

## Commentary on the FRC's Publication 'What Makes a Good Environment for Auditor Scepticism and Challenge

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### Introduction:

To the general public, auditing is a black box: esoteric and deeply technical. Indeed, to many auditors, accountants, and corporate managers too, auditing is a black box. But whilst there is a good deal of auditing that is complex, at its core the nature of auditing is rather straightforward. It is worth stating upfront what is the purpose of an audit because doing so can help clear up some of the muddle around audits and the need for a culture of challenge therein.

The demand for audit stems from the separation of ownership and management, and it is as old as civilisation itself. Indeed, auditing is, by some accounts, the very basis of writing.

In the context of professional management being delegated control of a corporation by its otherwise passive (share) owners, those managers are called to present periodic statements of financial performance and position. These statements embed managers' expectations of future economic conditions, that is, they embed managers' business judgements. Auditors are chiefly called to do two things with regards to these statements. First, to ensure that the statements are prepared in accordance with statutory accounting standards. This is the easier bit. Second, to provide an informed, independent set of eyes on the reasonableness of managers' business judgements that drive the statements. This is the challenging bit, that necessitates a culture of challenge in audit firms and that makes audit, as a profession, intellectually satisfying.

In addition to these financial statements, managers are also called to report on prospective financial risks as yet too speculative to be recorded in formal accounts. And increasingly, they are being called to report on non-financial performance, so-called ESG performance. Auditors must additionally comment on the reasonableness of management judgements embedded in these reports: and while a lower standard of accuracy is permitted of auditors here, a similar standard of *scrutiny* as applied to financial statements is expected of them.

That, in a nutshell, is the purpose of audits. Next, let me address why the FRC is writing a report on auditor scepticism and challenge. Principally, this is because the general public feel that when managers cook the books (usually through unreasonable business judgements embedded in their accounting assumptions), auditors don't do enough to stop them. They do not challenge the managers as forcibly as to forestall the chicanery. Particularly since the 2008 global financial crisis, there has been a widespread perception that the market economy works for insiders (managers and wealthy investors) more so than for average investors, and there is a perception that auditors have wantonly or unwittingly enabled this situation.

So, what does success for a report such as the FRC's 'What Makes a Good Environment for Auditor Scepticism and Challenge' look like? This is certainly not the first report on a culture of challenge in audit firms: indeed, there have been several in the last few years, particularly

following on from the disaster that was Carillion. And this earlier tranche of audit-challenge reports appears to have been somewhat successful: The data from the focus groups conducted by BritainThinks suggest that employees of all ranks at audit firms are more aware of the need for a culture of challenge than a few years ago.

But each of those reports has a certain natural shelf-life, and with a few years passed since the last tranche (they were, notably, pre-pandemic), it is time to reinvigorate the corporate-governance environment with another such report. That is what the FRC must seek to do with this publication, and success will mean keeping the challenge-culture issue salient in the minds of auditors, corporate managers, and their boards. Because challenge is not the natural order of business in any organisation; rather, complicity is. And sustaining a culture of challenge thereby requires a continual investment of external energy to resist the entropic forces of organisational complicity.

Just as it is helpful to define what success looks like for the FRC's 2022 Scepticism and Challenge publication, it is useful to identify what failure would look like. In my mind, we can unambiguously conclude that the publication has failed if it results in more hours of process paperwork by rank-and-file auditors, perpetuating the check-the-box malaise that has plagued the audit profession and that is contributing to dissatisfaction, burnout, and exits of early- and mid-career auditors.

In the remainder of this commentary, I will remark on the four specific elements identified by the FRC as being critical to auditor scepticism and challenge: employee training, firmwide culture, processes, and ecosystem.

#### *Employee training:*

The BritainThinks focus groups have identified the need for more on-the-job training and more “soft skills” training in the *art* of challenging clients. This finding gets to the nub of the issue. Audit firms do a reasonably good job training their rank-and-file in the various technical standards and processes that characterise the modern audit. But these deductive skills are only part of what is needed from auditors. Beyond deduction, auditors need to possess skills in critical thinking and judgement. Critical thinking is the basis for professional scepticism, which is the foundation for challenge in audits. And judgement is what finally determines “what matters from the rest” (to quote Isaiah Berlin) when making an audit decision.

