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ACCOUNTS AND ACCOUNTABILITY

The UK Government's misguided plans to regulate corporate reporting and audit

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About the author

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Summary

- The failures of BHS in 2016 and Carillion in 2018 prompted the government to launch three inquiries into financial reporting and auditing. Their findings and proposals were collected in the government's 2021 consultation document *Restoring Trust in Audit and Corporate Governance*. In May 2022, the government published its response to the consultation.
- Among other things, the government proposes to dictate the content of financial reports, require the 'Big Four' audit companies to undergo internal re-organisations, oblige FTSE 350 companies to appoint two audit companies, and create a regulatory agency with greater powers. Each proposal is harmful.
- Companies have a commercial interest in supplying investors with any information those investors value more than it costs to produce. Government-mandated information production is sure to be inefficient. The government has failed to demonstrate any market failure in the production of financial information by companies.
- The proposal to force Big Four audit companies to further separate their audit and non-audit operations is based on a misunderstanding of the incentives created by integration and ignores the market disciplines faced by auditors.
- The proposal to reduce audit market concentration by forcing FTSE 350 firms to appoint at least one non-Big Four auditor fails to appreciate the genuine benefits of scale in auditors. It also constitutes an outrageous intervention in the decision-making of private enterprises and a state-mandated subsidy for second-tier auditing firms.

- An enlarged financial reporting regulator with stronger powers will increase legal uncertainty for businesses operating in the UK. Contrary to their intended effect, the government's proposed regulations will make the UK a less attractive place in which to invest.

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Introduction

The retail chain BHS failed in 2016. Then the engineering contractor Carillion failed in 2018. In both cases, investors lost money and workers lost jobs. And in both cases, accounting irregularities were alleged: the financial statements of these companies did not provide an accurate representation of their parlous positions. If so, fault lay not only with the companies' directors but also with the auditors who certified that their financial statements were a 'true and fair' representation of the facts. PwC, the auditor of BHS, was fined £6.5 million by the Financial Reporting Council (FRC), and KPMG, Carillion's auditor, is being sued for £1.3 billion by the liquidator.

Government ministers feared that whatever failings occurred in these particular cases were indicative of systemic shortcomings in financial reporting and the audit industry. Three inquiries were launched in 2018 and their findings were published in 2019: Sir John Kingman's *Independent Review of the Financial Reporting Council (FRC)*, the Competition and Markets Authority (CMA)'s *Statutory Audit Services Market Study* and Sir Donald Brydon's *Independent Review into the Quality and Effectiveness of Audit.*

The government agreed with the findings of these inquiries and combined their recommendations in a consultation document, the White Paper *Restoring Trust in Audit and Corporate Governance*, published in March 2021. In May 2022, the government published its response to the consultation, which describes the legislative and other measures the government plans. The reforms cover, among other things, the duties of company directors, the information that must be contained in company reports, the powers of a new regulatory body to replace the FRC, the business model of auditing firms, and the supply side of the auditing market, which the government believes is too concentrated.

As of September 2022, legislation implementing the recommendations has yet to be presented to parliament. Advocates of the regulatory reforms have been frustrated by the delay.[1] But the delay is welcome. In fact, the legislation should be abandoned. This paper argues that the three inquiries did not establish the need for increased governmental regulation of financial reporting and auditing, and that the proposed regulations will do economic harm. Specifically, they will reduce competition among auditors and impose unnecessary costs and uncertainties on firms. They will make the UK a less attractive destination for investment. In sum, the proposed regulations will have the opposite effects of those intended by the government.

This paper proceeds by considering the major new regulations proposed by the government, showing why each is either unnecessary or positively harmful. It then argues that failures of financial reporting and audit do not, as the government claims, demand increased regulation. The final section identifies the extra costs and sources of uncertainty that the proposed regulations will impose on companies and those who invest in them. But first, it will be useful to understand what an unregulated market for auditing would look like.

1 'Ministers to set out long-awaited shake-up of UK audit regulations', *Financial Times*, 14 February 2022 (https://www.ft.com/content/f33f38ea-0019-4c40-ab8c-b0009f5ca514).

