



The Centre for Economic Justice

REMAKING AUDIT

**A PLAN FOR CULTURE
CHANGE AND
REGULATORY REFORM**

BRIEFING 2

**Carsten Jung and
Marco Meyer**

May 2021

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ABOUT THIS REPORT

This report meets IPPR's overall objective of research and education into industry, commerce, and public services. It also meets our objective to advance sustainable development and improve the efficiency of public services.

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INTRODUCTION

The audit industry is often seen as a not very exciting area. Auditors, sometimes referred to as ‘bean counters’, are seen as simply double-checking numbers with little room for judgement. As we showed in our last report, this view is entirely inaccurate. Auditors should fulfil the role of trusted referees who speak up, challenge, and conduct reliable detective work on behalf of society, checking whether businesses report an informative picture about their operations. If the audit sector does its job well, its outputs should be all but boring. However, the sector is a long way away from that. In this report we highlight how to get there.

In our first report (Jung & Nanda 2021), we showed the need for profound reform in the audit industry. In this paper, we flesh out how we think these areas should be tackled, with a particular emphasis on the need for policy changes that trigger culture change in audit firms. While there have been a number of proposals in the other five of the areas highlighted above (which we draw on), recommendations around culture change tend to be particularly under-developed. We aim to fill this gap with our proposals.

Our six key recommendations in this paper are:

1. a broadened purpose, ensuring auditors become trusted referees and making sure that audit-related consulting services work in line with public interest
2. a change to the accounting rules that enable auditors to scrutinise more clearly whether businesses’ payout practices are done in a sustainable way
3. fully implement the recommendations of the Kingman review, building a much stronger regulatory setup, and resource the new regulator with strong enforcement powers
4. a full legal separation of audit and consultancy services as the best way to lay to rest concerns around conflicts of interest in the audit industry
5. set out a framework for assessing organisational culture in audit firms. Building on the organisational behaviour literature, we highlight that this should cover three areas: putting in place policies that **motivate** employees to do the right thing, and ensure members are **responsible** for and **capable** of doing the right thing.
6. support the operationalisation of the framework into an assessment methodology consistent across firms.

In this paper, we put a particular emphasis on culture change in the audit industry – an area that is under-studied and has not been sufficiently covered in the government’s reviews. At present, the culture in audit firms – which the Financial Reporting Council¹ defines as “purpose, values and encouraged behaviours” falls short of living up to its desired standard. The FRC finds that: “In some firms, audit-specific values such as objectivity and independence are not sufficiently prominent”, and in all the audit firms it scrutinised, not enough was being done to manage staff rewards and promotions in line with the societal purpose of audit. Audit firms have begun to change this, but a more rigorous framework is needed to ensure this is fully implemented across the industry.

1 The audit regulator.

Policymakers should rigorously assess progress in this area. There is a risk of culture being treated as an afterthought and for culture change to not be rigorously defined, prioritised, implemented, or tracked.

Audit firms can learn from the approach used in banking reform in the UK following the financial crisis of 2008/09 (see box 1); they should examine their culture regularly and set targets against which to assess progress. There are now established methodologies to assess organisational culture: it can be measured through employee surveys, misconduct metrics, and client feedback, as well as qualitative instruments such as focus groups and interviews. Regulators should urgently require audit firms to work with independent third parties to conduct such reviews.

HOW WAS CULTURE USED IN THE FINANCE INDUSTRY?

The Banking Standards Board (BSB), a self-regulator for the banking industry established in 2015, conducts annual culture surveys of its members, as well as focus groups and interviews. This model provides a suitable starting point for the audit industry (Banking Standards Board 2016). Data on culture in audit firms should also be connected to outcome metrics such as employee turnover, misconduct as well as metrics of audit quality.

The BSB's assessment provides more than 30 banks in the UK with benchmarked evidence about their organisational culture to support them in achieving high standards of behaviour and competence. Underpinning this approach is a framework of nine cultural characteristics expected to be associated with any good culture in banking.

By giving members a view of their performance on these nine characteristics, the BSB provides an account of the capabilities expected to equip members to service its customers, members, and clients well. The nine characteristics against which firms are assessed are: honesty, respect, openness, accountability, competence, reliability, responsiveness, personal and organisational resilience, and shared purpose.

Aggregate results across all members are shared annually on the BSB's website.²

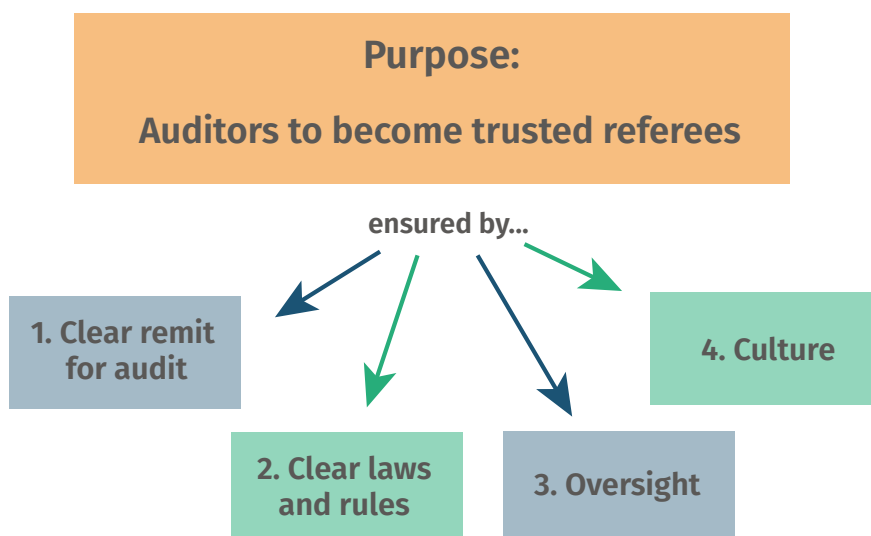
2 See: <https://bankingstandardsboard.org.uk/assessment-results-2020/>

