Britain’s accountancy watchdog has neither bark nor bite

The FRC has taken a breezy attitude to the business of rule compliance

It would be vastly better if the Financial Reporting Council had more distance from the industry it regulates

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Imagine that you are an auditor acting for a huge global company or financial institution. Your career prospects are linked to the enormous fee cheques that the relationship brings in for your employer. How likely are you to say or do anything that might force your client into making a disclosure that would be both damaging and possibly fatal for its share price, or indeed its boss?

Human nature suggests it is, at best, a toss-up, so long as there is some vaguely plausible workaround. Better to turn a blind eye or find a mechanism to avoid the lethal note or qualification. The one restraining factor (apart from your own firm’s internal culture) might be the presence of a credible watchdog looking over your shoulder. Especially one that might come back to bite you after the fact.

And herein lies the problem with Britain’s accountancy regulator, the distinctly un-punchy Financial Reporting Council. Under the chairmanship of Win Bischoff, a former investment banker and ex-Lloyds Banking Group chairman, the watchdog has not done much watching or barking of late, let alone any real biting. Indeed, it has taken a breezy attitude to the whole weary business of compliance with the rules.

Take three high-profile investigations, where in each case the FRC recently decided to take no further action. None involved peccadilloes by any stretch of the imagination.

The first was the 2007 audit of HBOS, the giant retail bank that collapsed just months after KPMG signed off an unqualified report, and whose demise was almost Britain’s “Lehman moment”.

Then there was PwC’s audit of Barclays and its failure to segregate client money between 2007 and 2011 — a failure for which the Financial Conduct Authority slapped the bank with a record £38m penalty.

And lastly, there was PwC’s work for Tesco, whose dodgy accounting for supplier rebates plunged the company into the worst crisis in its near-100-year history, and now has put three of its former executives on trial for fraud. The watchdog’s response? Again, nothing to see here.

Each time, the FRC has advanced the same reason for not proceeding to any disciplinary procedures. The audit firms in question had not fallen "significantly short" of the standards they might reasonably be expected to uphold.

- FRC drops probe of PwC's work for Barclays
- KPMG cleared over audit of HBOS before collapse
- PwC escapes censure over Tesco accounting scandal

Critics have been quick to point to how many Big Four accountants sit on FRC panels and committees. True, the watchdog may require some expertise, but the gene pool still looks shallow. For instance, the same FRC that cleared HBOS is stuffed with senior figures from KPMG, or former accountants who qualified there.

Indeed, it is not that hard to detect the whiff of regulatory capture. For example, the rule change that helped to exonerate the audit firm, when in 2013 the FRC decided that firms would have in future to fall "significantly short" of standards rather than just "short" as previously, was driven through by Paul George, then the executive director in charge of misconduct. Mr George is a former partner of . . . KPMG.

It would clearly be vastly better if the FRC had more distance from the industry that it regulates. That is not simply because the rules might be tougher, and more routinely and firmly enforced. It might also oblige the watchdog to take more account of those who actually consume financial reporting.

Notionally, the rules say that accounts should present a "true and fair view" of a company's profits or losses, assets and liabilities. That suggests they should, at the very least, be clear and comprehensible. Yet in practice, they embed judgments that are impossible for the layman to follow, generally encrypted in a mosaic of impenetrable notes.

Since the Enron scandal nearly two decades ago, accounting and compliance have become ever more technical and esoteric. New techniques such as "fair value" accounting make it ever harder to penetrate the mysteries of corporate figures, especially that which deals with large financial companies.

These changes clearly benefit the Big Four, who alone among the profession have the money and expertise to generate the computer models and data to support these complicated practices. They are great for big finance, whose manoeuvres they shroud in mystery. But they have created an unhealthy and closed priesthood around accounting — where rules are hard to challenge because the public does not understand them.

The result is that big accountancy firms have somehow ended up as the guardians of a system that protects their own market power.

If we want auditors to think twice before deferring to their clients, some hard thinking is needed. The rules need to be simpler, and thus more amenable to the spotting and punishment of infractions. We need more tough-minded laymen, and fewer auditors and financiers, on the FRC board.