Current audit practice is valueless

by Eric Chalker

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"The evidence suggests that audit quality is not up to the level expected by private investors." These were my words, in response to a brief survey of UK Shareholders' Association members prior to a recent half-day presentation by PwC on how its audits are conducted. These and similar comments by other members were reported, but not addressed, in PwC's presentation.

It is to PwC's credit that it was prepared to meet some fifty or so private investors and invite questions. It is unfortunate, though, that the presentation was defensive in nature and sidestepped the challenging issues raised by those present. Unfortunate, but not really unexpected. Auditors do not see themselves to blame for company failures, even when the quality of their audits is found wanting by the Financial Reporting Council, resulting in fines.

Since the presentation referred to, I have read two things which have gripped my attention. The first was a letter in the Financial Times. The writer, in response to an article in the FT ("*Watchdogs need to remind auditors of their proper role*"), sought to exonerate auditors entirely from valuations which turn out to be false. The example he gave was this:

> *"Had an auditor in 1635 confirmed that 40 Dutch tulip bulbs were worth 100,000 florins at a time when a ton of butter cost about 100 florins, he would have been entirely justified."*

My response to this, which the FT kindly published, was that if this would indeed have justified a clean audit certificate, then all audit certificates are valueless.

Intangible Assets

I followed this up at the recent Premier Foods' AGM by putting a question directly to the auditor, KPMG. I drew attention to the fact that the reported values of key intangible assets came to 110 per cent of total equity. Quite a small mistake in judging the value could therefore put the company into negative equity. KPMG had told us these values were "acceptable", so I wanted to know whether this meant they were "true". The answer sidestepped the question, by asking us to take the accounts as a whole, but if a key element of the balance sheet is in doubt, as in this instance it surely is, the auditor's certificate should be qualified.

Premier Foods is not unique in this respect. It is now a common feature of many balance sheets, routinely given a clean certificate by their auditors. Audit certificates now give more information, but they continue to be supportive of management when they shouldn't be.

Auditors forget that they are supposed to serve the interests of shareholders, not those of management. In financial reporting, as in other matters, the two are not necessarily aligned. Auditors should not be afraid of stating this when it becomes apparent, but all the evidence suggests that they value their commercial interests more than the interests of those they pretend to be serving.

The 'Big Four' Condemned

The second thing that has gripped my attention is a recently published book which every investor should read. It

is *"Bean Counters: the triumph of the accountants and how they broke capitalism,"* by Richard Brooks. It is the phenomenal story of the 'Big Four' accountancy firms, who are of course the big four in auditing too: PwC, Ernst & Young (now EY), KPMG and Deloitte. You will be horrified. The author's conclusion is, "*History shows that the Big Four accountancy firms have prospered by avoiding accountability for their part in false accounting, financial crises and the plundering of economies while paying attention to ever-expanding commercial opportunities.*"

The Companies Act puts responsibility for appointing a public company's auditor into the hands of its members, the shareholders. Private investors who attend AGMs or vote by proxy will be familiar with the standard resolution inviting them to approve an auditor chosen by the directors. Nominally, therefore, shareholders do appoint the auditor, but in reality this is little more than a fiction.

Auditors' certificates invariably include words to limit their liability. Some are more restrictive than others, but it is common to see that the report is made "solely" to the Company's members. This may seem fair enough, but then the words, "as a body" are added, which makes one think. One has to assume that, in claiming this limitation, the auditor thinks it gives the basis for refusing to answer questions from individual members, except at general meetings which all shareholders have the right to attend. So, we should ask questions of the auditors at AGMs, challenging any figures supported by the audit certificate for which justification may be in doubt.

Auditor Obligations

Auditors are required to comply with Chapter 3 of Part 16 of the Companies Act 2006, which can be found here: https://www.legislation.gov.uk/ukpga/2006/46/part/16/chapter/3. The primary obligation is to tell shareholders "*whether, in its (professional) opinion, the annual accounts give a true and fair view*". This is the crux of the matter. There are additional obligations to say whether the accounts have been properly prepared, but investors should regard the "true and fair" requirement as paramount.

In describing the value placed on Premier Foods' intangible assets as "acceptable", I could interpret this as meaning "fair". But these assets are crucial to the strength of the balance sheet, so I also wanted to know whether they were "true". My Oxford Dictionary defines "true" as "*in accordance with fact or reality*".

At issue are questions of value. Are values "true" as the law requires? The more significant they are to a company's "going concern" statement, on which its auditor is expected to comment, the more critical are the auditor's opinions. A tangible asset with an obvious function in the real world is one thing, but an intangible asset whose value wholly depends on fashion, or an obvious passing craze like tulipmania, or reputation (e.g. brands and goodwill), cannot properly be given a "true" value at a single moment in time. Accountancy standards – which are of course set by the accountancy profession itself – say how such values are to be assessed, but auditors should not seek refuge in them.

An auditor's opinion ought to be "*in accordance with fact or reality*", not based on some clever formula divorced from reality. Truth is required, not fantasy.

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