1. THE FOUR STEPS OF ENSURING THE AUDIT INDUSTRY FULFILLS ITS PURPOSE

There are four aspects to ensuring any industry works in line with the public interest (see figure 1.1). The remainder of this paper goes through each of them in turn. They are:

1. **A clear purpose:** In our previous paper, we argued that the audit industry does not currently live up to the role of ‘trusted referee’ of corporate Britain (Jung and Nanda 2021). The first step is thus to make clear what this purpose should entail.
2. **Strong rules and regulations:** The legal constraints and ‘rules of the road’ for businesses, rules and regulations are the highest level of policy ensuring businesses behave as intended. For the audit industry, much of this could be goals-based, and complemented by strong guidance and oversight by an independent regulator.
3. **Regulatory oversight and guidance:** One level down from rules and regulations, regulatory oversight and guidance ensure that firms stick to the rules, but also fill in some more detailed gaps on an ongoing basis, adjusting to new developments and practices.
4. **Culture:** The industry itself is expected to comply with the letter of rules and regulations, which are implemented by regulatory oversight and guidance. But many issues are too detailed and nuanced to put into the above two. Businesses need a culture that encourages their employees to ‘do the right’ thing. We emphasise this part in particular, because it has been largely neglected in the debate.

FIGURE 1.1: HOW TO ENSURE THE AUDIT INDUSTRY WORK IN THE PUBLIC INTEREST



Source: Author's analysis

2. SETTING A CLEAR PURPOSE FOR THE AUDIT INDUSTRY

An organisation's purpose is to solve a problem for people or planet (Mayer 2013). Hospitals help people live healthier and longer lives. Supermarkets give people access to food. The central purpose of the audit industry is to fostering trust in markets, by taking the role of the 'trusted referee' (Jung and Nanda 2021). In the first paper in this series, we outlined four ways in which audit fails and prevents auditors from achieving this goal. A renewed purpose needs to address the problem that auditors are being paid by clients while having their primary obligation to the public. In order to address this, a new purpose should enshrined in law. But firms will also need to translate what this purpose means for them in more detail on a day-to-day basis.

The current purpose of statutory audit is to assess whether business accounts are 'true and fair' (Brydon 2019). But, in practice, information could be 'true and fair' and yet not be useful at all to those requesting them. For example, it came as a surprise to many that auditors did not see it as their responsibility to flag the aggressive accounting practices at Carillion that overstated hypothetical future profits (DWP and BEIS Select Committee 2018). The over-optimistic assumptions underlying these accounts would have been useful for shareholders and others to understand, but they were never flagged because they were seen as justifiable within the rules. Moreover, today, if auditors discover useful undisclosed information that would be useful for investors, they are in fact expected *not* to disclose this information unless it violates accounting rules (ibid).

The government commissioned a review into how the purpose of audit could be improved (ibid) and has adopted many of its recommendations (BEIS 2021). This defines the purpose of audit as: "to help establish and maintain deserved confidence in a company, in its directors and in the information for which they have responsibility to report, including the financial statements".

We agree with Brydon that this should be the high-level purpose of audit. But we think this should be detailed further, to ensure audit firms can gain and maintain the status of 'trusted referees'. As stressed in our first paper of this series, the **purpose of audit explicitly should cover the following four elements:**

1. to detect material fraud
2. to make reasonable efforts to detect financial misstatements
3. to flag rules arbitration and potentially problematic accounting practices³
4. in audit-related consulting activity (see definition below), to live up to the same standards of objectivity and transparency as in auditing activity.

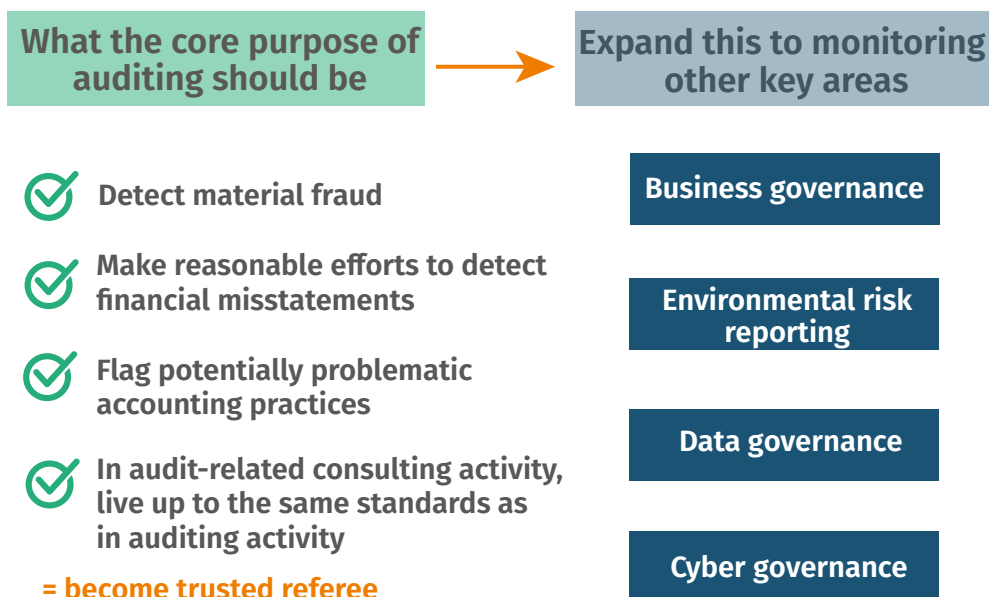
³ As we explained in the first report of this series (Jung & Nanda 2021), rule arbitrage refers to 'cases where rules are not violated but are used and interpreted in such a way that they yield an undesirable outcome from a public accountability perspective. Carillion in as an example for this too – it used potentially legal but aggressive accounting practices to pay out high profits, by emphasising future profits and de-emphasising current costs.'

