Making auditors completely independent

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There is a widespread perception that auditors are insufficiently independent, and that this is a key cause of recent UK audit failures. Fixing this requires radical action.

What qualifies me to have a view?

For over 19 years I was atax partner inPrice Waterhouse /PwC. As well as advising audit partners on the appropriateness of clients' accounting for tax, I also observed audit partners (and clients' directors) in action at audit committee meetings. Equally illuminating was helping audit partners prepare audit proposals for potential new clients.

I have also been on the client's side of the table:

- For five years I was on the board and audit committee of Manchester Training and Enterprise Council, a £40 million business audited by Ernst & Young.
- For six and a half years I was on the PricewaterhouseCoopers' Supervisory Board and on the firm's audit and risk committee. PwC was a £2 billion business audited by Horwath Clark Whitehill.
- For 18 months, I was on the Council and audit committee of Salford University, turnover £180 million, audited by Grant Thornton.

A structurally adversarial relationship

In audit proposal documents and at audit pitches, prospective auditors always stress how well the audit firm will work with the client, how smoothly things will go, etc.

The reality is that the relationship of auditor and auditee is inherently adversarial.

Management do not want the financial statements to reveal the weaknesses of the business. Obviously profit shortfalls impact negatively upon management bonuses and upon the share price and from time to time lead companies to descend into creative accounting. Less obviously, the company making too much profit in a year is also a problem for management. Management often seek to defer part of the profit into the future to smooth the results.

The sole reason for the existence of the auditor is to stop management getting away with such

things. **The independence problems and the solutions**

There is a widespread perception that if the firm providing the audit is also supplying significant amounts of non-audit services, the auditor will be less tough to avoid the firm losing the non-audit work.

Non-audit services were a bigger issue in the past. After auditing disasters such as Enron regulators and shareholders have put significant downward pressure on non-audit services. However, they are still perceived to be a major issue. There is no good argument against a complete ban on non-audit services.

However, there are some services which are technically not audit services which it would be perverse to have performed by any other firm. An example is reviewing the half-year results. Such services should be itemised, given a meaningful name such as "quasi-audit services", and provided only by the auditor as part of the overall audit contract.

The more fundamental problem is "who does the audit partner regard as the client?" If asked, all audit partners may be expected to give the legally correct answer: their client is the company as a legal entity.

However, take a closer look at the relationship.

Who hires the auditor? The real decision is always taken by the audit committee, heavily influenced by management, especially by the CFO. Shareholders merely rubberstamp the decision.

Who agrees the auditor's fee? Shareholders invariably delegate this to the board of directors, who are heavily influenced by the CFO.

Who fires the auditor? In practice, the audit committee, heavily influenced by management. Shareholders invariably rubberstamp any change of auditors proposed by the board.

When an audit partner has a client paying an audit fee of several million pounds per year, virtually the whole of their year is spent auditing that client. For that partner, to have his firm fired as auditors is normally a career catastrophe.

Accordingly, audit partners set out to have a good relationship with the CFO, the CEO, the audit committee and the board of directors, forgetting they are meant to be adversaries. The friendlier one is with the client's individuals, the harder it becomes to challenge them or to suspect them.

The solution, starting with PIEs (public interest entities) is to take away from the company the power to appoint the auditor, to set the fee, and to remove the auditor. Instead, this role should be performed by a specialist outside body. That outside body would rapidly build up expertise and would have a 100% view of the marketplace for PIE audits. It could compare audit firms and audit partners better than anyone. To enable this the appointments body should receive confidential copies of all documents that auditors present to company boards, most of which are presently never seen by anyone but the client's board. Similarly, the body should have unrestricted right to speak to audit partners.

Shareholders may complain that something important is being taken away from them. Such a complaint is not valid. Limited liability is a privilege conferred on companies, and therefore on their shareholders, by the rest of society. The costs of audit failure do of course fall upon shareholders, but they also fall upon employees, creditors and taxpayers.

Shareholders simply do not have the knowledge and expertise to choose and remove auditors. Furthermore, their present exercise of that right is a sham, since shareholders effectively delegate it to the board, who in turn are too influenced by management.