A free market for auditing

Like anyone else spending their money, investors want to know what they are getting in return. The value of a share in the ownership of a company depends on its future profits, which depend, in part, on its present financial position. Similarly, those considering lending to a company want to understand the risks involved and, hence, also want to understand its financial position. This gives companies seeking equity or debt capital a reason to make accounts of their financial position available to potential investors. Insofar as these accounts reassure investors, they become more willing to provide the desired capital, and the company's cost of capital declines.

To have this effect, the accounts must be credible. Those seeking capital have an obvious incentive to favourably misrepresent their company's financial position. This creates demand for independent certification that their accounts are accurate. In other words, it creates demand for auditing.

Although auditing provides reassurance to potential investors, it is now paid for by the audited company. This is what we should expect. Both the investors and the company benefit from auditing: the former from improved capital allocation, the latter from a reduced cost of capital. But when an individual investor would contribute only a small percentage of the company's capital, as is typical for all but very small companies, the company has more to gain than the investor and is, therefore, more willing to bear the cost.

This raises an obvious question. If the company is paying the auditor, why should investors be any more inclined to believe the auditor's assurance that accounts are accurate than to believe the company's say-so? Why won't auditors simply say what their client, the company whose accounts they are certifying, wants them to say?

The answer is that a lying or shoddy auditor would soon be found out. When their client fails or underperforms relative to expectation and a post-mortem reveals the accounts to have been misrepresentations, the assurances supplied by the auditor will be devalued. Companies will get less benefit from hiring the auditor, and the auditor's business will suffer.

Audit is a 'credence good': that is, one whose quality the consumer cannot easily assess. Auditors' success therefore depends on establishing a reputation for honesty and expertise. This can be achieved by operational disciplines aimed at avoiding errors or deception, by the professional accreditation of employees, and by investing in the creation of a valuable brand. The greater the value of the auditors' brand, the greater the cost of exposure for deceitful or shoddy work and, hence, the greater the reassurance to investors. Because the cost of creating a brand is largely fixed, this favours large firms.

In a free market for audit, as in other free markets, the product supplied by auditors depends on the cost of supplying it and on the willingness of consumers to pay for it. Auditors could opine on more or fewer aspects of the company; they could put more or less work into checking the accuracy of the company's accounts; they could hire more or less skilled staff; and they could spend more or less on establishing a valuable brand. More costs more. The higher cost to the auditing firm is likely to be reflected in costs to the audited client. The extra cost will be worth it to the client if it translates into a greater saving in the cost of capital, which ultimately depends on how much investors value the extra information or reassurance supplied. All else being equal, large companies stand to gain more from more thorough and expensive auditing, as do companies whose business models make them more difficult for investors to understand.

In an unregulated market, such variation in the benefits to companies would lead to variation in the 'products' offered by auditors. So would competition between auditors. An auditor that could come up with a cheaper way of executing audits would be able to undercut competitors' prices. And an auditor who could find ways of increasing the certainty of its findings or of providing valuable new information would be able to offer clients a better product and, again, win business from competitors. We should therefore expect not only a variety of audit products offered in the market but ongoing innovation in these products.

Auditors are human. And they rely on the cooperation of those whose financial statements they audit, who are also human. So, we should expect errors in auditing, whether the result of sloppiness or corruption or something less culpable. An auditing firm has an interest in avoiding errors, since they damage its reputation and earnings. The chance of error can be reduced in several ways, such as recruiting honest and diligent staff, adopting reliable operating processes, and monitoring staff performance. But, as with other features of the auditing process, these measures are costly. At some point, the cost of extra anti-error measures will exceed the value of the reduced chance of error, and clients will not be willing to bear them. And that point arises before the chance of error is zero. Even in an ideal market, where all worthwhile anti-error measures are taken, some errors will still occur.

Enough, for now, about what a free market in audit would look like. Let's consider the government's proposals for improving the market by imposing yet more legal prohibitions and mandates on those who operate in it.

