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Building a culture of challenge in audit firms

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Preface

Auditing today faces a crisis of trust, an especially perverse situation given the audit's central role in fostering trust in markets. The depth of public distrust in auditing is connected to the wider public disillusionment in capitalism. To many, the capital market system is no longer seen as enabling economic mobility, but rather as an insiders' club that enriches wealthy shareholders and their intermediaries — corporate management, bankers, and, worrisomely, auditors — at the expense of ordinary savers, employees, and citizens. Whether this perception is entirely or even substantially supported in empirical fact is somewhat irrelevant, because the perception has eroded trust in markets, and trust is, of course, what makes markets work.

I have been called in the media one of the "fiercest" critics of audit firms — and indeed some of my prior academic work has reported on the subversion of competition by, amongst others, auditors — so it bears explaining why I am writing this paper. In a nutshell, it is because I know of no better system than market capitalism to sustain liberty and create prosperity — and market capitalism cannot function without a robust audit function. If we do not save auditing, we cannot save capitalism.

Restoring public faith in auditing will require action from many players, but above all it will require action from the audit firms themselves.

Restoring public faith in auditing will require action from many players, including investors, client boards and management, regulators, the media, and civil society. But above all, it will require action from the audit firms themselves. This is the primary focus of this brief paper: What can audit firms do to reclaim their position of responsibility in society? To that end, I am especially focused, in this paper, on the "culture of challenge" within audit firms. This is the culture that empowers rank-and-file auditors to do their job without fear or favour — to hold to account the client management's reporting on business performance and prospects. If auditors did more of this, perhaps that would abate some of the concerns about insiders' expropriation of wealth and returns that have given capitalism a bad name.

The paper describes what it takes to build a culture of challenge within an audit firm, with a particular focus on enabling the audit engagement team. The paper draws on my own understanding of the field and my experience teaching management in professional schools. I have also drawn on a number of informal conversations with employees, regulators, and clients of audit firms. The paper does not offer a comprehensive assessment of the current state of the culture of challenge within audit firms — such an assessment would require a formal, academic study, which this paper is not. Rather, it is a succinct summary of recommended actions for audit firms to undertake if they seek to do right by their privilege.

Introduction

Two broad challenges to the audit industry have emerged in the public debate in recent years. The first is that auditing has lost an element of its professional identity: auditors are no longer perceived as market custodians acting in the public interest but as ordinary counterparties acting by the "morals of the marketplace" (to borrow from Judge Benjamin Cardozo). Auditors were ennobled with a public charter — one of the highest dignities afforded by the state to tradesmen — in recognition of their bedrock status to markets, but we worry that auditors today have, at best, a variable salience of that foundational identity.

The second challenge is that auditors are too cosy with the managers of companies they audit — that the real clients, the shareholders, and wider stakeholders in those companies are underserved. Here, what draws most ire is the potentially pernicious and corrupting influence of high-margin consulting services by audit firms. We worry that with such consulting, broadly defined to include any service other than that of the statutory audit, auditors have become conflicted in their stewardship mission.

The breakdown in trust between the public and the audit firms comes at a time when trust in capitalism itself is reportedly at its lowest since the Great Depression.

These challenges, and the associated concerns, have resulted in a breakdown of trust between the public and the auditing profession. The profession that is in the business of trust is no longer trusted. And this at a time when trust in markets and capitalism itself is reportedly at its lowest since the Great Depression — perhaps that is no coincidence.

A large part of the current angst about capitalism emerges from the aftermath of the 2008 Financial Crisis and the impression that the financial system is not generating sustainable value across society — that is, value that benefits a wide range of society and returns proportionate to risk. Audit firms have been implicated by the general public in this non-performance, and the public is especially angry that auditors have not been able to stop (or, at least, have not generated sufficient forewarning of) major corporate collapses, even as some executives and inside shareholders have been well rewarded. Auditors, who were once seen as watchdogs against such extractive behaviour, are now sometimes seen as enablers of it.

The foremost question for audit firms is how they want to respond to this moment of scrutiny.

Building a culture of challenge to address the concerns

The demand for auditing in modern, complex economies arose from the recognition that managers of client organisations have incentives to manufacture favourable realities of their own performance and of the financial position of their companies. The role of the auditor is to probe those manufactured realities, to determine if they can be sustained in an objective truth — put differently, to "verify," which as the word's Latin origins suggest, is to "make true" such accounts by client managers. The core work of the audit is backward looking — it involves verifying past transactions for authenticity. But, critically, some of it is not — the audit also requires projection into the future, to test for the economic soundness of the client management's assumptions. This is a question of judgement, where auditors can add great value to markets.

Doing so requires professional scepticism, which is a questioning mindset. But it also requires a setting that allows individual audit professionals to exercise that questioning mindset; a setting that necessitates individual auditors to call on managers to prove or justify their judgements about realised and expected performance. Nurturing such a setting — a "culture of challenge" — is one of the primary responsibilities of the audit firm. It is at the heart of how such firms add value in markets and organisations.

An audit firm with a thriving culture of challenge is one that is naturally focused on the custodian role of member auditors to its ultimate clients and the public, undistracted by other potentially conflicting economic interests.

The notion of a thriving culture of challenge within audit firms can appear goading or off-putting to some, particularly client managers at whom such challenge is directed. After all, very few managers at client companies are likely to have intent to defraud, and even bias amongst client management can, perhaps, be handled without overt "challenge." These are not unreasonable observations, and my own intent in describing how to build a culture of challenge emphasises a culture that promotes disagreement without being disagreeable.

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That said, "good" client managers will respect an auditor who challenges, because they see the long-term value from such challenge. But the audit is not just for good client managers; it is distinctly relevant when client managers do not respect challenge. That is, in effect, why audits are mandatory and why auditors are empowered with a public charter. And, moreover, the hard reality is that there are more "bad" client managers than we would all like to believe. Indeed, if there were more good client managers in the economy, then audit firms would already enjoy thriving cultures of challenge, because this would be the market equilibrium, and I would not be writing this report, and you would not be reading it.