Neither critical thinking nor judgement can be taught through textbooks and professional-certification exams. They are most effectively taught through the case-study method of education, where students are exposed to a series of challenging scenarios without any manifestly correct answers, and where they must debate and reason with each other, under the thoughtful guidance of a facilitator, on how they will decide on the matter. This Socratic-style education is the on-the-job learning in soft skills that (especially junior) auditors are crying out for. An urgent next step is to train the trainers (i.e., audit partners and engagement managers) in imparting this education amongst their mentees. It will involve

getting otherwise garrulous audit leaders to themselves embody the practice of active listening as a way to inspire and mobilise their juniors into this mindset.

Beyond critical thinking and judgement, another essential element of challenge that is underdeveloped in audit education is the art of disagreeing without being disagreeable. This is what the middle Stoics referred to as “dialectical sophistication” – the ability to manage emotion and impulse whilst serving a mission or doing one’s duty. It is the basis for effective challenge, particularly in the current environment where auditors must challenge those who seemingly make the decisions on whether they stay or go and how much they must be paid.

A further impediment to challenge that is discussed later in this paper is the overworked status of auditors, a situation that can impede their mental and emotional bandwidth to push back against client unreasonableness. Here, all I will note is that the situation calls for (more or better) training in time-management skills amongst especially pre-partner ranks.

Another element of needed training that may have emerged from the BritainThinks focus groups is acculturation of Millennial and now Gen Z workers to the state of discomfort that defines challenging a client. Younger workers may be unfairly classified as wallflowers, but there is little doubt that they have enjoyed more “safe spaces” throughout their schooling years than prior generations, potentially making them less comfortable with even constructive confrontations.

The Covid pandemic has ushered in what seems like an irreversible trend toward more hybrid ways of working. Challenge-in-person is hard enough, but challenging remotely involves rethinking many of the tactics for effective provocation that rely on reading body language. So, audit firms are well-served to continue investments in understanding how hybrid working necessitates new styles of audit.

Challenge is inalienable to audit, and clients will be more supportive of challenge if they respect their auditors’ intellects. The sort of training described here is part of the journey of upskilling auditors to a level where they can thoughtfully provoke the (client) hands that feed them, sustaining a value-creating symbiotic mutualism, rather than a client perception of audit challenges as a distraction.

#### *Firmwide culture:*

Beyond employee training, auditors in a firm must implicitly feel that their organisation supports and encourages the practice of client challenge. As already noted, there is some evidence from BritainThinks to suggest that audit firms are today doing a better job in sustaining this culture of challenge than even a few years ago. But there is also evidence from the BritainThinks focus groups to suggest considerable variation across audit firms in this regard. Put differently, some firms are doing better than others, and those that are falling behind would be wise to invest in understanding what they should be doing differently in setting their firmwide culture.

But embracing another firm's culture is easier said than done. Scholars of organisational culture have noted how companies, even with a full knowledge that they are falling behind their competitors and a full understanding of what their competitors are doing differently, are often unable to replicate their competitors' cultural successes. This is the problem of replicating "relational contracts" of other firms.

Consider the famous case study of the Andon cord in the Toyota assembly line. This cord plays a special role in Toyota's famed reliability-at-cost model. Rank-and-file workers on the Toyota assembly line are encouraged to pull the Andon cord (a sort-of lantern) when they notice a possible manufacturing defect on the line, effectively stopping the entire production process at great expense. There are no explicit rules on when to pull the cord and when not to – if it were possible to specify such rules, then the cord itself would be unnecessary, and low-cost reliability would not be as elusive as it is. Instead, employees are, over time and on-the-job, trained in the "good judgement" of when to pull the cord. If they are too prudent in pulling the cord, quality will suffer; if they are too liberal, cost will suffer. They must also believe that Toyota's management will trust them to exercise that judgement wisely; so that if they make a mistake (whether a Type I or Type II error<sup>1</sup>) and that mistake is not intentional, management will not punish them. But management cannot give them any such explicit assurance, because if it does, the quality of worker judgement in deciding whether to pull the cord (the vaunted discerning nature) will suffer. Thus, the whole system relies on an implicit relational contract between management and line workers at Toyota.

Other car companies have tried for years to copy the Toyota system, knowing full well what it entails. But they have not succeeded. Because the culture of challenge embodied in the Andon cord system at Toyota cannot be codified. This is analogous to the issue every audit firm faces with respect to building and sustaining a firmwide culture of challenge by simply trying to copy what others have done. Importantly, what this means is that for every audit firm that *does* succeed in building an effective culture of challenge, there are enormous profits to be earned, as their challenge culture cannot be easily replicated.