Mandated reporting

The government's proposed regulations aim to improve not only the performance of auditing firms but also corporate governance in relation to financial control. It aims to achieve the latter by imposing two significant new reporting duties on company directors. The first is that directors will be obliged to

> … carry out a review of the effectiveness of their company's internal controls each year and make a statement, as part of the annual report, as to whether they consider them to have operated effectively. The statement should disclose the benchmark system used and explain how the directors have assured themselves that it is appropriate to make the statement (HMG 2021: 19).

As the Brydon Review puts it, this introduces a 'UK version of SOX' (Brydon 2019: 62). The US Sarbanes-Oxley Act of 2002 (SOX), which was introduced in the wake of the Enron and WorldCom failures, requires listed companies to commission an external audit of their internal controls. The UK government's currently preferred option is to leave any such appointment to the discretion of the company's directors.[2] And, following the consultation, it has decided to impose the obligation to make such a declaration on directors not by way of legislation but by amending the UK Corporate Governance Code (see HMG 2022: 39).

Why is the government mandating this declaration from directors and, thereby, mandating the cost of the work required to make it? HMG 2021 gives no explanation, if only because it provides no rationale for any of

2 During the consultation, the Big Four audit firms expressed strong support for the idea of obliging companies to pay external auditors to assess their internal controls (see HMG 2022: 36).

its recommendations: it merely refers deferentially to the 2019 reviews upon which it relies. How then do the Brydon Review and Kingman Review, from which the idea is taken, justify it? Brydon defers to Kingman. Kingman gives this justification:

> The Review is particularly struck by the extent of support for these [SOX-style] provisions amongst senior audit committee chairs with experience of operating this regime in US-listed companies. A number of members of the Review's own advisory group also support the provisions. The arrangements are seen as having led to better financial reporting, fewer significant accounting restatements and stronger reassurances for audit committee members about the robustness of internal controls (Kingman 2018: 51).

'People we spoke to like the idea, and we like it too' is a weak argument, especially when those who like the idea stand to benefit from it. And the justification is not much improved upon by listing some of the perceived benefits of SOX. SOX may well improve financial reporting and increase reassurance. After all, it forces companies to devote considerable resources to the task. But this wouldn't suffice to justify SOX or the proposed UK equivalent, because it doesn't show that such benefits exceed the cost. Suppose the government permitted cars exceeding a certain quality standard only. Pointing out that people will be safer or travel in more comfort does not suffice to justify the compulsion because it does not show that such benefits are worth the thousands of pounds consumers must spend to gain them. People may have a better use for the money. Indeed, since they did not choose to buy superior cars, we must presume they do have better alternatives.

And just as people are already free to buy better cars if that is the best use of their money, UK companies are already free to perform the control audits and make the declarations that the government will force them to make. Why don't they choose to? SOX has been in force for twenty years. If the regime were so valuable to investors, this would be evident and UK firms could reduce their cost of capital by voluntarily adopting its disciplines. The fact that they do not is strong prima facie evidence that SOX-style disciplines are not worth their cost.

Neither the government nor Brydon nor Kingman address this obvious objection. They fail to say why the market mechanism described in Section

2 does not operate. A principal–agent problem is the only plausible explanation. Perhaps shareholders value SOX-style disciplines more than they cost but company directors and executives (the agents of the shareholders, who are the principals) have no incentive to satisfy investors' preferences in this regard. Although Brydon does not say this explicitly, his report does include a sub-section called 'An Agency Problem'.

Alas, no evidence is provided to show that the interests of company directors and executives are misaligned with the interests of investors in this respect. And the idea is implausible because senior executives are typically paid bonuses on the basis of performance measures that approximate the return to shareholders. These measures include the cost of capital.[3] All else equal, executives' bonuses vary inversely with the cost of capital. And, if only for this reason, they make great efforts to minimise their company's post-tax cost of capital, for example, by finding the optimal mix of debt and equity. Why would this enthusiasm for reducing their company's cost of capital disappear when it could be achieved by adopting a more rigorous reporting standard?