In order to fulfil this purpose, auditing needs to move away from a ‘tick-box exercise’ (Leaver et al 2019) and towards a more nuanced description of both the financial accounts and the assumptions underlying them. One example of more insightful auditor reporting is “graduated findings”. According to KPMG, “graduated findings involve the auditor giving a view on management’s own judgements on areas subject to particular estimation uncertainty or areas of judgement within the financial statements” (KPMG 2019).

These high-level principles should be enshrined in law on a goals-based basis (Decker 2018). This means the law should stipulate the intended outcome (for example, useful audits) rather than the exact ways in which this is to be achieved. The latter can be delivered through the interplay of regulatory guidance as industry practice evolves. Accordingly, the new audit oversight body should be mandated to devise rules and guidance around these areas, fleshing out further how they should be interpreted in practice.

As per point four above, consultancy services are a crucial part of the corporate governance ecosystem and play an important role in preventing audit failures (Jung & Nanda 2021). For instance, in the case of Carillion, consultancy work by audit firms has been found to have been intimately involved in developing and promoting its ultimately disastrous business strategy and have been described as “looking the other way” (DWP and BEIS select committee 2018). Audit-related consultancy services should therefore also be covered by – and help achieve – the same purpose as audit services. Consultancy is often closely related to audit, accountancy, tax, business strategy, and corporate governance. Therefore, the remit of the new audit regulator should also include overseeing audit-related consultancy services. This could include devising a code for consultancy, address damaging practices as those that contributed to the collapse of Carillion or affect the effectiveness of other regulations (Jung and Nanda 2020).

FIGURE 2.1: ONCE AUDITORS HAVE GAINED THE STATUS OF ‘TRUSTED REFEREES’, THE SCOPE OF AUDIT CAN BE BROADENED



Source: Authors' analysis

We think this should apply to all consultancy providers, whether or not they are part of an audit firm. But it does not have to apply to all kinds of consultancy, but cover four areas which we refer to as ‘audit-related consultancy’:

- consultancy affecting regulatory purposes
- consultancy affecting public policy decisions
- tax advice
- internal audit and assurance services.

If this core purpose of audit is achieved, the scope of audit can then expand to other aspects beyond what is currently the statutory audit, such as the need for rigorous assessment of environmental, social, and governance (ESG) factors, the auditing of algorithms, or cyber and data issues (figure 2.1). Of course, rigorous audit cannot and should not replace regulation in any of these areas. But auditors help assure information provided to external stakeholders on these issues is of high quality and decision-useful, including informing them how businesses are complying with regulations (figure 2.1).

3.

REFORMING RULES AND OVERSIGHT OF THE AUDIT INDUSTRY

In the previous section, we have addressed the issue of setting a clearer and broader purpose for the audit industry. In this section, we address three further areas that need reform: rules, oversight, and competition.

RULES

Accounting rules are the legal obligations, guidelines, and industry practices that determine how businesses' financial accounts can be compiled. There can be prescriptive rules-based regulations, as well as more high-level, goals-based regulations which are complemented by more detailed regulatory guidance (Decker 2018). As mentioned in section 2, we think audit and corporate governance should be driven by goals-based regulation, in order to avoid practices that comply with the rules but fail to achieve the outcomes expected by society.

As we highlighted in our first report, today's accounting rules leave significant leeway for a number of problematic practices (Jung and Nanda 2021). One of the key problems is that they allow the pay-out of profits today on the basis of overly-optimistic assumptions about the future. Notably, this contributed to the collapse of Carillion (ibid.).

Baker et al (2020) propose two essential rule changes that would help address this issue. Firstly, they have proposed addressing this through **strengthening the capital maintenance regime**. They argue for the need to “repurpose the corporation... through a stronger recognition in company law and accounting rules that management's core obligation is to protect the capital base of the company so that it may withstand shocks and serve the needs of multiple stakeholders”. Auditors in turn would check how, and to what extent, businesses are complying with the updated capital maintenance regime.

Secondly, **rules on fair value accounting should be changed** in order to leave less room for broad assumptions about future profits. Profits should be based on actual transactions rather than subjective estimations of future cashflows, which fuel both excess distributions and 'procyclicality'.⁴

The government's recent audit white paper (BEIS 2021) does propose stronger guidance around what earnings firms can distribute. But it puts all the onus on the new audit regulator and does not anchor it in law in a goals-based way. Moreover, it should be clearer on the need to prevent the use of subsidiaries (across international borders) by businesses to increase the amount they can pay out to shareholders.

REGULATION AND OVERSIGHT

Regulation should address poor quality accounting and auditing, increasing the risk of it being discovered and the costs that discovery would generate. In its recent white paper, the government has proposed sweeping changes to the regulatory landscape, turning the current regulator into a new agency called the

⁴ In other words, they are correlated with, and help increase the volatility of, the business cycle.

Audit, Reporting and Governance Agency (ARGA). Our three suggested priority areas for change are as follows.