There couldn't be a more urgent moment for the firms to refocus on building the culture of challenge. In the wake of the last major public crisis in auditing, after the Enron and WorldCom collapses in 2002, the emphasis was largely on rejuvenating professional scepticism across individual auditors. But the crisis today is far more systemic — with capitalism in the West today experiencing deep unpopularity, populists on both the political left and right are calling for increasing restrictions on markets. If capitalism is to remain legitimate in the public's eye, the public needs to know that audit firms take seriously their responsibility to empower challenge within the market economy. Anything short of that would be both an abrogation of duty and a missed opportunity for audit firms.

Many in the audit profession have responded by framing the public's anger as an "expectations gap" — the notion that the public expects something of auditors (for example, preventing client bankruptcies) that they are not really set up to do. Quite frankly, this framing is read by critics as a deflection of responsibility — it is the audit profession telling the public, "Yes, there is a problem, but it's not our job to address it."

For the audit firms, the danger with this approach is two-fold. First, it does not mollify the critics, who are then unlikely to change their mind about audit firms. Second, and perhaps more importantly, it sets up a narrative where the audit practice is relegated to the periphery on one of the most important issues in society today — how to create a sustainable model of capitalism. Rank-and-file employees within audit practices will see themselves as second-order players in the business world, and the very best and most energetic amongst them will want to fly to organisations that are willing to tackle the issue. As I overheard one young recruit say, "The difference between auditing and consulting is that in consulting you are naturally adding value." This is, of course, simply not true: auditing, too, naturally adds value when it works, but the sentiment highlights how audit firms can frame themselves into irrelevance.

The implication here is that audit firms are well served to unambiguously and boldly embrace the wider public's challenges to capitalism. If the firms are not seen as being willing to tackle those first-order challenges around disproportionate risk-taking and unequal distribution of returns, then their member auditors will find it harder to believe that the audit firms are genuinely willing to scrutinise individual client practices for economic sustainability. And this is, all told, what auditors are expected to do and can create great value by doing.

Building a culture of challenge takes: People, with the technical judgement to challenge; Shared beliefs that the organisation will support people who challenge; an Alignment structure that rewards challenge; and Processes that normalise the practice of challenge.

The essential elements of a culture of challenge

What does it take to build a culture of challenge in audit firms? It takes: People, with the technical judgement to offer meaningful challenge; Shared beliefs that the organisation will support its people in exercising that challenge; an Alignment structure that recognises and rewards employees who challenge; and Processes that normalise the otherwise uncomfortable practice of challenge. To identify these four elements of a culture of challenge — People, Shared beliefs, Alignment, and Processes — I have loosely drawn from the academic literatures on leadership, innovation, and organisational dissent. To these four, I have added in this paper a fifth element, support from clients, without which such a challenge culture is unlikely to be sustainable.

My list deliberately excludes regulators. Certainly, regulators are indispensable to auditing today, and the structure and conduct of regulation plays a first-order role in the behaviour of auditors, so the need to comply with regulation will feature in parts of this paper. That said, audit regulators in the UK are themselves currently the focus of review and restructuring, so the precise role they will play in supporting a culture of challenge going forward is unclear. Besides, the culture of challenge can and should exist within audit firms even without direct regulatory intervention.

There is a need to refocus on the quality of the audit, by reconnecting with auditors' identity as market custodians, and by re-establishing the independence of the audit product.

What follows in the paper is an exposition of why People, Shared beliefs, Alignment, and Processes each matter to building a culture of challenge and what needs to be done to get us there. Two overarching themes emerge across the action items. The first is the need to refocus on the quality of the audit by reconnecting with auditors' identity as market custodians in the way People and Shared beliefs are nurtured. There should be no doubt in the minds of employees that the audit firm exists to enable its individual members to exercise their professional obligations toward probing and verification, in line with their public charter, to the fullest extent demanded by any set of circumstances. In effect, employees must believe that the firm will protect its members, at all costs, in the exercise of these obligations.

The second is the need to re-establish the independence of the audit product, by proving credible, external assessments of the incentive Alignment and internal control Processes for auditors. All major audit firms have in place already some form of an independent advisory body, composed of externals willing to lend their reputation to the firms. The audit firms can strengthen and empower these external bodies to do what is necessary to assure the public that reward structures and internal controls within the firms mitigate conflicts of interests. This means the externals have the authority to hold the firms to account internally and, if necessary, publicly.

Finally, in the segment on Client responsibilities, I discuss actions for client non-executive directors (NEDs) to balance and support the initiatives asked of audit firms.

People

Why People matter to the culture of challenge: "People" here primarily refers to audit employees who are not already partners at their firms. They are on the front line of identifying client issues that must be challenged, and they are the talent pipeline for the next generation of audit leadership. A workforce with the raw smarts, the cold, hard knowledge of professional principles, and the judgement to apply those principles prudently in a given context, is a necessary first step to a culture of challenge.

What needs to be done: Juniors, those with less than four years of experience, need more hands-on training in what I call the technical ability to challenge. This is a training in business judgement, and it comes from good mentoring — more face time with partners and other mentors. Seniors, non-partners with more than four years of experience, need better skills and tools for time management, to look up from the copious amounts of regulatory documentation expected of them and to focus instead on issues of business judgement.

Auditing, done right, is no easy task — an auditor must understand a business at its most fundamental levels (including issues of the underlying science and technology) and then be able to formulate a position on the way the economic prospects of that business can be objectively communicated. This requires people of the highest calibre of raw intellect working in auditing, but it also requires an acquired judgement in commercial sustainability. Together, I call these characteristics the "technical ability to challenge."

When an auditor challenges a client's reporting practice or management control, she is not doing so simply on the basis of her intuition. Rather, her challenge is grounded in a set of accounting and auditing principles that are the core of her profession. At the same time, those professional principles afford a wide range of options to recognise the diversity of economic and technological models amongst client businesses. So, too much challenge from an auditor can just as equally be an indication (as too little challenge) of low technical ability to challenge. A workforce with the raw smarts, the cold, hard knowledge of professional principles, and the judgement to apply those principles prudently in a given context, is a necessary first step to a culture of challenge. How can audit firms do better at developing this technical ability to challenge?