Besides this SOX-style mandate, the government will also require companies to

> … disclose their distributable reserves, or a "not less than" figure if determining an exact figure would be impracticable or involve disproportionate effort' (HMG 2022: 45) and 'a narrative explaining the board's long-term approach to the amount and timing of returns to shareholders (including dividends, share buybacks and other capital distributions) and how this distribution policy has been applied in the reporting year (HMG 2022: 46).

This compulsion involves the same mistake as requiring the attestation that internal controls are excellent. Companies are already free to make such declarations. Why don't they? The starting presumption must be that the beneficiaries of the declared fact – in this case, companies' creditors and shareholders – don't value it sufficiently highly. If companies could get a better price for the bonds or shares they issue by applying such a discipline and making such a declaration, and if doing so cost less than

3 The cost of capital varies with the uncertainty of returns. Investors demand a premium for more uncertain returns. An incentive scheme that makes executives care about the cost of capital makes them care about the uncertainty of returns. In other words, it aligns the interests of executives and investors (in this regard).

they gained from better bond or share prices, why wouldn't they do so voluntarily? If banks lending to companies valued the discipline and the declaration, why wouldn't they demand them in covenants of the loans they advance?[4]

Brydon claims that audit is now 'producer-led' rather than being consumer-led, as it asserts audit should be (Brydon 2019: 44). That is to say, audit standards are now determined by the auditors whose customers are the audited companies rather than by the consumers of audits, such as those who buy shares of the company or lend to it. But, given that companies care about their cost of capital, the fact that auditors decide on their offering in response to the preferences of their corporate customers provides no reason to think their standards are too low.

But matters are even worse. Brydon himself points out that 'recent work by EY suggests that asset managers and asset owners rank audit and assurance seventh out of eight stewardship categories in importance' (Brydon 2019: 44). Consumers are apparently satisfied with current standards. But this fact doesn't impress Brydon. On the contrary, he thinks it shows that they are 'not giving audit the attention and focus it deserves'. And, he informs us, 'I was also rather underwhelmed during the Review by the [lack of] interest in audit shown by some of the portfolio managers with whom I spoke' (Brydon 2019: 44).

Brydon wants audit to be consumer-led. But not by actual consumers with their actual estimation of current audit standards and their preferred trade-offs between cost and quality. Instead, he wants it to be led by imagined audit consumers who share his estimations and preferences. In other words, he wants it to be led by him.

The hubris is astounding. Brydon seems to believe that the tens of thousands of dedicated experts at asset management firms, investment banks and the rest, whose clients have trillions of pounds at stake and who themselves have billions at stake, have failed to appreciate the true importance of audit and its current deficiencies. According to Brydon, the kind of reporting and auditing that results from companies and auditors responding to the various preferences of investors and their agents – the

4 Following Brydon's advice, the government also proposes to oblige directors to publish an 'annual Resilience Statement' and an 'Audit and Assurance Policy' (HMG 2022: sections 3.1 and 3.2). These mandates are misguided for the same reason that the 'internal controls' and 'dividend' declaration mandates are misguided.

market outcome – should be replaced by an outcome that depends instead on Brydon’s preference.

And the government agrees with him.

Separation of audit and non-audit

In 2019, under pressure from the FRC, the Big Four accountancy firms – Deloitte, EY, KPMG and PwC – internally banned selling non-audit work to audit clients.[5] This does not satisfy the government. In HMG 2021, it proposed separating audit and non-audit operations within the Big Four firms. Specifically, the government would mandate:

- the creation of a separate board for the audit practice, which would be responsible for remuneration decisions and developing and maintaining audit quality standards;
- a requirement to produce separate financial statements that would reflect the costs of services provided by the non-audit part of the firm; and
- a requirement that profits should not be shared between the audit and non-audit [partners] (HMG 2021: 146).

Following the consultation, the government proposes giving a newly created regulator, the Audit, Reporting and Governance Authority (ARGA) – a beefed-up replacement for the FRC – powers to bring about these changes (HMG 2022: 116).

