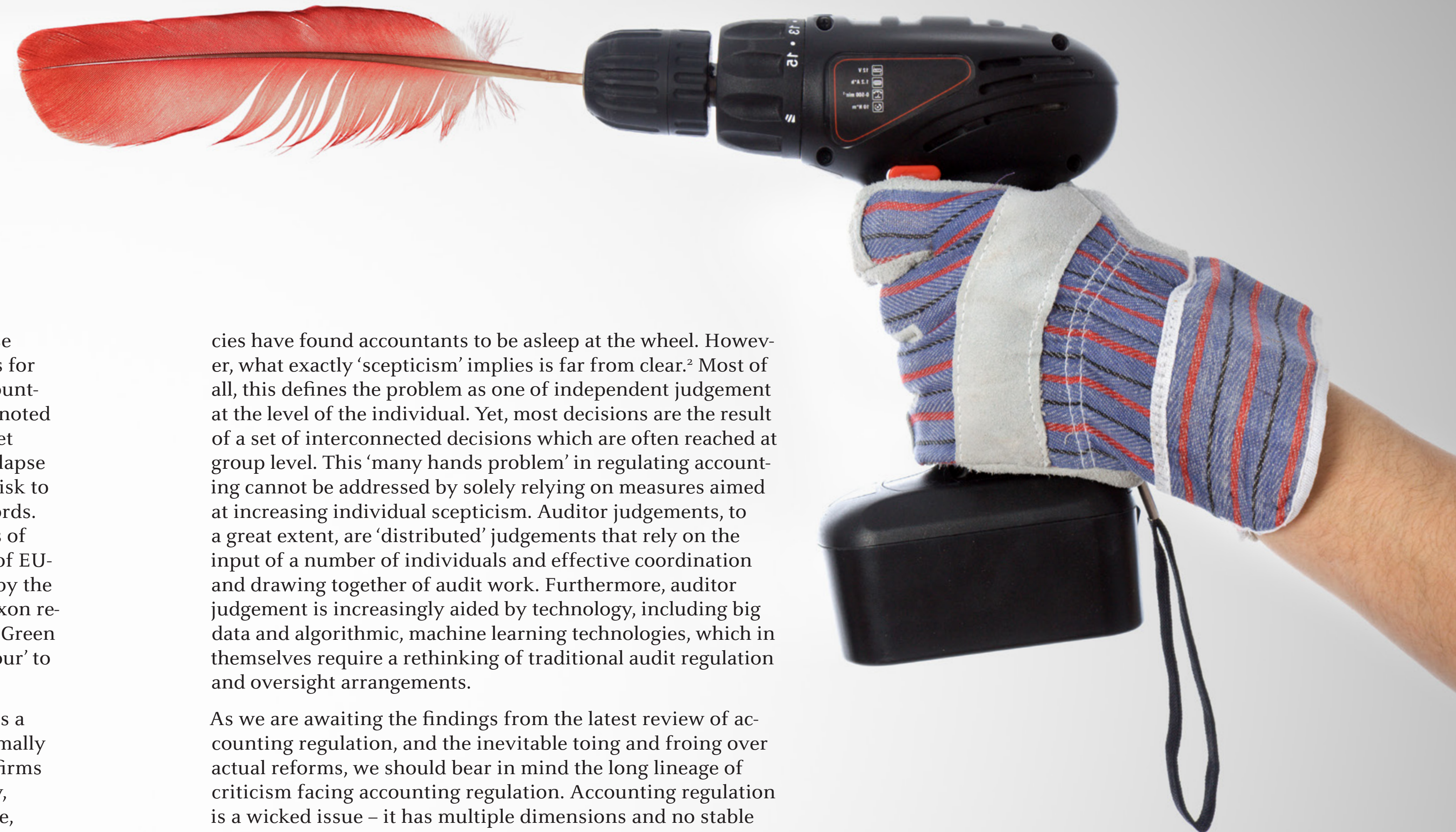
# Regulating wicked issues – the next round of accounting regulatory reform

**Andrea Mennicken** and **Martin Lodge** consider the likely disappointment of contemporary reform initiatives



Barely a day goes by where calls for reform in accounting regulation do not feature in the headlines. Whether it is calls for tighter controls over conflicts of interests, ethical behaviour, or changes to market structures to enhance competitiveness, taken together all these debates seem to signal a determination to tackle deep-rooted problems in the accounting profession. Yet, however valuable these calls are, the potential solutions to the diagnosed problems are likely to disappoint. Since regulating accounting is about regulating a distinct 'wicked issue', simple solutions won't do.