The partnership model is a defining feature of the people culture at audit firms — with many insiders referencing the somewhat steep step between everyone else and partners. The progression to partnership is therefore pertinent to the question of how to improve on the technical ability to challenge. At the same time, audit firms today are organised as strict hierarchies, with many ranks and numbers of employees below the partnership level. Here, it is worth separating pre-partner roles into junior and senior, with juniors being those with roughly under four years of audit firm experience.

The work of junior auditors in audit firms today is quite distinct from that of seniors and partners. Juniors often face fairly routinised work, with little judgement or discretion. Their focus is on familiarisation with accounting and auditing rules and its application to very specific client scenarios. I have been generally impressed by the dedication and effort of audit firms in supporting juniors in this activity. The work requires an attention to detail and a facility with minutiae, but it is usually black-and-white in nature. The hours for juniors can be long, especially given the comparatively low starting pay scales within the profession and the repetitive nature of the work.

There is potentially a mismatch between the kinds of people who are recruited to be juniors (often through very successful advertising to top university graduates) and the work to which they are actually being deployed. The key relevant question for the firms is whether they are equipping juniors with the opportunities to build the business judgement needed to be audit leaders down the line.

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Large audit firms often recruit juniors who have the (raw) potential to be partners. They are hired on their capacity and interest to do work that involves judgement and creativity, but this is seldom what is currently asked of them. The result can be, somewhat perversely, a flight of talent from the junior ranks (often to the firms' own consulting practices) of those most valuable to the firms as potential audit partners a decade or so down the line. This can also result in a "missing middle," as the ranks from which the audit practice must draw to promote to senior has thinned out of some of the much-desired talent.

An oddly promising solution to the issues above is the likely technological obviation of the routinised work of juniors. Advances in artificial intelligence, blockchain methods, and data analytics have the potential to automate the more predictable elements of the audit, lowering error rates and allowing for human auditors to focus on higher levels of abstraction and judgement. Whilst this would reduce overall numbers of employees at junior levels, the work would be more fulfilling and potentially higher quality, increasing retention. Most importantly, lower numbers of juniors will also increase the odds that they will receive much needed mentoring from seniors and partners in building the judgement implicit in the "technical ability to challenge."

In advancing the need for improved mentoring of juniors, it is worth explicitly calling out the role of social networking, which is somewhat nuanced. On one hand, social networking technologies allow for more flexible work environments, including cross-country teams and teams with remote or part-time work arrangements. On the other hand, social networking robs the audit practice of face-to-face relationship building, which is invaluable to coaching. Ironically, even as more seasoned employees complain of the challenges of getting their millennial colleagues to "look up from their smartphones," those very millennials often lament the lack of face-to-face mentoring.

Seniors are the imminent next generation of audit leadership. It is here that the most valuable skills needed of audit partners — technical judgement, the political acumen to productively challenge clients, and the ability to coach others — can be honed and refined. Yet the overwhelming focus of many seniors appears to be delivering the formal audit product, with its oodles of documentation, leaving little chance for critical reflection and professional development. What likely also suffers is the mentoring relationship between seniors and juniors that audit firms hope to cultivate.

Under heightened public scrutiny for market failures, regulators have responded by increasing the documentary requirements of auditors, a classic case of bureaucratic risk shifting.

For better or worse, the statutory audit today largely involves punching through tediously detailed checklists on the various standard elements of client financial reporting. This situation is largely the result of a market ecosystem where the regulators themselves have come under fire for allowing corporate mismanagement to go undetected. The defensive regulators have responded by requiring documentary proof from auditors that they have conducted numerous basic tasks, a classic case of bureaucratic risk shifting. "If all the regulator does is to scrutinise required documentation, then that's where auditors will put their focus," one industry insider noted to me, adding, "We have moved from a profession where we did things to one where we document things."

This documentation overload is unlikely to be lifted anytime soon. The public is rightly suspicious of regulators, who are then prone to continue to seek refuge in documentation scrutiny. The burden of this documentation falls upon seniors, and it takes away valuable time from their exercising judgement and mentoring. The consequences are felt all around: whilst partners sometimes worry that seniors too often focus on procedural details of the client audit, ignoring the underlying economics of the client's business, seniors lament for more time to "just stop and understand how the client truly operates."

Given these realities, perhaps the most valuable offerings to seniors are skills and tools for time management, as many describe the ongoing pressures of looming filing deadlines that in turn compromise their ability to do the work to their own generally high standards. Here again, advances in computing technology offer some promise, with new real-time systems that automatically check-the-box on the myriad documentation processes that are embedded in the audit today.

Partners are the engine and identity of any audit firm. Considering the gruelling road to partnership and the high standards required to keep one there, partners at audit firms generally score very well on technical ability to challenge. Where more questions arise is in their ability to encourage challenge from within their team — for instance, can audit firms better train partners to be challenged without becoming defensive?

Whether they like it or not, partners' every action and word shapes the culture of those around them. When I asked one young auditor how she knew if it was okay to challenge a client, she said that she looks to the cue implicit in the relationship between her engagement partner and the client CFO — if that is a relationship of healthy debate, then she knows it is okay to probe lower down the client hierarchy. If partners do not embody and encourage the spirit of challenge, no amount of technical training in non-partners will matter. This observation brings us to the next element of a culture of challenge, the shared beliefs of the audit firm around the value of challenge.

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Shared beliefs

Why Shared beliefs matter to the culture of challenge: Shared beliefs are the organisational values that drive people's behaviour when confronted with ambiguity and uncertainty. The essential shared belief needed across audit firms is that the firms exist to enable auditors to exercise their professional obligations toward probing and verification — so that the firms will under all circumstances provide "air cover" to their employees to do the right thing.

What needs to be done: The firms' leadership, both senior partners and the independent non-executives who have lent their reputations to the firms, must bring the full force of their rhetoric and action on providing such air cover. Rank-and-file employees need to experience such commitment loudly and credibly — for instance, the independent non-executives could jointly and publicly commit to resigning (as a last resort) if their firm was ever found abandoning a whistleblower.

Even with the right people and technical abilities in place, audit organisations must sustain an environment enabling of challenge, if they are to encourage professional scepticism and the license to act on such scepticism. Put differently, audit firms must continually nourish a culture that provides the "air cover" to challenge.