According to the Competition and Markets Authority's *Statutory Audit Services Market Study* (2019), whose advice the government is following, this compulsory internal separation will overcome an unwelcome

5 'PwC and EY to ban non-essential consulting for UK audit clients', *Financial Times*, 30 January 2019 (https://www.ft.com/content/4378a39e-2484-11e9-b329-c7e6ceb5ffdf).

consequence of the integrated model of the Big Four firms: namely, that audit partners lack incentives to deliver high-quality audits (CMA 2019: para. 3.204). The old concern was that auditors 'go easy' on companies for the sake of 'cross-selling' them lucrative non-audit work. This was never an entirely plausible theory given the reputational and legal risks of exposure. And, in any event, the ban on using audit to cross-sell non-audit work eliminated this concern. Why then does the CMA think that the integrated model discourages high-quality audits?

It is because they believe that, despite the cross-selling prohibition, the audit partners of Big Four firms still care about the performance of their non-audit colleagues. Their bonuses are partly determined by the profits of the whole firm, and management encourage a 'one firm' culture. The CMA alleges that this commercial interest in the performance of non-audit parts of their firm causes audit partners to go easy on clients. They hope that, when the audit contract ends, as it legally must after twenty years, the client will award non-audit contracts to the firm as a mark of gratitude (CMA 2019: para. 3.225). Moreover, the 'one firm' culture inclines audit partners to adopt the inappropriate profit-oriented attitudes of their non-audit colleagues. Or, as the CMA puts it, 'the … "one firm" culture … risks undermining the public interest purpose of audits … because … non-audit activities are providing a service to the client. Audit is fundamentally different in requiring objectivity and challenge to the client on behalf of shareholders' (CMA 2019: para. 3.207).

The CMA here makes the same mistakes that Kingman and Brydon make when mandating the features of corporate reporting: namely, over-estimating the principal–agent problems at public companies and under-estimating the ability of market mechanisms to determine optimal audit 'product features'.

Start with the CMA's opinion that Big Four firms are (or should be) objective and working in the interests of shareholders when they engage in audit work, but not when they do non-audit work. It is an extraordinary idea. All the work done by Big Four firms with or for their clients should be aimed at increasing their clients' total shareholder return – in other words, at serving the interests of shareholders. The tax partners, for example, should be no less objective than the audit partners, and serve the interests of shareholders no less.

This is because the interests of the company executives who commission non-audit work are reasonably well aligned with the interests of shareholders. Their bonuses are usually linked to net profit or risk-adjusted return or something else closely correlated to total shareholder return. And this alignment is also easily explained. Investors will prefer companies whose executives work under such incentive schemes. So, there is no reason to believe that absorption into the wider culture of their firm will undermine either the objectivity of audit partners or their concern for their clients' shareholders. All the partners, audit and non-audit, are ultimately working for the shareholders of their clients.

And those shareholders are well aware that Big Four firms provide companies with many services besides auditing. Banks and other lenders are also aware of this fact. If they were as concerned by it as the CMA is, companies audited by firms without the recommended separation would need to pay a premium for their equity and debt. This would create an opportunity for firms that offer nothing but auditing to win the business of companies seeking to reduce their cost of capital. The fact that this opportunity is not being taken suggests that it does not exist, that investors are not sufficiently bothered by the other lines of business of audit firms.

The CMA might adopt the Brydon view that investors and their agents don't know what's good for them. Given the trillions of pounds at stake and the expertise employed to protect that wealth, this is an implausible idea. Indeed, investors may favour the firm auditing a company also doing other work for it. Suppose an investor took the reasonable view that the legal and reputational risks of exposure suffice to keep the auditor honest and diligent; then the involvement of the same firm in the company's tax planning, strategy development, regulatory compliance and so on would be welcome. The knowledge gained from this other work would inform the audit, and vice versa. The shareholders and creditors would benefit from the integration.

The same objection applies to the government's initial proposal to create a new auditing profession (HMG 2021: 117–8), separate from the accountancy profession, as proposed by Brydon. Membership of a profession entails the cost of gaining admission (perhaps by passing an exam), of annual membership fees and, usually, of ongoing training. If clients are willing to pay a premium for members of the profession, the gains of membership may exceed these costs. If so, there is an opportunity to establish a profitable professional body. Again, the fact that this

opportunity has not been taken for auditing suggests that it does not exist, that the consumers of auditing would not value separate professional accreditation for auditors sufficiently to make the costs worthwhile.