- **More investment in staff.** As of 2019/20, the FRC had only 227 staff (FRC 2020b). The new agency will have a broader remit and will need more resources to ensure checks of audits can be done in sufficient depth.
- **Statutory powers to scrutinise all aspects of the audit firm, including things beyond statutory audit.** This should include doing regular thematic reviews whether audit firms are putting in place the necessary steps to deliver on their purpose. Crucially, this includes expanding the power of the regulator to also include oversight of audit-related consultancy providers (whether or not they are part of audit firms).
- **The regulator needs to be independent and challenging.** Strict rules should be in place that ensure there is no real or perceived conflict of interest for regulators. This should include significant cooling-off periods, meaning a fixed period of time needs to have passed if an employee switches between the industry and regulators, and ensuring that regulators do not get to work on the firms that have previously employed them.

Finally, as we outlined in our previous cross-selling paper, a key pillar of reform should be to **address the appearance and risks of conflicts of interest in audit firms**. The potential for conflict stems from cross-selling consulting services. There are now limits and ethical guidelines for audit firms when selling consulting work to their audit clients (FRC 2019). But there are signs that these are insufficient. For example, audit partners in some divisions have persistently received higher compensation than warranted by the profits of the division (Ishaque 2018). It is still commonplace for audit firms (though not individual audit partners) to seamlessly change from being a firm's auditor to becoming its consultant.

The current approach to addressing conflicts of interest between the audit and non-audit arms of firms is to move towards operational separation between these different organisational groups (FRC 2021). This approach has the advantage of preserving economies of scale and scope in audit firms by continuing to allow them to make use of resources across business branches. However, it comes at the cost of very detailed regulation and oversight to ensure that conflicts are indeed fully prevented. The FRC has started the process of implementing this, but has called for further powers to enforce it (FRC 2020a). For operational separation to truly do away with risks of conflicts of interest, the complexity and intrusiveness of regulation will likely increase further. As Kingman (2018) argued, a full legal separation would have the benefit of a 'clean ring-fencing', such that the cross-subsidy could not occur.

We believe that a full legal separation of audit and non-audit arms of firms would ultimately have the best cost-benefit trade off. Given how important it is for the economy at large that auditors become trusted referees, we should place a high premium on ensuring that there is no real or perceived conflict of interest. In line with the BEIS Select Committee (2019), we believe that audit-only firms will be able to build up significant expertise in-house, and will be able to purchase further expertise in the market. Audit may become more expensive as a result, but this would be welcome if it comes with increased audit quality, increasing trust in its independence and ability to challenge. There may be other ways to resolve this trade off, but the burden of proof is on audit firms to show that these would be more cost effective, from a public interest perspective, than Kingman's 'clean ring-fencing'.

In the third instalment of our series of papers on audit reform, we will flesh out the above arguments further, directly responding to the government's white paper (BEIS 2021). In the remainder of this paper, we turn to culture. This often-neglected aspect of bringing corporate behaviour in line with societal objectives features only peripherally in the government's review. We therefore look at it here in detail.

4. CULTURE

Even with our above recommendations on purpose and regulation in place, audit firms might still not behave in an optimal way from a public interest perspective. To achieve this, audit firms need to cultivate an ethical organisational culture. Culture is a critical component in any attempt at reforming the audit industry. Delivering culture change in the audit industry has been recommended by the Brydon (2019) review. And FRC has started to consider this issue albeit with a limited set of actions (FRC 2020a).

But there is a risk of culture being treated as an afterthought and for culture change to not be rigorously defined, prioritised, implemented, or tracked. In this section, we aim to outline a systemic view of how culture change in the audit industry can be approached, followed by concrete policy suggestions that can help put it into practice.

We define an organisation's culture as the shared practices and values that influence how members of the organisation act and behave (Mayer 2014). By 'practices' we refer to the ways things are done in an organisation – from the way meetings are conducted, to how technology is used. 'Values' refer to the norms an organisation holds; for example, care, meritocracy, or fairness. The values that actually influence behaviour in an organisation often differ from those found in its statement of values. Practices and values need to be 'shared' by a meaningful part of the organisation – although not necessarily by everyone and not to the same extent. Many organisations contain different subcultures, endorsing competing values and practices.

Organisational culture has a profound influence on how people act and behave in an organisation, and, most importantly, it can act as a backstop against misconduct (Salz 2013). Misconduct is often attributed to individual 'bad apples' in an organisation, and sometimes to conflicts of interest or pressures common to the industry. In between individuals and industry-wide structures, organisational culture exerts a strong influence on actions by signalling to people what is acceptable and what is valued behaviour (Epstein and Hanson 2020).

Regulators can play an important supporting and monitoring role in embedding an ethical culture at audit firms. First, regulators can request that firms report on their strategy for building and maintaining an ethical culture. Second, regulators can require audit firms to assess their culture. Third, regulators can enable collaboration between firms by encouraging the use of the same metrics for measurement and creating forums for sharing best practices. Fourth, regulators can improve public accountability by requiring audit firms to publish their metrics and strategies around building an ethical organisational culture.

“ There is a risk of culture being treated as an afterthought and for culture change to not be rigorously defined, prioritised, implemented, or tracked. ”

Introducing a strong ethical organisational culture can be required by government and regulatory policy, but ultimately it has to be put into practice out by the firms themselves. Building an ethical culture requires sustained commitment from leadership and business areas of the company. Organisations need to take responsibility for building a sound ethical culture that checks any negative behavioural tendencies of individuals, and prevents conflicts of interests and pressures leading to misconduct.