A mentor once said to me, "Every organisation has a culture. It's often not the one written up in the employee handbook; rather, it is seen through the employees' shared beliefs." These shared beliefs are the implicit organisational values that help employees make decisions when faced with ambiguity and uncertainty.

The most important shared beliefs in an organisation are those that describe how that organisation is creating value in society. In this vein, I have asked, what are the shared beliefs that will help audit firms address the very public existential challenge to their legitimacy and the legitimacy of capitalism?

Firms should, at all costs, enable and protect individual members in fulfilling their professional obligations toward probing and verification.

To me, it is that the firms will, at all costs, enable and protect individual members in fulfilling their professional obligations — endowed through state charter — toward probing and verification. This is the culture to which audit firms must aspire.

Such a culture is not alien to audit firms — in fact, it is the basis for why such firms (should) exist. If they have it right, the firms create scale economies in credibility that then allow individual members to fearlessly execute their obligations as market custodians.

But, in practice, there is a good deal of variance in the salience of the market custodian identity in audit firms today, and this is a matter for the firms' leadership to address. A key source of that variance is confusion over whom an auditor serves: in particular, whether an auditor's "client" is the management of the company it is auditing (usually, the CEO or CFO). I think not. The purpose of the audit is, after all, to verify that management's financial reporting judgement. The auditor does this largely for the shareholders of the client firm, and it is to those shareholders that auditors' obligations chiefly accrue. These shareholders are represented by directors, but, when necessary, auditors can overrule even directors if it is their professional judgement that doing so is in the best interest of shareholders.

Auditors' obligations do not end at shareholders. In the UK, and indeed in many jurisdictions worldwide, all limited liability companies are required to have a statutory audit. The reason is that limited liability is a gift by the state to shareholders to venture in risky commerce without fear of unlimited recourse in failure. In the words of a former colleague, "limited liability is a put option with zero strike-price issued by the state to shareholders" so that they can foster economic activity. To prevent the abuse of this gift of put option, the state requires limited liability companies to be audited by chartered professionals.

The direct implication of this observation is that auditors must also serve a public purpose. Their actions must be pro-social. This does not mean that auditors must at all times put the general public interest over private client interests, but it does mean that auditors cannot condone activity that violates the spirit of good public policy. If it did, then chartered auditors would have no legitimate basis for their monopoly over audits.

Auditors' professional identity as publicly-chartered custodians, with a duty to probe and verify, can serve as a powerful rallying point for audit firms to turn this moment of public challenge and scrutiny into one of opportunity and responsibility.

Creating a culture around such an identity is not something the firms' leadership can simply mandate via pithy slogans in employee memos or manuals. People at all levels of the organisation must experience it every day for it to be real.

A culture of challenge is not something the firms' leadership can simply mandate via pithy slogans in employee memos or manuals. People at all levels of the organisation must experience it every day for it to be real.

Where one learns of an organisation's shared beliefs depends on where one sits in the audit firm hierarchy. Junior auditors imbibe values from their managers, who in turn look to their engagement partners for implicit and explicit signs that it is okay to challenge. Partners themselves might seek the license to challenge from the client's management team or board — a good client leadership appreciates the value of being challenged. But, more crucially, partners must seek this license from their fellow partners and from their own audit firm as a whole — the partners must know, and they must be able to credibly communicate to their teams and clients, that the firm will always back them up on matters of challenge.

As a practical matter, where employees most experience shared beliefs is in the organisation's "shared narratives." The shared narratives are the stories that employees tell each other, the "water cooler stories," outlining the implicit norms and beliefs of the organisation. For instance, in most top universities, there is an implicit tension amongst faculty between research and teaching. Faculty and universities are lauded on research excellence, but teaching is critical to our mission. When I first joined the faculty of the Harvard Business School many years ago as rookie professor, one of the earliest narratives I heard was about a long-serving and highly respected research professor. This gentleman, I was told, had skied to the school from across Boston, during a winter snow storm that had shut down the roads, to avoid being late for class. This narrative was meant to drive home the school's emphasis on meeting teaching obligations, even amongst its top research faculty, a lesson particularly valuable for new professors who had invariably been recruited for their research potential.

The leadership of audit firms are well served to ask: what are the narratives that auditors (should) tell each other about what it means to be a member of this firm? How do (will) these narratives protect and encourage individual auditors in the exercise of their obligations as market custodians?

One immediate and specific test of this question is to ask employees to speculate on what might happen if an audit firm and a large, listed client were unable to resolve a difference in judgement on a material account even as the client's filing date has approached. "Would my firm ever delay a FTSE 100 filing?" one young recruit wondered uneasily when posed with this extreme hypothetical. The recruit's lack of clarity on this matter is an indication of the work to be done by the entire audit profession.

Narratives can provide the first level of air cover that audit employees need to live out a culture of challenge. Narratives can be very specific, showing employees how critical governance structures within audit firms, such as the engagement leader, the quality review partner, the ethics partner, and the non-executive board will all respond when tested with challenges. In fact, the more specific the narratives, the more credible they are.

For instance, as signal of commitment to the culture of challenge, the independent non-executives across all audit firms could jointly and publicly commit to resigning (as a last resort) if their firm was ever found abandoning a whistleblower. What a powerful narrative that will make!

Highly effective organisations are those that create a safe space to question, without allowing either "safe" to devolve into "cosy" or the questioning to devolve into conflict.

Creating a culture and the air cover for challenge can evoke anxieties within any organisation, audit or non-audit. Even as much as challenge may be necessary externally with certain clients or stakeholders, employees can rightfully become concerned that challenge internally will create divisions, eroding the trust and reciprocal assistance that are the basis for the synergies on which organisations build their comparative advantages. Leaders worry that a challenge culture will devolve into a conflict culture. The goal then for any organisation building shared beliefs around a culture of challenge is to walk the line between encouraging high standards of robust inquiry whilst seeding a deep empathy. High standards of robust inquiry should not be conflated with meanness, just as deep empathy should not be conflated as a free pass. Indeed, highly effective organisations are those that create a safe space to question, without allowing either "safe" to devolve into "cosy" or the questioning to devolve into conflict.