Perhaps some barrier to entry or other market imperfection prevents a professional auditing body from being voluntarily formed, even though it would be a worthwhile venture. What might that barrier or imperfection be? Neither Brydon (2019) nor the government even claims that there are any, let alone provides evidence of them. They seem to proceed on the assumption that opportunities for profit are simply squandered. This is generally hard to believe. Twenty-pound notes don't lie around on the ground for long. It is especially hard to believe of people who, according to the government, need to be regulated precisely because they are so profit-motivated that they are willing to risk legal and reputational peril for the sake of increasing their profits.

Following the consultation, the government has decided to reject Brydon's suggestion:

> Rather than trying to create a new professional body for auditors that is independent of the existing accountancy professional bodies, the Government will ask professional bodies to improve auditor qualifications, skills, and training in order to help create a more effective and distinctive audit profession (HMG 2022: 11–12).

But this watered-down intervention makes the same mistake.

Competition and market concentration

Between them, the Big Four accountancy firms audit 97 per cent of FTSE 350 companies. The government agrees with the CMA's 2019 report which claims this concentration shows the audit market is uncompetitive. To fix this problem, it proposes obliging FTSE 350 companies to hire two firms to audit their accounts, only one of which can be a Big Four firm. And if this 'managed shared audit regime' fails to deliver the market fragmentation sought by the government, it will impose market-share caps. No auditor will be allowed more than some yet-to-be-specified share of FTSE 350 companies as clients.

The proposal is based on a faulty understanding of competition. The dominance of four firms does not demonstrate an absence of competition. And the proposed regulations would only reduce competition.

Consider the market for cars. Imagine that a single firm, ACME Automotive, produced every car purchased in the UK. It would not follow that the UK car market was uncompetitive. If other manufacturers faced no barriers to entry, the dominance of ACME would show merely that consumers preferred ACME cars to any other yet offered to them. ACME would continue to face competition, not from actual manufacturers but from those who were free to offer something that consumers might prefer. If ACME were to increase its prices at all significantly, for example, such a competitor would probably enter the market and win customers from ACME. This possibility constrains ACME's pricing, and protects consumers, even in the absence of any other actual manufacturers.

Similarly, the dominance of four auditing firms (for FTSE 350 auditing) does not show that the audit market is uncompetitive. Perhaps it reflects

only the consumers' preferences. To show that it is uncompetitive, the CMA would need to identify barriers to entry.

Apparently recognising this obligation, the CMA report lists a number of 'barriers to expansion facing smaller firms' (CMA 2019: para 3.131–3.163). It starts by considering 'demand-side constraints' (CMA 2019: para 3.139–3.144). As it turns out, what the CMA means by 'demand-side constraint' is the preference of FTSE 350 companies for big auditors. This preference is unsurprising given the reassurance provided by an auditor having a valuable brand and many clients (for the reasons given in Section 2 above). What should be surprising is that the CMA treats consumer preferences as a barrier to entry. If all consumers prefer ACME cars to (potential) competitors' cars, that is not a barrier to entry – not, at least, in the sense that 'barriers to entry' are inimical to consumer welfare.

Matters get no better when the CMA considers 'supply-side barriers'. For these too are merely the result of consumers' preferences. For example, the CMA describes the cost of tendering for an auditing contract with a FTSE 350 company as a supply-side constraint. So it is, insofar as more firms might tender if doing so cost less. But tendering cannot be cost free, since it requires time and effort.

Suppose an auditing contract will be worth £5 million to the winner and that the tendering process costs the competing firms £500,000 each; then the expected value of competing for the contract is positive only if the chance of winning the contract is greater than 10 per cent. This explains why the Big Four compete for FTSE 350 contracts, and the largest other firms (Grant Thornton and BDO) sometimes do, but small auditors do not. FTSE 350 firms are very unlikely to award the contract to a small firm. This 'barrier to entry' is really just a reflection of consumers' preferences and not, therefore, a threat to their welfare.

