

# Research impact: making a difference

## Reforming auditing and risk management to improve governance

LSE research on auditing and risk management has influenced organisations ranging from financial institutions to the United Nations

### What was the problem?

Auditing plays a key role in ensuring that organisations are properly run and performing well by confirming their claims about their financial position and ensuring the integrity of the systems behind those claims.

In recent years there has been an explosion in the use of auditing as a form of governance and control – a significant expansion beyond auditing’s historical role as a neutral process of gathering, evaluating and presenting evidence on organisational performance and status.

### What did we do?

LSE Professor of Accounting Michael Power was the first to identify this trend in his highly influential Demos paper, *The Audit Explosion*, and in his book, *The Audit Society: Rituals of Verification*.

In his research Power had found that this expansion in auditing was the result of a transformation in the nature of governance, away from the traditional forms of direct governance and towards indirect governance through regulatory bodies and self-control practices within organisations.

Auditing practices were, in effect, becoming a force for unintended change. Quantitative measures of performance were being instituted to make organisations ‘auditable’ and ‘inspectable’ and in the process were forging a deep link between performance culture and audit culture.

Power looked at the effects of this imperative to ‘make things auditable’ on organisations and the individuals working in them. He showed that whereas Value-for-Money auditing was meant to produce a focus on outcomes and policy effectiveness, in reality it tended to focus organisational attention and effort on measurable outputs and cost efficiency.

This imperative also led to the explosion of risk management in the 1990s and to what many practitioners have referred to as a ‘box-ticking’ culture. Power found that organisational control systems were being transformed into risk management systems, and that these were being made into more public and auditable objects through the imposition of regulatory regimes.

As a result, organisations were being turned ‘inside out’ and becoming more vulnerable to reputational damage in external environments. This development was not a reflection of an actual

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increase in the risks being faced by organisations, but rather the rise of the ‘risk management of everything’ and of accountability as a vehicle for assigning blame.

Power argued that the ‘risk management of everything’ was not only not as functional as practitioners believed, but actually reckless and epistemologically flawed. It focused on easily auditable risks and ignored those that were difficult or complex. It also focused on organisations as entities and ignored the interconnection risks existing between organisations. The validity of Power’s observation became even more apparent during the financial crisis.

## What happened?

### *Auditing*

Power’s research influenced the policy debate and led to changes in the way that performance auditing is carried out both in the UK and in other jurisdictions.

Power gave evidence to the inquiry into the banking crisis conducted by the House of Commons Treasury Committee. He was explicitly named in the Committee’s recommendation that the Financial Reporting Council, the UK’s independent regulator responsible for promoting high quality corporate governance, should require auditors to use a graduated scale of concerns in their official audit reports.

He also gave evidence to the inquiry conducted by the House of Lords Committee on Economic Affairs into the auditing sector, which examined concerns about market concentration and about the scope, relevance, quality and regulation of traditional audits.

These activities led directly to participation in discussions about audit report reform at the Auditing Practices Board of the Financial Reporting Council, which resulted in a new policy focus on audit committee reporting. Power was also an advisor to the Department of Business Innovation and Skills (BIS), which drew on his work in their audit reform proposals.

Power’s work has directly shaped the reform of internal audit practices in the Pan-American Health Organisation, a regional office of the World Health Organisation, and influenced public sector audit and evaluation reform processes in Canada.

“*The Audit Society* has been very influential in our thinking and in Treasury thinking. I was seconded to Lord Sharman’s Review of Audit and Accountability for central government and I know at that time and in the subsequent discussions that the National Audit Office had with Treasury, [that] several ideas from the book shaped the agenda.”

**Jeremy Lonsdale, Director of Value-for-Money, National Audit Office**

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## *Risk management*

Power was a member of the advisory board of the UK Financial Reporting Council's Financial Reporting Lab, which was launched in 2011 to provide a forum for investors and companies to develop pragmatic solutions to reporting needs. He provided input into the reform of the Turnbull Guidance on risk management, part of the UK Governance Corporate Code, which sets out standards of good practice in relation to board leadership and effectiveness, remuneration, accountability and relations with shareholders. Power is specifically cited in Minutes of Evidence to the House of Lords Select Committee in Economic Affairs.

In April 2013 Power gave evidence to the Salz Review, an independent review of Barclays' business practices. His thinking influenced the section on "complaints as a window on culture". The Chartered Institute of Management Accountants (CIMA) cited Power's research in a report looking at how to adapt risk management to align with organisational motives.

One of Power's publications is on the reading list for the Institute of Risk Management professional examinations, and another is discussed in CIMA study notes for professional examination in Management Accounting – Risk and Control Strategy.

## *Other impacts*

Power's research has had wider impacts in fields such as childcare, higher education, medicine and psychiatry. LSE Professor Eileen Munro consulted Power while preparing her report on child protection for the Department of Education, and cited his research in her recommendations around restoring professional trust.

Power's work has also influenced an official investigation into education evaluation in Sweden. Power met the Swedish Education Minister in January 2013 and will be involved in the investigation through the Chair of the report, Leif Lewin, who has drawn on Power's ideas.

Power has also influenced the 2011 design of the UN Principles on Business and Human Rights. These principles address the issue of human rights with regard to the operations of transnational corporations and other business enterprises, including the obligations of business to use surveys and audits in tracking their impacts on groups of people.

In 2011, Power was also invited to be an honorary fellow of the UK Institute of Risk Management in recognition of his "considerable contribution to risk management", which included influencing organisations as diverse as the Railway Safety Standards Board and the Equality and Human Rights Commission.

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the Institute for Risk Management (IRM). He has held visiting fellowships at the Institute for Advanced Study, Berlin and at All Souls College, Oxford. Professor Power was awarded honorary doctorates by the University of St Gallen, Switzerland in 2009, and by Uppsala University, Sweden in 2012.

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