Alignment

Why Alignment matters to the culture of challenge: "Alignment" refers to the ways in which an organisation recognises, promotes, and rewards behaviours so that they are in line with its core objectives. If, for instance, auditors are compensated for selling consulting services to clients, they are unlikely to be aligned with living a culture of challenge.

What needs to be done: Audit firms must empower an independent, external remuneration committee to advise on how their partners are rewarded, with a particular eye to mitigate the perceived conflicts of interest between audit and non-audit service provision. Partner rewards should be driven off positive efforts to advance a culture of challenge.

Even without a direct link between consulting and auditing at the client level, the scale of dependence on non-audit services at the audit firm level may be a source of the trust gap with the public.

Organisations often fail to achieve their stated objectives when they create dissonance between their intangible values (the narratives) and their tangible rewards. Alignment is the process of getting tangible rewards to focus on what really matters — in this case, the tangible rewards must, at the very least, not disincentivise challenge. In audit firms, tangible rewards can be experienced in numerous ways — through increased pay, through promotion up the tall hierarchy, and through lateral moves into more prestigious or lucrative practices (e.g., FTSE 100 audits or consulting). How can this reward structure in audit firms better reflect the demands of an organisation building a culture of challenge?

Perhaps the greatest area of concern about how audit partners are rewarded is the shared profit pool between audit and non-audit services in these organisations. Effectively, audit partners benefit from the profits of their firms' non-audit practices, and by most accounts the scale of non-audit profits dwarfs those from audits. Most Big Four audit partners are likely to adhere to their firms' generally accepted policies of not selling consulting services to audit clients. Nevertheless, their dependence on profits from non-audit services is perceived by many in the public to have a chilling effect on the desired culture of challenge, as such dependence can draw audit partners away from the stewardship mindset demanded by client shareholders to one of collaboration and mutual co-adventuring with client management. Even without a direct link between consulting and auditing at the client level, the scale of dependence on non-audit services at the audit firm level may be a source of the trust gap with the public.

How can such potential conflicts of interest be managed? One option that has been proposed, including by me in previous writings, is to forbid the joint provision of audit and any other advisory service by the same legal entity. Another related, but less severe, proposal is to limit the proportion of income an audit firm can realise from non-audit work. For instance, federal judges in the United States are limited in the amount of income they can earn from outside work, such as teaching in law schools. Both solutions have the flavour of restricting free market activity, solutions that in the long run tend to do more harm than good when deployed in private settings. But given the already highly regulated nature of auditing (including regulations favourable to auditors, such as a mandated demand for their product), such profit-restricting measures are part of the portfolio of policy options in regulatory circles.

But the UK cannot and should not act alone in this matter since doing so could put its entire audit industry (and therefore its capital markets) at a competitive disadvantage. A unilateral profit restriction for UK audit firms would likely result in a flight of talent from UK auditing. And, as much as the need for a robust culture of challenge in auditing is a global phenomenon, outside of the UK there is at present very little political momentum for systemic change to audit regulations.

What else then can be done? Here the firms' independent, non-executive boards can play a bigger role than they currently do. These boards, which are composed of members representing audit firms' broader obligations to society, can be charged with conducting an annual (or at least biennial) assessment of the degree of cross dependence created by profit sharing across audit and non-audit parts of the firm.

The goals here would be two-fold. First, to identify whether the pool of profits available for audit partner compensation is contaminated by monies earned from consulting activities that compromise the firms' market custodian responsibilities in audit — for instance, profits earned from consulting on how to establish shell companies that effectively reduce financial transparency. Second, even conditional on the audit partner compensation pool being non-tainted, to identify whether drivers of individual audit partner compensation are detracting from audit quality — for instance, (indirectly) rewarding an audit partner for "selling" to her client.

The independent assessment of the sources and drivers of audit partner compensation must be made public, together with a recommendation, if warranted, to adjust compensation in ways that safeguard the audit firm's public responsibilities.

This independent assessment must be made public, together with a recommendation, if warranted, to adjust audit partner compensation in ways that safeguard the audit firm's public responsibilities. Such a role would give the externals oversight akin to an independent compensation committee on a statutory corporate board of directors. The objective of such a move is for audit firms to show that they take the public's concerns about non-audit profit sharing seriously and have made credible commitments to deter any compromising effects on the audits.

An independent compensation committee can also focus on positive rewards, recognising, in particular, efforts by audit partners to advance a culture of challenge within the firm. Such efforts can be identified by expanding the scope of the 360-degree internal feedback already generally used to highlight effective mentors.

Client managements' evaluations of their auditors should rarely, if ever, factor directly into how those auditors are rewarded.

Client feedback is another area where audit firms can create better "alignment" with a culture of challenge, notably by scaling back on the use of client management feedback in audit partner pay and recognition. Of course, many client managers do appreciate the value of a good audit, and they do reward an auditor who challenges them constructively. But it only takes a few bad managers at clients to skew an auditor's feedback ratings and, eventually, the auditor's propensity to challenge. Moreover, very quickly, such noxious effects can spread across the entire audit firm. For the same reasons that student evaluations of teaching are rarely part of the methods to evaluate faculty, particularly at the top schools such as Harvard Business School, client management evaluations of their auditors should rarely, if ever, factor directly into how those auditors are rewarded.

Beyond tangible rewards, behaviour in audit firms is likely shaped by regulatory mandates. Regulation in audit is by its nature risk averse, and this risk aversion can unwittingly constrain the habit of speaking up. For instance, as one audit leader remarked to me, the best praise a UK auditor can currently receive from a regulator is being identified as "compliant," hardly inspiring. Moreover, regulatory provisions can create unintended consequences — e.g., the requirement for mandatory FTSE 100 rotation has reportedly reduced the prestige once associated with being a FTSE 100 audit partner and potentially heightened the partners' incentives to develop consulting practices. How can regulation sustain, or at least not detract from, the culture of challenge in audit firms?

The first step is creating a regulatory mandate that encourages challenge and, in particular, challenge about client managers' optimistic assessments of the future. Here, regulators will be well-served to reintroduce the prudence principle into accounting rules. Prudence — the notion that client managers' good news estimates should be held to a higher standard than their bad news estimates — is an age-old accounting principle, with deep roots in pragmatism and common sense. Prudence can be the auditors' best friend, as it creates a sort of regulatory air cover auditors need to challenge client managers without appearing stodgy or negative. The last thirty years have seen a steady erosion of prudence from accounting rules, a trend that is best reversed.