Mistaking consumers' preferences for a barrier to entry leads the CMA not only to conclude, without proper evidence, that the auditing market is not competitive but also to recommend a remedy that *reduces* competition. Obliging FTSE 350 companies to be audited by two firms, only one of which is a Big Four firm, is guaranteed to increase the market share of non-Big Four auditors. But increasing market fragmentation is not the same as increasing competition. Potato production in the Soviet Union was fragmented across thousands of farms. But these farms did not compete with one another. Obliging consumers to buy from one supplier

rather than another or from one class of supplier rather than another class – as the CMA and government propose – can only reduce competition between those suppliers. The proposal amounts to a massive regulatory gift to the biggest or best of the non-Big Four auditors. The additional income these auditors receive will result not from outcompeting the Big Four but from a legal obligation placed on their 'customers'.

And, as noted above, if this 'managed shared audit regime' does not result in the sought-after market fragmentation, the government will impose a market-share cap. This is also anti-competitive. Suppose that the cap is set at 15 per cent, so that the greatest possible combined market share of the Big Four is 60 per cent, this effectively bans 140 FTSE 350 firms from using a Big Four auditor. Without the cap, auditors compete to be preferred by the company, to be its first choice of auditor. Once the cap is imposed, 140 FTSE 350 contracts will be winnable by becoming the company's fifth choice. It is an astonishing imposition on everyone except the fifth-choice auditor firms, for whom it is an astonishing gift.

Failure and response

If the normal market mechanism results in an efficient outcome for financial reporting and audit, how to explain the failings that motivated the government-sponsored reviews of audit and the recommended new regulations? What might explain the failures of audit that occurred at BHP and Carillion?

Consider the safety of passenger jets, both in their design and manufacture and in their maintenance. Plane manufacturers and airlines take every reasonable measure to ensure safety. After all, if one of their planes crashes, they stand to lose not just the aircraft but billions in legal action and lost business. Yet planes still do sometimes crash. To eliminate all possibility of a plane crashing would cost more than passengers are willing to pay for the increased safety. Indeed, given the role of fallible humans in the creation and maintenance of planes, the only way to eliminate any chance of a crash would be to stop planes flying altogether.

The point is entirely general. We should neither expect nor seek perfection in any product or service. It could be achieved only at a cost that most consumers would be unwilling to bear, even assuming that it could be achieved at all. We do not seek failure in products or services, but nor do we normally seek products in which failures never happen. When it does, that is not evidence of 'systemic failure'. Two large audit failures in three years is quite possible in a well-functioning audit market.

This is not to say that KPMG can afford to ignore whatever failings occurred in its work at Carillion. It stands to lose £1.3 billion in the negligence lawsuit that has been filed against it and is likely to take measures that will reduce the chance of something similar happening again. That the companies involved and their competitors will voluntarily respond to the failings is another reason that spectacular failures do not require regulatory intervention by the government.

Consider the spectacular ‘rogue trader’ cases in investment banking, such as Nick Leeson’s fraud that brought down Barings Bank in 1992. For obvious reasons, other banks were keen to understand how he perpetrated the fraud and to take measures to ensure it wouldn’t happen to them. Governments do not need to tell businesses that they should try to avoid suffering catastrophic losses. Nor are governments well placed to instruct businesses on the most efficient ways of achieving this goal. Whoever wrote *Restoring Trust in Audit and Corporate Governance* apparently failed to recognise that, insofar as such restoration was required, audit firms would need no compulsion to get on with the job.

The regulatory reflex to events such as the BHP and Carillion failures displays not only an under-estimation of market responses but also an over-estimation of those who draft regulations and those who enforce them. America’s 2002 Sarbanes-Oxley Act (SOX) was also introduced in response to two large accounting scandals: Enron and WorldCom. As argued above, the failure of companies in other jurisdictions to voluntarily adopt the practices compelled by SOX is strong evidence that they are on balance harmful. But there is a more obvious objection to SOX. Just six years after it was introduced, America suffered the worst spate of corporate failures since the Great Depression. According to financial reports prepared under SOX, Lehman Brothers was a solvent going concern, as were the other banks that would have failed if not for government bailouts. SOX failed to prevent precisely what it was introduced to prevent.