THE CULTURE PROBLEM IN AUDIT

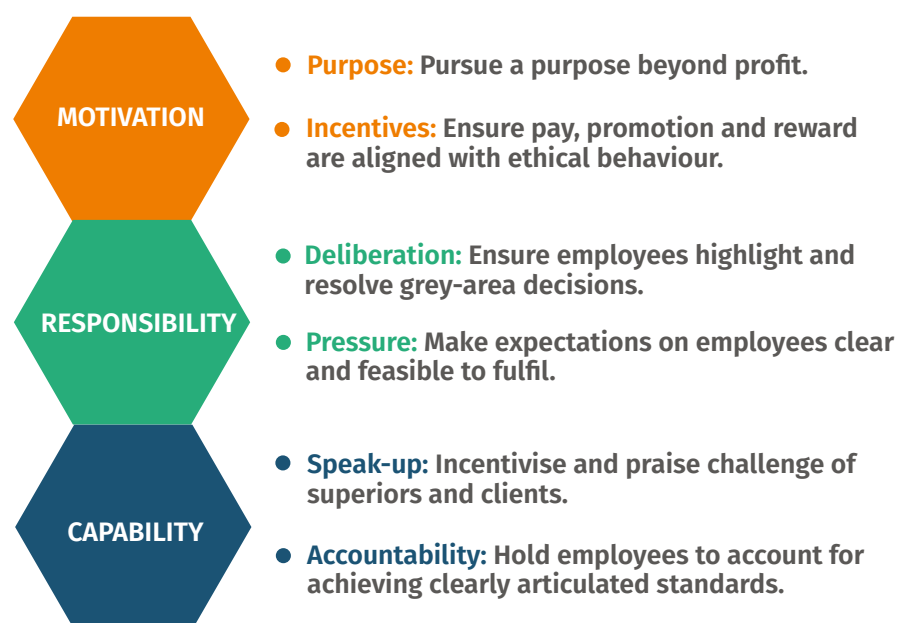
As outlined in the first paper of this series, there a serious problem of insufficient challenge of management. Auditors' career incentives are too reliant on giving 'good news' rather than flagging 'bad news'. While firms have taken steps to address this, a more comprehensive, industry-wide change is needed, which will have to be partly driven by policy.

Research focussed on audit firms confirms the importance of culture for ethical decision-making: the ethical culture of audit firms and whether the firms' purpose emphasises the commitment to the public interest are important determinants of ethical decision-making (Barrainkua et al 2018). Moreover, the commitment to acting in the public interest and the organisational culture of the firm reinforce each other, leading to either virtuous or vicious cycles.

THE KEY ELEMENTS OF AN ETHICAL ORGANISATIONAL CULTURE IN THE AUDIT INDUSTRY

We define an *ethical* organisational culture as consisting of shared values and practices that support employees in consistently doing the right thing. Such a culture should **motivate** employees to do the right thing, and ensure that members are **responsible** for and **capable** of doing the right thing. We break these components down to the six key elements of an ethical organisational culture in the audit industry.

FIGURE 4.1: THE SIX ELEMENTS OF A STRONG AUDIT CULTURE



Source: Author's analysis.

ESTABLISHING AN ETHICAL PURPOSE IN AUDIT FIRMS

In chapter 2, we have outlined a clear purpose for the audit industry: that auditors should become ‘trusted referees’ by preventing four types of audit failure. Aside from clear public expectations enshrined in law, purpose is one of the most important elements of an ethical organisational culture. Organisations need to clearly state what their purpose is, but they also – crucially – need to operate accordingly. Employees need to be able to connect their day-to-day work with the purpose of the organisation. In organisations that align their decisions and operations with their purpose, purpose can serve as a powerful ‘north star’ for employees, protecting against bad decisions and even misconduct. On the flip side, organisations that fail to articulate a purpose beyond profit, or fail to put it into action, breed cynicism in their workforce. Cynicism about purpose leads to moral disengagement, lack of consistent decision-making, higher incidence of misconduct and lower audit quality.

“organisations that fail to articulate a purpose beyond profit, or fail to put it into action, breed cynicism in their workforce

What can audit firms do to implement a strong ethical purpose?

- **Firms need to articulate a purpose:** Building on the purpose outlined above, audit firms need to articulate how they interpret the purpose of ‘trusted referee’ across all their business activities.
- **Act on purpose:** In order to deliver on their purpose, audit firms and audit-related consultancy providers need to establish binding guidelines for the design and delivery of audit, tax, and advisory services that go beyond the letter of the law. Audit firms also need to clearly align business strategy with their purpose and disclose how they are doing. Corporate strategic decisions at audit firms today are typically motivated by growth and profitability, giving employees and stakeholders the impression that only these criteria count in practice. Instead, business strategy should be evaluated in light of the purpose of audit firms; risks to achieving its purpose need to be identified and mitigated; and leaders need to reference the organisation’s purpose consistently in their decision-making. As in finance, the regulator would regularly assess whether firms put in place actions to ensure they deliver on their purpose.

SETTING THE RIGHT INCENTIVES

Incentives are the ways in which employees and partners are rewarded and recognised. Pay and performance bonuses for employees and structure of partner compensation are crucial incentives in audit firms. But opportunities for promotion, for working on more rewarding projects, and other ways of conferring status and prestige also drive employee and partner behaviour.

At the heart of the incentive structure in the audit industry are three conflicts of interest that put pressure on the mission of auditors to challenge their clients.

1. The conflict created by audit firms being paid by clients while having their primary obligation to the public.
2. The conflict of interest between the integrity of an audit and an audit firm’s financial interest - when losing the revenue stream from a large company can affect a partner’s career, they are less likely to challenge clients.