A second step for regulators is to create a more affirming regulatory environment, one that rewards and not just punishes. A simple move would be to recognise highly effective audits as something more than "compliant" (perhaps "good"), with a view to highlight and potentially disseminate emerging best practices in audit, especially when they involve clients with new production and revenue generation technologies.

Processes

Why Processes matter to the culture of challenge: Robust internal processes to sense check audit judgements help normalise the practice of challenge, which can otherwise be jarring. But, over time, particularly if these processes largely fail to shift judgements, they can become routinised, and people start to approach them as a chore.

What needs to be done: High-functioning organisations keep their internal control processes salient by constantly testing them and subjecting them to external scrutiny. Audit firms should empower their independent boards to periodically test their internal controls, with public reporting of the results. The firms should also celebrate instances of effective controls, with periodic awards for review teams that demonstrate particular diligence and tact.

The most successful challenges of both clients and colleagues are usually from those who are experienced as enabling rather than hostile.

If an employee is to productively challenge colleagues or clients on a matter of professional judgement, the process to do so must be clearly understood by all concerned parties. This not only reduces the odds that the challenge will be misinterpreted; it also increases the odds that such challenges will actually occur and thus will have a meaningful effect. Having the right processes in place gives people the bandwidth and ability to disagree without being experienced as disagreeable.

Just as much as challenge is inseparable to the nature of audit, so too is cordiality to the nature of any sustainable business. And to auditors the ability to disagree with effectiveness is not just a survival instinct, it is the basis for competitive differentiation. As human beings, we are more prone to ignore the judgement of someone we dislike, even if that judgement is otherwise sound. The most successful challenges of both clients and colleagues are usually then from those who are experienced as enabling rather than hostile. How can audit firms better create processes that allow challenge?

Most large audit firms today already have, on paper, well-developed internal processes that seek to enable challenge within the firm. In fact, in speaking with auditors as I prepared to write this paper, I was most struck by the comprehensiveness of these processes. The most important and visible of these is the role of the quality review partner (QRP), who provides a sort of peer review of the audit engagement team.

In practice, the QRP can oscillate somewhere between being a second engagement partner to being an assessor on a given audit. This variance is in itself not undesirable, particularly because in the vast majority of audits the role of the QRP is formative rather than evaluative. But what is essential is for the QRP to feel that she can disagree when there is a sense that an audit engagement team has been led astray. This might well be happening already, but public sentiment about auditing suggests that there is more for audit firms to do. Audit firms are well served to assure their clients and the wider public that the quality review process works when it is most needed.

As with the issue of potential audit and non-audit conflicts of interest, this is an area where the firms' independent non-executives can be further empowered. The externals should from time-to-time be called to test the quality review process by assessing whether this process actually surfaces and moderates questionable audit judgements. In the field of airport security, for instance, baggage screeners are routinely evaluated by determining how often they detect armed, undercover marshals. What is the equivalent test for the audit's quality review process? The results of such independent tests by the externals should be made publicly available. Doing so would be a credible commitment by the audit firms to their seriousness. Other questions for the externals to address in their periodic reports include: How well does the quality review process reflect the intent underlying a culture of challenge? How often is it being used as a source of second opinions on the audit, and when is it being used to enable genuine disagreements to emerge? How can the process be strengthened where necessary?

The externals, or the firms' executive leadership itself, should complement such assessment reports by identifying and celebrating positive instances of effective controls, with periodic awards for review teams that demonstrate particular diligence and tact. Such awards can raise the salience and prestige of the quality review process, further buttressing the process against devolving into a chore.

The firms' executive and non-executive leadership should also celebrate positive instances of internal challenge, with periodic awards for internal quality review teams that demonstrate particular diligence and tact.

Beyond the formal quality review process, audit firms have several informal internal controls already in place. For instance, because of the complexity of modern day audits, many engagement teams have more than one attending partner (one for general accounting issues, one for tax issues, one for pensions, and so on), thus effectively creating multiple power centres within an engagement. This decentralisation of authority itself serves as a sense check, and it creates more bandwidth for non-partners who might be conflicted about audit judgements to speak out. Some of these informal controls are by design not externally visible (to clients or to the public at large), so it is worthwhile for the firms to clarify what already exists and how effective such controls are.

For instance, client leadership sometimes worries that the advice they receive on complex technical matters solely reflects the opinion of the engagement lead, since that individual is their primary point of contact. In practice, however, engagement leads are unlikely to offer such an opinion without at least some consultation with technical experts within the audit firm. And this process can involve robust and vigorous internal debates. As audit firms grapple with addressing concerns about their cultures of challenge, they should consider if there are more cases where the client would be better served to be included in such debates. Doing so can be especially valuable when the opinion being offered by the audit firm is itself contended internally, as it could give the client a perspective on the variance around that opinion.

In general, processes for internal and external challenge work best when time is not the enemy. More time makes it easier for all parties to truly understand the issues; and, just as importantly, more time makes challenge less awkward as all parties are less prone to misunderstandings when not under pressure. As I have noted earlier, audit seniors in particular seem to be stretched for time, which can undermine their ability to deliver quality audits and challenge effectively.

But perhaps the most important question in thinking about the processes for challenge within an audit firm is, what happens if the challenge is misinterpreted — by colleagues or by the client? Do employees have the confidence to challenge knowing that there is enough trust in the relationships to repair any unintentional misunderstanding? This is where the issues raised in the segment on Shared beliefs — in particular, employees' confidence in "air cover" from the firm — once again become critical. Every audit firm needs strong, specific narratives, grounded in verifiable facts, that testify to the commitment of the firm's leadership — its senior executives, non-executives, and ethics function — to always back up and not punish challenge, even if that challenge is eventually deemed misguided. To paraphrase what one audit partner said to me, "My team needs to know that even after asking nine irrelevant questions, there are no penalties to asking the tenth."