Conclusion: Making the UK unattractive for investment

In his foreword to *Restoring Trust in Audit and Corporate Governance* (2021), Kwasi Kwarteng, then Secretary of State for Business, Energy and Industrial Strategy, claimed that the UK is a 'world-class destination for investment'. And he believes the new regulations will 'reinforce the UK's position'.

In fact, they are likely to have the opposite effect, because they impose unwarranted costs on companies. According to analysis by the *Financial Times*, the annual cost of the proposed regulations will be £434 million.[6] Much of this (£200 million) comes from the government's plan to redefine a 'public interest entity' (PIE), to which the more burdensome of current rules apply and to which the new rules will apply. It will now include not only listed companies, banks and insurers but also large privately owned businesses. This will increase the number of companies covered by the regulations from roughly 2,000 to 4,000.[7] Complying with the SOX-style requirements will cost companies £170 million. The 'managed shared audit regime' will add £23 million of cost. Turning the FRC into the ARGA, with its 200 additional staff, paid for by a levy on PIEs, will add £39 million. And the cost of the operational split imposed on Big Four firms, which is ultimately borne by their clients, is estimated at £23 million over ten years (or £2 million a year, let's say).

6 'UK audit reform set to cost businesses more than £430m a year', *Financial Times*, 18 March 2021 (https://www.ft.com/content/7c66877e-9cb0-44ca-984b-f983f7bcabee).

7 The government's response to the consultation means this analysis (from September 2021) over-estimates the number of additional companies that will be counted as PIEs. The government has increased its criteria from a turnover above £500 million and more than 500 staff to turnover above £750 million and more than 750 staff. No attempt has been made here to revise the FT figure, because it is immaterial to the argument.

When divided between 4,000 companies, £434 million is £108,500. That's not an impossible burden for a large company. But the costs estimated by the *Financial Times* are merely the additional operational expenditure entailed by the regulations. The far bigger cost comes by way of increased uncertainty for large UK companies. Some of this uncertainty is created by the government's plan for 'a more pro-active role for the regulator in identifying and assessing serious issues relating to a company's corporate reporting or audit' (HMG 2021: 23). ARGA will have 'the power to require an expert review, paid for by the company, to investigate issues in greater depth and explore the underlying causes' (HMG 2021: 23). In other words, PIEs will be subject to discretionary interventions by ARGA.

That is bad enough. But why should the senior executives of PIEs expect the extension of such powers to be limited to matters concerning financial reporting? For example, the government will require companies to publish a 'resilience statement' that, among other things, explains how the company is 'identifying and managing climate change risks (and opportunities) over the short, medium and long term, including with reference to their governance, strategy and risk assessment processes' (HMG 2021: 64). If bureaucrats at ARGA do not like what they read in such a report, will they have the power to demand a change of policy by the company? And, if ARGA is to have authority over companies' climate strategy, why not over other matters that affect their resilience, such as their marketing strategy, recruitment policies, planned responses to terrorist attacks, electricity failures, and so on and on?

Making PIEs subject to 'a strengthened regulator' decreases the legal certainty under which they operate. It reduces the confidence with which they can formulate and pursue business strategies. For all they know, their plans my go wrong not because customers or suppliers take against them but because the government does.

Nor is it only the proposed new powers of ARGA that will increase investor uncertainty and, hence, companies' cost of capital; the planned interventions in the audit market are astounding. The government will dictate the internal organisational arrangements and remuneration policies of four non-governmental commercial enterprises. And it will force at least 350 companies to appoint not only their preferred suppliers of audits but also an alternative preferred by the government. Why should investors believe that this will be the last such intervention in the decision-making of supposedly private enterprises?

If the government wants to make the UK a more attractive destination for investment, it should not subject commercial enterprises to the arbitrary diktats of bureaucrats and politicians. It should announce that it will not, after all, implement the proposed regulatory regime for corporate reporting and audit.

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