HBOS-KPMG: looking beyond the audit

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Public and regulatory scrutiny is increasingly on auditors but perhaps it is time that the framework within which they operate shares the spotlight too, suggests Ross Dixon, partner at Hickman & Rose

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The Treasury's decision in September 2015 not to renew Martin Wheatley's contract as head of the Financial Conduct Authority (FCA) was widely seen as evidence that the government was keen to ease up on the banking sector, which since the 2008 financial crisis has been the target of much public and parliamentary opprobrium. But whatever slack the banks are now being cut, the focus on auditors and regulators shows every sign of intensifying. It is the FCA, not the institutions it regulates, that has recently faced harsh questioning from MPs.

Nor is this trend limited to the banking sector; the Financial Reporting Council (FRC), the FCA's counterpart in the accountancy industry, has also been in the spotlight recently. In particular, it has come under mounting political pressure to open an investigation into KPMG's conduct as the auditor of HBOS prior to the bank's collapse; and to explain why it did not do this in the first place. The public want to know who should be held accountable: the bank, the auditor or the regulator.

The answer is not so simple. Those with inside experience understand that company accounts are drawn under a complicated set of principle-based guidelines – the International Financial Reporting Standards (IFRS). Applying these rules is an exercise in professional judgment.

> *It is the IFRS themselves, not their application, that several investor groups blame for the collapse of banks like HBOS*

In the case of HBOS, criticism revolves around the scale of impairments recognised in the balance sheet and the consequent shortfall in impairment provision. Calls for the FRC to investigate question the auditor's role in these judgments.

Revenue recognition can be another grey area when auditors are applying the principles to facts that are novel or distant from those envisaged by the rules. The problem is exacerbated in cases involving different countries with sometimes conflicting guidelines, such as the more rule-based US GAAP. We act in one such case currently under investigation by the FRC and US authorities. Allegations of misconduct were made after decisions taken under the IFRS were retrospectively reviewed through the lens of US GAAP.

Interpretation

The reality of a principle-based approach is that two professionals acting in good faith can arrive at different conclusions. Hindsight is a wonderful thing, but not everything it uncovers is due to deliberate jiggery-pokery by the company or auditor. It is true that when a set of guidelines like the IFRS is so reliant on subjective judgment it will then be prone to error and even manipulation. But calls from outside the industry for investigations seem to be based on a fundamental misunderstanding of the role of the auditor and the application of the rules.

In fact it is the IFRS themselves, not their application that several influential investor groups blame for the collapse of banks like HBOS and other recent major accounting scandals. For example, the Local Authority Pension Fund Forum (LAPFF) has campaigned hard, enlisting the help of senior legal counsel to back up their claims that the guidelines fail to provide a 'true and fair' view of a company's financial position and can even serve to mislead.

In December, the group wrote to all FTSE 350 listed companies telling them to ignore 'defective' guidance from the FRC, which it accuses of being 'taken in [by] elements of the accounting profession [seeking] to portray the law as something different to what it actually is'. The FRC deny this in no uncertain terms and maintain that the IFRS are fit for purpose.

Calls for a formal investigation into KPMG are growing louder, and the regulator's dithering is starting to give weight to accusations that it acts more as a public relations body for the accountancy industry than its regulator.

Yet, this criticism may not be entirely fair. While it is right to demand the highest standards from our auditors and their regulators, a wider understanding of the auditor's role - interpreting the principles - and the extent to which reliance can be placed on their findings, would assist this debate. Otherwise, we may be better served heeding the calls of the LAPFF – for reform of the IFRS framework itself.

About the author

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