Perhaps the most important question in thinking about the processes for challenge within an audit firm is what happens if the challenge is misinterpreted — employees' confidence in "air cover" from the firm is critical.

Client responsibilities

Why Client responsibilities matter to the culture of challenge: If there is insufficient demand from clients in the marketplace for challenge by auditors, do not expect its supply to last.

What needs to be done: Despite best aspirations, client management cannot be expected to sustain auditors' challenge in equilibrium; rather, client NEDs are better placed to drive the demand for a culture of challenge amongst auditors. Client NEDs should directly empower rank-and-file auditors to challenge client management as needed.

NEDs should take the lead for the culture of challenge amongst their auditors, chiefly through auditor appointment, compensation, and retention decisions.

Even if audit firms are on the frontier of promoting a challenge culture internally, their efforts are unlikely to deliver impact in practice if they are not supported by demand-side forces in the marketplace. Here, clients play an essential role. Whilst, in practice, "clients" has come to refer to many groups — including shareholders, non-executive directors of client boards, and (perhaps most disconcertingly) managers of client firms — for the purposes of this discussion, I focus on the role of client NEDs.

Historically, client NEDs have not had the resources, and thus the power, to play a particularly active role in auditor management. In fact, until as recently as the early naughts — and the Enron and WorldCom disasters — NED roles were even seen as sinecures. Their status has since changed, and especially amongst large companies, such as the FTSE 100, NEDs are today usually quite diligent about oversight responsibilities. In fact, amongst these largest companies, the audit committee chair, rather than the CFO, is increasingly seen by the audit engagement partner as the boss who most matters. This is a promising development.

Still, more needs to be done, both at these largest companies and especially in smaller clients, where NEDs are sometimes underworked and underpaid.

Client NEDs are best positioned to provide the necessary demand-side support, even if they are not always appropriately empowered. Of course, those primarily dependent on an auditor's work are the shareholders and other immediate stakeholders (such as creditors) of the client organisation; and when these groups are themselves financially sophisticated and have a large stake in the client (such as with institutional investors and banks), they can and should take a direct role in promoting challenge by auditors. But less sophisticated players, such as retail investors, are critically dependent on the monitoring role of NEDs. The NEDs themselves, despite their own sophistication, do rely on auditors to provide assurance of the financials prepared and controls deployed by client management. For all these reasons, NEDs should take the lead for the culture of challenge amongst their auditors, chiefly through auditor appointment, compensation, and retention decisions.

As a statutory matter, this is often the case; but, in practice, NEDs do defer to client management on some of the most important aspects of the auditor relationship. "No self-respecting CFO will allow an auditor to be chosen without his consent," I was once told by an industry insider. This situation results in a perverse set-up where client management appoints the auditors responsible for their own oversight. Auditors then are naturally more deferential to client management than they would otherwise be.

Admittedly, in the vast majority of cases, this set-up does not directly enable fraud; but in a few high-profile and systemically important cases it has. And the set-up is less than desirable from the perspective of sound governance policy. As much as we would like to believe that client management itself can provide this support for the culture of challenge, the difficult reality is that they do not. Academic evidence from the United States suggests that client managers punish audit practices that are stricter in their assessments (for instance, through lower fee growth), undermining the idea of a healthy market for audit in the absence of additional independent checks on client management.

Not only should NEDs be concerned with how much audit firms are compensated, they should also pay attention to the issue of how the engagement partner and key members of her team are assessed and rewarded by the audit firm.

For NEDs, and in particular for the audit committees of boards, there are many advantages to directly working with the auditors, outside of intermediation by the client management. For instance, the tender process for a new auditor can be hugely informative to NEDs, if they are required to be intimately involved, as it forces NEDs to think carefully about questions around auditor qualifications, independence, and remuneration. Not only should NEDs be concerned with how much audit firms are compensated, they should also pay attention to the issue of how the engagement partner and key members of her team are assessed and rewarded by the audit firm. For example, a NED may upon reflection not want her engagement partner to be evaluated on how much the CFO likes the partner's work, especially if that CFO is challenge averse.

NEDs may also wish for the audit engagement team to have wider, year-round conversations within the client firm, beyond the finance functions. Often, an auditor's engagement with a client, even when conversing with operations and scientific teams, is closely intermediated by the client's finance group, and it is conducted when the parties are pressed for time. Such a scenario is not usually in the best interests of client shareholders. A key issue for an audit committee chair's checklist then is to secure depth of the auditor's access beyond the client's finance functions and to ensure that auditors have access to relevant sources within the firm in a timely and unhurried manner. This can also alleviate some of the time pressures on audit seniors discussed earlier.

But perhaps the most meaningful single act from NEDs is to meet with all members of the audit engagement team before they begin their annual process, even if only for a short pep talk explicitly offering air cover and the license to probe. This simple act can speak volumes, particularly for junior auditors, who may be otherwise isolated from power centres and experience reluctance to challenge. Oddly, such direct conversations between the NED and rank-and-file auditors are quite uncommon.

Whilst such measures might seem, at first glance, hostile to the client CFO, they do not have to be so. After all, no good NED wants anything less than a healthy working relationship between the CFO and the audit lead; what these measures are intended to avoid is the auditor-CFO relationship becoming too cosy or dependent. Eventually, if the responsibility of sustaining a culture of challenge is enforced on NEDs, then even with an especially strong personality as CFO or a particularly weak personality as audit committee chair, the auditors themselves will find their probing and verification roles better protected.

Beyond NEDs, a culture of challenge can also be supported by appropriate regulation and civil society organisations, such as the financial media; but a detailed discussion of these roles is outside the scope of this paper. Hitherto, the financial press, like the regulators discussed earlier, have largely focused on highlighting instances of auditor malfeasance over recognising positive performance. Whilst this disciplining role must continue, its one-sided nature structurally erodes the standing of the audit profession in society, imposing externalities on us all. Given the public's insatiable appetite for rankings, and the media's financial interest in creating such rankings, there is an opportunity for a respected financial press outlet to produce an annual listing of auditors and audit firms noteworthy for their practices that advance a culture of challenge.

If NEDs deliver on their responsibility of sustaining a culture of challenge, then even with an especially strong personality as CFO or a particularly weak personality as audit committee chair, the auditors themselves will find their probing and verification roles better protected.