3. The conflict between keeping audit costs for clients low and profits for audit firms high on the one hand, and doing the work necessary for a high-quality audit on the other. Research shows that higher audit fees tend to be correlated with higher audit quality (Eshelman et al 2013). Spot checks by regulators consistently find that average audit quality is low, which suggests that audit quality could be improved by investing more in audits (Jung & Nanda 2021). This relates to the first point above: the level of investment in audit demanded by clients may not be the same as the socially-optimal level.

While conflicts of interest raise red flags, they can be addressed by cultural drivers as well as appropriate systems and controls. Conflicts of interest are common in many industries, and there are structural similarities between audit firms and other professional service firms such as law firms and consulting firms. However, audit firms have a special obligation to mitigate conflicts of interest because, in contrast to other professional services firms, their primary responsibility is to the public. Audit firms should thus build sound systems and embed cultural values to address conflicts of interest.

In particular, audit firms can shape the behaviour of their partners through compensation schemes. At present, commercial success is paramount in determining partner compensation, whereas professional quality plays a minor role (Vandenhoute et al 2020).

What can be done about it?

- **Reform partner compensation.** The compensation of partners in audit and consultancy arms should be fully separate. As we argue above, we judge that the most cost-effective way of achieving this is a full legal separation of audit and consultancy practices. Absent legal separation, it is difficult and intrusive to ensure there are no cross-selling activities by audit partners to the consultancy side. Instead, as suggested by the FRC, the amount of profit distributed to the partners of any one company's audit practice should not persistently exceed the value implied by the profits of the division itself.⁵
- **Reward audit partners for audit quality:** Audit firms must develop mechanisms to reward audit partners for quality. This requires monitoring of audit quality that goes beyond the spot checks that regulators occasionally carry out. This should be part of the regulator's responsibility. In addition, audit firms can empower an external auditing board to make decisions about the quality-related bonuses for partners. If the same external board determines quality-related bonuses for partners across the Big Four, this can additionally inspire competition for quality between the firms.

DELIBERATION

Deliberation is the capacity to become aware that you are facing an ethically charged decision and to exercise sound judgement when facing 'grey-area' decisions. Awareness is an important prerequisite of sound decision-making. Many cases of auditor failure start off as a mere fudge. It is on the slippery slope starting off with this initial fudge that corporate accounting scandals are made. A case in point is the Italian food company Parmalat. In 2003, an investigation uncovered a multi-billion-dollar black hole in its books, which led to the collapse of the company. This fraud had started off in 1990 as an attempt to hide operating losses in its South American subsidiary. The company feared that if they reported the losses, it would be more difficult to raise capital for future acquisitions.

⁵ This too is not an ideal solution as it is very crude. Again, this is why we believe a legal separation has the highest cost benefit calculation.

Once auditors recognise an issue that is not clear cut, they need the tools to work through grey-area decisions. This will be particularly important if, as we argue above, society expects increasing amount of judgement from auditors.

But, at present, audit firms may be sending their employees and partners the wrong signals leading to deliberation being insufficient. Research shows that when auditors become managers, they perceive a shift in the demands the firm places on them. Exactitude and professional scepticism drilled into junior auditors during training counts for less than performing in front of clients. The shift to manager leads some to leave their careers, because they cannot square their professional self-image with the commercial expectations placed on them (Kornberger et al 2011). Some partners report that they feel 'on their own' when making decisions about whether to confront an important client. Research on deliberation skills in audit finds that the ability to work through difficult ethical decisions increases with career progression from new joiners to managers, but is much lower for partners than for managers, suggesting that mature ethical judgement is not an advantage in the promotion process to partner (Rest and Narv 1994).

“*Exactitude and professional scepticism drilled into junior auditors during training counts for less than performing in front of clients.*”

Moreover, challenging clients on grey-area decisions risks negatively affecting the audit firm's relationship with them. Perhaps the most important cultural value thus is for audit firms is to stand by auditors who challenge clients, even where this risks extra work and therefore eating into slim margins on audit projects, or even losing an important client account. In turn, to make the economics of this work in practice, there need to be significant fines for firms failing to do the right thing and challenge clients where necessary.

What can be done about it?

- **Improve deliberation skills:** The training of auditors should be enhanced to address grey-area decision-making. One action that should be taken is to heed the call of the Brydon (2019) review to integrate elements of the curriculum for forensic accountants into the training of auditors. Another is to integrate insights from the psychology of decision-making into the curriculum, to raise awareness of the 'slippery slopes' that can lead to violations of audit standards. Partners should be a particular focus of these efforts.
- **Celebrate courage:** Audit firms need to signal in their actions to employees and partners that the firm will have their back when they challenge clients. Leadership and partners should seek opportunities to publicly celebrate cases of challenging clients, especially when it leads to uncovering fraudulent behaviour. When challenging a client does not result in uncovering problems, partners and staff still need to feel that the firm has their back. Building a culture of professional scepticism requires that auditors see colleagues who challenge superiors and clients advance in the firm.
- **Build institutional memory:** Audit firms should openly discuss past cases of audit failure, and routinely analyse their root causes with new joiners. To this day, the space agency NASA analyses the root causes of the explosion of the spacecraft Challenger in 1986 during their onboarding process. This helps organisations build the institutional awareness that protects them from repeating the same mistakes.

PRESSURE

Employees are under pressure if their workload is higher than what they can feasibly do within the required time. Pressure in the audit industry is high; research finds that staff auditors consistently underreport time during busy season, stating that they would not meet the budget if they were to charge for all the time they actually spend (Sweeney and Pierce 2006). Budget pressure is the expectation to complete work within a certain number of chargeable hours. However, deadline pressure, the pressure to complete a job by a certain date is experienced as the strongest driver of pressure. As one auditor put it in response to a researcher: “Yes if you do blow your budget you will have to go and explain it, actually ironically it’s very rare that you blow your budget ... you actually physically can’t because you don’t have enough hours to blow it” (ibid). Deadline pressure can be imposed by the client, or internally in the process of planning the audit.