Current key criticisms relate to questions of market structure, auditor independence and auditor judgement. Questions about the power of the 'big four' accounting firms (Deloitte, E&Y, KPMG, PwC) highlight the considerable market concentration of large accounting firms, whose influence is further advanced by the close connection of accounting with associated consulting services. Another concern is the competence of individuals and organizations to properly 'audit' firms and exercise a sufficient degree of scepticism in their assessments, for example in their judgement of large uncertain accounting estimates, including fair value estimates and impairment write-downs. Furthermore, there are quests for a reform of the Financial Reporting Council, the UK regulator for auditors, accountants and actuaries. The proposal is to turn this body into a more muscular regulator with statutory authority, being accountable to Parliament. At the time of writing this article, an independent review of the Financial Reporting Council (FRC) led by Sir John Kingman is being conducted. The review's objective is to 'help government to assess the FRC's governance, impact and powers, to ensure they are fit for the future'.[1] The review encompasses an assessment of FRC's audit quality review process. It is currently planned that findings will be submitted to the Secretary of State for Business, Energy and Industrial Strategy and the FRC Board by the end of 2018.

None of the above listed concerns are necessarily new. They featured heavily in the aftermath of the collapse of Enron (and, subsequently, Arthur Andersen); they returned to the fore during the financial crisis; and they have received renewed attention in the context of recent failures, such as Carillion in the UK. In the case of Carillion, criticism was particularly directed at Carillion's auditors, KPMG, signing off on accounts just before the firm's first profit warning and, six months later, insolvency.

If concerns about auditor judgement, close relationships (i.e. lacking auditor independence), audit market concentration and timid regulatory oversight are nothing new for those interested in accounting regulation, then the same holds for regular attempts at tinkering with the regulation of accounting itself. In 2011, the House of Lords Select Committee noted distinct vulnerabilities arising not just from audit market concentration per se, but also from the peril that the collapse of any one of the large four firms would also present a risk to the sustainability of the audit market itself (House of Lords. Select Committee on Economic Affairs, 2011). Questions of market concentration were also very much at the heart of EU-led audit reform initiatives (see the Green Paper issued by the European Commission, 2010). At the time, the Anglo-Saxon resistance to extensive reform proposals contained in the Green Paper, such as the mandatory splitting up of the 'large four' to create 'more competition', was particularly noteworthy.

Since then, a range of initiatives have taken place. One is a mandatory audit firm rotation requirement that has formally become part of European Union law. Further, EU audit firms have been banned from providing a number of advisory, non-audit services to audit clients, including for example, services linked to management advice, or advice on financing, capital structure or investment strategy of the audited entity (drawing on US-SOX legislation).

In France, joint audits (i.e. audits of an entity by two or more auditors) have been required for listed companies since 1966. Inter alia, such a mechanism can reduce audit market concentration by offering smaller firms an opportunity to work alongside the big firms.

Yet, none of the above outlined initiatives (auditor/audit firm rotation, prohibition of non-audit services alongside audits, introduction of joint audits), is likely to lead to significant reform results as they do not go to the core of the 'wicked issue' character of accounting regulation. At one level, there is a problem of the target of regulation. On the one hand, accounting regulation is about professional standards aimed at the governing of individual professional conduct (individual independence, competence, objectivity, etc.). On the other hand, individual professionals operate in an organizational context of an audit firm context, which brings with it a number of different issues. Some of these issues are related to audit firm governance, internal incentive and compensation structures, client management and retainment demands, and so forth.

At first sight, calls for 'more scepticism' in auditor judgements sound plausible in view of accusations that recent bankruptcies have found accountants to be asleep at the wheel. However, what exactly 'scepticism' implies is far from clear.[2] Most of all, this defines the problem as one of independent judgement at the level of the individual. Yet, most decisions are the result of a set of interconnected decisions which are often reached at group level. This 'many hands problem' in regulating accounting cannot be addressed by solely relying on measures aimed at increasing individual scepticism. Auditor judgements, to a great extent, are 'distributed' judgements that rely on the input of a number of individuals and effective coordination and drawing together of audit work. Furthermore, auditor judgement is increasingly aided by technology, including big data and algorithmic, machine learning technologies, which in themselves require a rethinking of traditional audit regulation and oversight arrangements.

As we are awaiting the findings from the latest review of accounting regulation, and the inevitable toing and froing over actual reforms, we should bear in mind the long lineage of criticism facing accounting regulation. Accounting regulation is a wicked issue – it has multiple dimensions and no stable solution, and how problems are being defined inevitably leads to particular, partial solutions, which in turn, generate their own vulnerabilities. While therefore increased spotlight on the world of accounting regulation can only be welcome, it is fairly unlikely that any subsequent reforms will mean an end to questionable practices, concerns about market structures or accusations of missing 'red flags' in future insolvencies.

1 See *https://www.gov.uk/government/publications/financial-reporting-council-review-2018* Accessed 25 October 2018.

2 See also *Auditor scepticism: raising the bar* issued by FRC's Auditing Practices Board in 2010, London: APB.

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