Conclusion

The need for a culture of challenge in audit firms is inalienable to broader societal questions on the future of capitalism.

On learning that I would be writing this paper, a long-time business executive remarked, “I am glad you are doing this — audit firms are one major scandal away from oblivion. If they don’t want governments doing the audits, they need to step up.”

My focus in this brief paper has been to describe what it takes to build a culture of challenge in audit firms, to respond to the widespread public concern that auditing is broken. I have done this by describing what I see as the five essential elements of a culture of challenge and identifying some ways in which they can be improved. In listing these action items, I have prioritised brevity over thoroughness, in the hope that at least some of these items can be quickly adopted.

I hasten to re-emphasise that the issues underlying the crisis of trust in auditing and capitalism are structural and generational, and, indeed, there are no quick fixes. The good news is that the audit firms are listening — at the risk of overstating, the fact that I was asked to write this paper, despite my outspokenness against the industry’s past actions, is perhaps some early evidence to that effect. What I hope I have conveyed in this paper is that there are win-win opportunities for the audit industry to do what’s right by society and still do well financially.

I should also emphasise that the five elements of challenge discussed here — People, Shared beliefs, Alignment, Processes, and Client responsibilities — are not alternatives to each other; rather, they build and reinforce each other. Without all five, it is unlikely that a firm will be able to sustain a thriving culture of challenge. For instance, it is pointless to attract and mentor people with the “technical ability to challenge” without creating an environment that provides “air cover” for such challenge; and it is futile to expect auditors to challenge client management if non-executive directors on client boards do not encourage and value such challenge. Each element is part of the ecosystem that makes up the culture of challenge.

I conclude by leaving the reader with an explicit rendering of the “plot line” to this paper — the themes that animated the introduction and carried through the five elements.

First, the need for a culture of challenge in audit firms is inalienable to broader societal questions on the future of capitalism. Building a culture of challenge is an existential question for audit firms because it can help them, at a minimum, stay relevant, but, more promisingly, drive public confidence that capitalism can produce a sustainable society. (For more, see the segment titled Introduction.)

Second, creating an affirming culture of challenge is good business. A proud tradition of auditors as custodians of the public trust, who are mentored by the firms in the art of good judgement and then supported to act with all integrity, attracts talented and purposeful people to the audit profession. (For more, see the segments on People and Shared beliefs.)

Third, the public's disillusionment with auditing will continue until the firms can credibly demonstrate that they are managing conflicts of interests. This requires both an organisational architecture that is more open to external scrutiny and the firms being more open to take substantive actions when the scrutiny so suggests. (For more, see the segments on Alignment and Processes.)

A summary agenda for action

On People: To foster challenge, audit firms need a workforce with the raw smarts, the cold, hard knowledge of professional principles, and the judgement to apply those principles prudently in a given context. The firms are generally quite good at recruiting raw talent and training them in the audit and accounting rules. Where they fall short is opportunities to help early-career employees build the judgement to apply those rules in real-world, high-pressure, time-sensitive scenarios. Partly this is because early career auditors spend so much time on the check-the-box documentation reports that constitute the modern audit; they have little time for exercising initiative and developing business intuition. The firms need to create more opportunities for their next generation leaders to receive an education in good judgement — this is the intangible skill that spurs people to do the right thing when it is not straightforward what is the right thing to do.

On Shared beliefs: Shared beliefs are the organisational values that drive people's behaviour when confronted with ambiguity and uncertainty. The essential shared belief needed across audit firms is that the firms exist to enable auditors to exercise their professional obligations toward probing and verification — so that the firms will under all circumstances provide "air cover" to their employees to do the right thing. At present, there is variable salience of this identity within audit firms. The firms' leadership, both senior partners and the independent non-executives who have lent their reputations to the firms, must bring the full force of their rhetoric and action on providing such air cover. What is the evidence that the leadership can offer to show employees that they mean it with all credibility?

On Alignment: "Alignment" refers to the ways in which an organisation recognises, promotes, and rewards behaviours so that they are in line with its core objectives. Here, what is most worrisome is that high margin consulting services by audit firms are creating conflicts-of-interests for auditors' mission to challenge. The audit firms must credibly signal that partners are being rewarded for skills in scepticism rather than in selling. To do this, audit firms can empower an independent, external remuneration committee to advise on audit partner pay. True, audit firms are private partnerships, but their public mandate behoves an external voice to safeguard against:

- the pool of profits available for audit partner compensation being contaminated by monies earned from consulting activities that compromise the firms' audit responsibilities — for instance, profits earned from consulting on how to establish shell companies that effectively reduce financial transparency; and
- the drivers of individual audit partner compensation being detractors to audit quality — for instance, rewarding an audit partner for selling to her client.

On Processes: Robust internal processes to sense check audit judgements help normalise the practice of challenge, which can otherwise be jarring. Audit firms have, on paper, a well-developed internal quality review process. But, over time, particularly if these processes largely fail to shift judgements, they can become routinised, and people start to approach them as a chore. High-functioning organisations keep their internal control processes salient by constantly testing them and subjecting them to external scrutiny. Audit firms can empower their existing public interest bodies to periodically test their internal controls, with transparent reporting of the results. In the field of airport security, for instance, baggage screeners are routinely evaluated by determining how often they detect armed, undercover marshals. What is the analogous test that the public interest bodies can conduct of the audit quality review process?

On Client responsibilities: If there is insufficient demand from clients in the marketplace for challenge by auditors, do not expect its supply to last. Whilst in practice, "clients" has come to refer to many groups — including shareholders, non-executive directors of client boards, and (perhaps most disconcertingly) managers of client firms — for the purposes of this discussion, the onus is on client NEDs. Despite best aspirations, client management cannot be expected to sustain auditors' challenge in equilibrium: after all, it is their reporting judgements that must be challenged. Client NED roles have, until recently, been seen as sinecures, and these NEDs have largely deferred to their CEOs and CFOs in audit recruiting and oversight. This must change — the entire audit engagement team should hear loudly and clearly that the NEDs (and not the CFOs) are the "boss," and the NEDs should directly empower auditors to challenge client management as needed.

About the author

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