“*Time pressure also creates a strong incentive not to report a potential audit irregularity, because addressing the irregularity will likely create more work and slow things down.*”

Pressure on staff auditors during ‘busy season’ is often so intense that it may compromise audit quality. Challenging performance goals and time pressure are consistently identified as important drivers of unethical behaviour (Belle and Cantarelli 2017). In audit firms, pressure during busy seasons can become so intense that staffers have insufficient time to rest. This atmosphere makes it more likely that auditors will cut corners to get through work despite insufficient time allocated to it.

Time pressure also creates a strong incentive not to report a potential audit irregularity, because addressing the irregularity will likely create more work and slow things down. Pressure also flattens auditors’ ability to perceive potential issues in the first place.

The amount of time pressure varies greatly across audit teams. Audit partners and senior auditors bear primary responsibility for setting the parameters and cultural norms for how to deal with pressure. In the extreme, seniors explicitly ask auditors to underreport chargeable time. It is more common, however, for signals to reach employees implicitly (Sweeney and Pierce 2006).

What can be done about it?

- **Institutionalise shadow time reports:** In addition to existing time-reporting practices, audit firms should commission an external body to regularly conduct surveys asking about hours worked, explicit and implicit requests for under-reporting of chargeable time, and metrics of physical wellbeing.
- **Test for red flags on pressure:** These metrics should be collected consistently across firms and results should be made available to regulators. The external body should analyse data to identify audit partners whose teams consistently under-report time, and work with firms to address this; with measures ranging from additional training for audit partners on how to set an acceptable culture, to reducing their compensation, to dismissal in repeated and extreme cases.

SPEAK-UP

‘Speak-up’ is the disposition of junior staff to challenge their superiors and to raise potential accounting irregularities to their supervisors. Junior auditors conduct the bulk of audit tests and collect the vast majority of evidence, but often decide not to speak up about potential irregularities (Vandekerckhove 2016). Since supervisors

and partners have no independent way of raising issues outside the work of junior staff, this behaviour puts the quality of audits in jeopardy.

Hierarchical organisations face a common challenge in building a ‘speak-up culture’ (Kish-Gepart et al 2009). Employees in large and complex organisations fear negative consequences to themselves or others for ‘being difficult,’ or have resigned because they have experienced supervisors failing to act when issues have been raised. Long hours and work pressure further discourage junior auditors from speaking up; after all, speaking up about irregularities will most likely lead to additional work.

In addition to these common problems, audit firms also seem to cultivate a culture that creates challenges to speak up. Research shows that many junior auditors hesitate to raise issues to certain types of supervisors more than others. Overall, junior auditors mostly turn to peers for advice, but they systematically underrate the importance of raising issues compared to their supervisors (Griffith et al 2020). As a result, junior auditors act on advice not to raise issues that their superior would deem important.

Advice on whether to raise an issue is more sensitive to cultural factors than to the importance of the issue. The most important cultural determinant of whether employees are willing to raise issues is the expected reaction of supervisors (Pickerd et al 2012). In particular, whether senior staff provide feedback about issues raised is an important factor in whether or not a junior auditor decides to raise issues. Expectations of no or low-quality feedback that arise from prior experiences dampen the appetite of junior auditors to speak up. Unfortunately, such experiences abound.

What can be done about it?

- **Improve feedback quality to junior auditors:** Firms need to ensure that senior auditors and partners provide timely feedback to junior staff who raise issues. High-quality feedback explores whether an issue was addressed and why, and describes the steps taken in detail.
- **Train junior auditors to encourage speak-up:** To prevent junior auditors from discouraging each other to raise issues, early training should specifically address the social and psychological dynamics on audit projects and emphasise the obligation to raise issues. Audit firms should regularly survey audit staff to track their willingness to raise different types of issues.
- **Tell stories of failure:** One of the most powerful ways to build a speak-up culture is for partners in the firm to openly talk about failures and near-misses due to lack of speaking up. These stories function as cautionary tales and set a tone from the top that encourages speaking up.

ACCOUNTABILITY

Accountability is the assurance that individuals or organisations will be evaluated on what they do and how they do it according to their responsibilities. The partnership structure of audit firms has ambivalent effects on accountability (Bedard 2008). On the one hand, partners are highly accountable for business outcomes through performance-based compensation schemes. But on the other hand, partners enjoy a higher degree of autonomy and are subject to less oversight than managers in more hierarchically-organised companies.

As a result, there is huge variability between the ways in which auditors run their teams. Variability can be positive if the work environments partners create are consistent with an ethical culture; audit firms would then present staffers with a

choice between a range of work environments with characteristic advantages and disadvantages. But accountability in audit firms is currently insufficient to foster a consistent ethical culture. We have seen above that not all is well concerning the culture of audit firms, especially concerning the ability of partners to encourage speak up, keep pressure at a reasonable level for employees, and work through difficult judgement cases.

In addition to a lack of oversight, the dependence of staffers on the support of partners for assignments to interesting projects and promotions creates a barrier to holding partners to account. In the extreme, partners run audit teams as ‘personal fiefdoms’, with little risk of being held to account. Many staffers fear negative repercussions if they complain about partner behaviour. Even if there is no retaliation, staffers risk the withdrawal of support from partners they speak up about.