But even as some firms have enjoyed success in sustaining a culture of challenge, there are opportunities for improvement. Perhaps the most important stressor to a challenge culture that has emerged from the BritainThinks data is the tenuous state of middle management at the audit firms. Whereas audit partners report feeling somewhat supported and rewarded for challenging clients, middle managers appear to be less certain of what is expected of them. For one, they are stretched for time, often working long hours at considerably less pay than partners. Their time is consumed by providing much needed technical advice and mentoring to audit juniors, whilst also ensuring the reams of paperwork inherent to modern audits are completed. This leaves them little bandwidth for challenge. And while they sometimes feel the pressure to challenge, they do not always see their challenge as being rewarded in promotion and compensation decisions.

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<sup>1</sup> A Type I error is calling out a client for misreporting when there is no misreporting; a Type II error is failing to call out a client for misreporting, when there is misreporting.

All this suggests that middle management is due for more attention from audit-firms' leadership. Perhaps as a first step, the leadership might clarify what is most expected of middle management: mentorship, paperwork, or challenge. The leadership might also clarify why dissonance exists between (a) middle managers' *perceptions* of what determines their professional success and (b) the factors that *actually* determine middle managers' professional advancement. Finally, it is perhaps time for audit-firms' leadership to re-evaluate the level and determinants of middle management pay. While firms should be careful to avoid a purely transactional culture – where audit quality is not valued for its own sake, and rank-and-file auditors simply provide challenge to earn bonus points – there does appear to be a case to provide more fulfilling working conditions for mid-level auditors. Unlike junior auditors who have not “sunk” much time into the profession, and audit partners who enjoy more security of tenure, mid-level auditors are vulnerable to unintentional exploitation by the system.

Notwithstanding the above, my own judgement is that the biggest cultural impediment to client challenge in audit firms is not personnel-related but rather structural to the industry: this impediment arises from the perception that the client company's executive management (particularly the CFO) is the embodiment of the client itself. This perception reflects the reality that client CFOs generally commission audits and determine audit compensation. Essentially, it is the “fox” who is commissioning the evaluation of henhouse security, so auditors are wary of being seen as hostile to foxes. This is a situation that the FRC can seek to remedy by forbidding involvement of client executive-management in audit appointment, retention, and compensation decisions: requiring instead that these decisions are vested in the non-executive members of the client's board, especially its audit committee. Of course, such a move would be a significant departure from current corporate governance practice, and it would necessitate substantial changes to the audit committee, as I describe later.

#### *Audit processes:*

I have already alluded earlier to the byzantine nature of the modern audit, with its many checklists and mind-numbing forms. Audit firms themselves have little direct control over these processes, as they are the consequence of ever more detailed regulations.

The procedural nature of the audit may be precipitating perverse and unintended consequences on audit challenge and thus audit quality. For one, it renders audits boring, so many of the best minds might leave the profession early on, or even choose to avoid it altogether.

Data from BritainThinks suggests alarming levels of employee turnover at some firms. With eye-popping employee turnover, UK audit firms are often left relying on international partner networks to fill in gaps, but such “outsourced” fixes rarely build and promote the kind of “Andon” culture described earlier.

The procedural enormity of the contemporary audit also means auditors are absurdly busy, so busy in fact that they do not appear to have much mental bandwidth to reflect deeply on

substantive client judgements that might necessitate challenge. Evidence from behavioural science also suggests that when people are stretched, their emotions rather than their reason guide their decision-making – and emotional auditors are also unlikely to have the dialectical sophistication I mentioned earlier, to disagree without being disagreeable.

There is a temptation in the face of staff exits and chock-a-block diaries to conclude that audit firms are understaffed, and that we should increase the supply of accountants in the economy. I remain sceptical of this argument. Recent data for the UK suggests that there are about 380,000 accountants in a workforce of about 32.5 million, which is more than 1 accountant for every 1000 working members in society. While there is no objective benchmark for this statistic, it is reportedly amongst the highest in the world. Create still more accountants, and the UK risks channelling talent away from undersupplied sectors such as engineering and healthcare.

Perhaps as a next step, the FRC and audit-firms' leadership might collectively study the work patterns of existing auditors of all ranks to gain a better understanding of what auditors are actually spending their time on. If it so happens that too much time is being spent on low-value paperwork, the regulator and the industry can come to a collective agreement to reduce such requirements and free up more time for high-value cognition and judgement. Such a move might also reverse the suspected brain-drain in auditing today.

