanctions are rarely large enough to materially affect partner pay and hence change behaviour. This creates a moral hazard whereby the upside of diluting audit quality in terms of maintaining good client relations is high, and the downside minimal.

7.Conclusion and recommendations

In conclusion, we believe 'reward for failure' should be understood as a **structural problem** which reflects the gatekeeper role of large accounting firms within the UK economy which allows them to charge a form of rent; and their Limited Liability Partnership structure which affords partners positional claims on those fees, whilst sheltering them individually from risks.

In summary:

a) In a context where managers are rewarded for creating shareholder value yet information asymmetries exist between managers and shareholders/other stakeholders, auditing becomes an essential service that ensures the integrity of the reporting process.

b) If all large firms need to be audited, this produces – in effect - structural 'rights' to a present and future audit income stream and a powerful intermediary position within the corporate economy.

c) Those rights will tend towards oligopoly rights when the audit demands of large, global firms require broad, multi-purpose skills and an international presence which few firms can offer.

d) The client-pays model, plus demands by clients for more lucrative non-audit services may create incentives for large, all-service accounting providers to dilute audit quality in order to maintain good client relations in order to sell more profitable non-audit services in the future.

e) This dilution renders audit practically meaningless. A watchdog that is trained not to bark for fear of disturbing the burglar is no watchdog at all.

f) At the same time, the limited liability legal identity of Big Four partnerships gives partners an equity share in the maintenance of harmonious client relations, creating incentives to dilute audit scepticism, whilst minimising direct partner exposure to audit failure risks…

g) An ineffectual regulatory, oversight and sanctions system then provides little disincentive for this model to change

h) We argue that this creates a form of layered 'rentiership' - that Big Four firms extract a rent from economic activity which is consolidated within the LLP structure, and that partners within the LLP then take a second rent through their structural position as equity partners. The term 'rentier' is meant in the Veblenian sense, that Big Four firms are able to accrue substantial financial gains from quasi-monopoly rights via their powerful structural position within the wider ecology of economic activity without assuming proportionate risks.

i) Declining audit quality and increasing remuneration in the audit industry are therefore two sides of the same coin.

A structural problem requires a structural solution:

Our recommendations are:

1. A new mission for audit, provided by a new regulator - that auditors should exercise independent judgement and professional scepticism to verify whether a true and fair view of a company's assets, liabilities, financial position and profit or loss is being presented.

2. A reformed culture of audit - professional scepticism is the auditors' ying to the yang of consulting's 'can-do' creativity and optimism. There needs to be a more effective balance.

   We recommend legal separation of audit and non-audit services as the start point for any future reform. The client-pays model also creates too many conflicts of interest and needs reform. Although these recommendations are likely to receive opposition from the audit industry they are, in our view, necessary pre-conditions for change and have been discussed in government reports[26] as well as external advocates for reform[27]. Other measures that would also go some way to improving the culture of audit include:

   i. A keener focus on nurturing the principles of professional scepticism, independent judgement and prudence within the professional bodies who represent auditors. Audit culture should be closer to that in the medical profession where a commitment to upholding a professional ethos to serve the public trumps financial considerations.

   ii. New auditor-specific qualifications, skills, and training in the area of forensic accounting and fraud awareness which deals with real-world examples of creative accounting and gaming; but also real world 'soft skills' such as the ability challenge and push back on powerful CEOs and CFOs who draw up optimistic financial statements.

   iii. Greater co-ordination between the professional body and universities to create accredited educational pathways that embed these different norms and skills to provide for a more distinctive professional culture of audit.

3. A new regulator for audit via the recommended Audit, Reporting and Governance Authority (ARGA) to replace the FRC. This would include:

   i. A new regulator with enhanced enforcement powers, lines of accountability to parliament, and funding via a statutory, rather than voluntary levy;

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[26] See for example BEIS (2019) The Future of Audit [online] https://publications.parliament.uk/pa/cm201719/cmselect/cmbeis/1718/1718.pdf

[27] See for example the Project on Government Oversight (2022) Accounting's Big Lie — and How to Fix It [online] ' https://www.pogo.org/reports/accountings-big-lie-and-how-to-fix-it

ii. The enforcement of CEO and CFO annual attestations on the effectiveness of internal controls over financial reporting and the legality of dividends and other distributions, which would be audited;

iii. More meaningful sanctions for audit failure

4. Greater partner accountability for audit failure who currently receive too much of the upside of audit and non-audit revenues, but much less of the risk of failure. This would include a reformed sanction regime to target partner incomes and reduce moral hazard. Limited liability privileges should be removed.

The Audit Reform Lab