A common trope in audit firms is that certain partners in particular can ‘get away with anything’. Some of these partners are ‘rainmakers’ – particularly commercially successful partners – and there is a perception that firms are more willing to look the other way in issues involving these partners, rather than risk losing substantial income for the firm. Others are ‘lifers’ with strong networks in the partner community. Understandably, partners find it more difficult to hold a senior peer to account who has had a hand in advancing their own careers.

The autonomy of audit partners can turn into a liability for them. Autonomy can also be experienced by partners as being left alone with difficult decisions and challenges. Anecdotally, some audit partners report that they felt abandoned by the firm when their audits were scrutinised by the regulator about quality.

The pressure points for accountability that are characteristic of partnerships need to be carefully monitored and managed. The key is to keep control processes effective by constantly testing them and subjecting them to external scrutiny.

What can be done about it?

- **Conduct independent culture reviews:** Firms should be required to commission external bodies to conduct culture reviews with a mandate to collect data sufficient to spot red flags about the behaviour of individual partners and the perception of staffers about the culture. These reviews should be available to regulators, and the same process should be followed at all firms to enable comparability.
- **Strengthen partner accountability:** Firms should make partners accountable for the quality of the culture they create in audit teams, particularly with respect to aspects that most influence audit quality, such as speaking up, pressure, and deliberation. Poor performance on externally-collected metrics should factor into partner compensation and, in the case of repeated performance below thresholds, lead to disciplinary consequences.
- **Strengthen firm accountability for partner behaviour:** Firms should be accountable to regulators for showing that they have taken appropriate action to address red flags in partner behaviour. If problematic behaviour by partners persists, regulators should be able to impose penalties the firm.
- **Establish an ethics counsel:** To address the problem of audit partners being ‘left alone’ with difficult decisions, firms should create an ethics counsel within the office of the general counsel.⁶ Some law firms have done this to give partners a channel to raise difficult decisions and as a point of call to discuss when partners think they may have made a mistake.

6 The head of a company’s legal department.

5.

A PUBLIC POLICY ROADMAP FOR CULTURE CHANGE IN AUDIT

The new audit regulator ARGA should conduct oversight and hold audit firms to account for building an ethical organisational culture. Specific examples of this, highlighted in the previous section, include the following.

- Ensuring firms develop and deliver on purpose. As in finance, the regulator would regularly assess whether firms put in place actions to ensure they deliver on their purpose.
- Unless legal separation is achieved, ensuring there is no significant cross selling of audit-to-consultancy services, as measured by partner compensation.
- Monitoring whether firms put in place structures that reward audit quality.
- Ensuring firms reward and champion challenge and speak-up, and putting in place fines where the absence of this led to audit failures.

To do so, the government should legislate for ARGA to take the following four steps.

1. SET OUT A FRAMEWORK FOR ASSESSING ORGANISATIONAL CULTURE IN AUDIT FIRMS

We recommend that ARGA should set out broad standards for firms to establish an ethical risk culture. This approach is less intrusive and has a better chance of succeeding than prescribing a particular culture and a way of implementing it. Audit regulators can learn from the approach the Financial Standards Board took after the financial crisis of 2008/09 in providing a framework for assessing risk culture (FSB 2014).

A culture framework for the audit industry can help establish common standards and language to approach organisational culture. This framework should cover the elements of culture described in this paper as well as additional elements to be identified in consultation with researchers and practitioners.

The framework should also outline ways to manage organisational culture, such as communication from the top and from the middle, internal and external communication, and relevant policies and processes. For each component, the framework should set out broad expectations, yet leave room for firms to determine how to embed them.

2. SUPPORT THE IMPLEMENTATION OF THE FRAMEWORK INTO AN ASSESSMENT METHODOLOGY CONSISTENT ACROSS FIRMS

Audit firms should measure their culture regularly and set targets against which to assess progress. There are now established methodologies to assess organisational culture. Culture should be measured through employee surveys, misconduct metrics, client feedback, as well as qualitative instruments such as focus groups and interviews. Qualitative measures consist of controlled interviews with an organisation's leadership and

employees as well as employee, customer, and other stakeholder surveys and focus groups (Salz et al 2013). While these surveys and interviews have traditionally formed the core of culture research, these qualitative methods are increasingly combined with quantitative measures (Mayer 2014). Most recently, some have started using natural language processing and network analysis, for example on the frequency and patterns of email exchanges, as contributing inputs to measure culture.

In light of the pressure points on accountability and speaking up, regulators should require audit firms to work with independent third parties to conduct the review. Audit firms can learn from the approach that banks took in the UK. The Banking Standards Board, a newly established self-regulator for the banking industry, conducts annual culture surveys at its member base as well as focus groups and interviews. Its methodology provides a suitable starting point for the audit industry (Banking Standards Board 2017). Culture data should also be connected to outcome metrics such as employee turnover, misconduct, and loss data, as well as metrics of audit quality.

3. MAKE AUDIT FIRMS ACCOUNTABLE FOR REPORTING ON THEIR ORGANISATIONAL CULTURE

Benchmarked results from assessments should be shared with regulators. The new ARGA should require audit firms to provide a plan on how to address cultural weaknesses and vulnerabilities, especially those that fall below critical thresholds established by the regulator.

Regulators should also require firms to address any concerning patterns in reports from the audit teams of individual audit partners, ranging from training to disciplinary action in the case of severe and repeated underperformance.

The outcome of this consultation process should be a set of actions that each firm commits to conducting in the course of the year and a set of targets for the subsequent round of the culture assessment. Actions should at a minimum focus on the six elements of culture that are critical for ethical behaviour in audit firms (as outlined in this report), and any additional areas of concern. Auditors should penalise firms that repeatedly fall short of their commitments.

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