#### *Audit ecosystem:*

Scholars of organisational teams have noted that, without external support, such teams rarely survive our individualistic natures. Likewise, the unnatural state that is an organisational culture of challenge means that to sustain such a culture requires continual outside investments. For audit firms seeking a culture of challenge, an under-developed source of outside support is the audit committee.

Client firms' non-executive directors, especially their audit-committee members, need to step up and support audit challenge. After all, to protect their own reputation and liability, they are strongly incentivised to do so. Despite substantial improvements in corporate governance at the board level since the 2008 financial crisis, non-executive directors are often recruited not for their independent mindset but because they are seen as "a safe pair of hands" who will keep out of the CEO's hair.

The FRC and associated corporate-governance regulators can themselves randomly audit the audit committees of overseen companies, asking whether their members feel appropriately enabled to challenge and have shown sufficient commitment to do so. Elsewhere, I have noted that many audit committee members do not even know the names or emails of members of their external auditors' engagement teams, beyond perhaps the engagement lead itself.

Such changes to the nature of work for audit-committees will necessitate a conversation on whether they are commensurately remunerated. Of course, by the standards of most citizens, the average non-executive director pay in the UK is already very generous. But the

nature of additional work being described above is highly nuanced, and it will require attracting the very best governance talent worldwide, especially for the top UK companies.

Currently, there is a substantial pay difference for audit-committee directors between the FTSE 100 and the S&P 500: roughly £100K for the former and \$300K for the latter. Perhaps this pay difference reflects the differential expectations of audit-committee members in the UK versus the US – that US directors, operating under the Sarbanes-Oxley regime, must work much harder than their British counterparts? But if so, that is hardly an attractive situation for Corporate Britain.

*Conclusion:*

I will conclude with one further observation: on the public-interest purpose of auditing. Auditing is a state-sanctioned monopoly because it serves a public purpose, and that purpose is the basis for the respectability and status of auditing as a profession. The media occasionally bandies about that purpose in its, often justified, criticisms of audit-firm practices. But, that public purpose is sometimes misstated and misunderstood, so it bears clarification.

The public purpose of auditing stems from the systemic benefits of audits to the integrity and stability of our market-capitalist system, where (share) ownership and management are separated. Auditing is integral to investors' trust in the system, without which the market economy would collapse. So, auditors have a dual mandate to both their clients (i.e., the shareholders of the entities they audit) and to the system as a whole (i.e., to safeguard public trust in capital markets). This is akin to the dual mandate that lawyers have to both their clients and to the interests of justice, as a whole, in society. In the vast majority of cases, these interests are aligned, in that the broader (systemic) interest is served through the pursuit of the narrower (client) one. In a few cases where the interests are misaligned, auditors, like lawyers, need to tread carefully given both their professional oaths and their fiduciary obligations to clients.

The public-interest purpose of audits is not, however, to represent the interests of all of the firms' stakeholders in the process of conducting an audit. There are, of course, cases where, as a client approaches bankruptcy, auditors assume responsibilities for bondholder interests as well. But, in a going concern, the auditor must look out principally for the clients' shareholders. While the growing number of ESG audits, and a growing fashion for "stakeholder capitalism" may change this perception, for now, at least, there can be no confusion for auditors as to whom they serve: shareholders.

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The BritainThinks surveys reveal that some auditors still bemoan that they are unfairly treated in the media, and that audit firms need to employ more sophisticated rhetoric to counter those criticisms. Whilst not all those media criticisms are in fact fair, the best way to counter them is not through clever public-relations, but rather through doing great work. It is with that intent that I hope the FRC's publication 'What Makes a Good Environment for

Auditor Scepticism and Challenge’ and this brief commentary, can inspire an improvement in audit quality and help the UK restore its reputation as a corporate-governance vanguard and an investments powerhouse in the world economy.

*Karthik Ramanna is a professor of business and public policy at the University of Oxford’s Blavatnik School of Government; he is a keen observer of, and commentator on, these issues. The FRC shared the BritainThinks report with him to get an academic perspective in addition to the practitioner perspectives we will gain from discussions with audit firms. The views expressed are therefore his own personal views (not those of the FRC) and are shared with the intention of adding to the debate.*

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