



AUDIT CULTURE THEMATIC REVIEW

**FIRMS' ACTIVITIES TO ESTABLISH, PROMOTE AND EMBED
A CULTURE THAT IS COMMITTED TO DELIVERING CONSISTENTLY
HIGH QUALITY AUDITS**

MAY 2018

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Definition of culture

Culture can be defined as a combination of the values, attitudes and behaviours manifested by an organisation in its operations and relations with its stakeholders.

Firms included in this thematic review

The scope of this thematic covered the eight firms that have adopted the Audit Firm Governance Code¹ ("the firms"), being:

BDO LLP ("BDO")
Deloitte LLP ("Deloitte")
Ernst & Young LLP ("EY")
Grant Thornton UK LLP ("GT")
KPMG LLP ("KPMG")
Mazars LLP ("Mazars")
PricewaterhouseCoopers LLP ("PwC")
RSM UK Audit LLP ("RSM")

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¹ Audit Firm Governance Code (revised 2016) available at: www.frc.org.uk/getattachment/8e2026c0-cac0-4faa-8326-4713511f139a/Audit-Firm-Governance-Code-July-2016.pdf

Financial Reporting Council

Audit Culture Thematic Review

Firms' activities to establish, promote and embed a culture that is committed to delivering consistently high quality audits

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1 Executive Summary

1.1 Overview

Narrowly defined, audit provides assurance to shareholders on the truth and fairness of an entity's reported performance and position set out in its financial statements. The societal purpose of audit goes beyond this and serves the public interest. Audit facilitates investors and other stakeholders, including the general public, in forming views about an audited entity based on trustworthy information. Accordingly, audit underpins transparency and integrity in business.

Events such as high profile company collapses within months of the date of the audit report; evidence of poor audit quality or reputational issues within the main international firm networks; and the perception of the wider firms' commercial success taking priority over audit quality all impact on public confidence in audit. They also raise questions about whether the quality, scope and delivery of audit is sufficient to meet public expectations.

In June, we will release the results of our most recent audit quality monitoring at individual firms. This will be followed in July by publication of our overall assessment of developments in audit over the last year. We have set the firms a target that at least 90% of the FTSE 350 audits reviewed by us should be assessed as requiring no more than limited improvements by 2019. While we recognise that there have been improvements in audit quality, our monitoring activity in recent years continues to identify a lack of consistency, such that we cannot be confident that the 2019 target will be achieved.

As the competent authority for audit in the UK, we use a variety of means to stimulate improvements in audit quality. These range from inspecting audits and, where appropriate, using our enforcement powers to hold auditors to account where audit failures have occurred, to performing thematic reviews (like this one) to compare, and provide transparency to, actions at different firms in relation to a particular topic. Thematic reviews provide an opportunity for shared learning by the firms and for us to bring our influence to bear on them.

This thematic review provides a 'snap shot' of the actions being taken, by the eight firms² that have adopted the Audit Firm Governance Code, to establish, promote and embed a culture that is committed to delivering consistently high quality audits. The findings are drawn from a wide range of evidence including our analysis of documentation obtained from the firms; a series of interviews with the firms' leadership, Independent Non-Executives ("INEs"), investors, and audit committee members; our survey of a sample of audit partners and staff; and a series of focus groups run on our behalf by an independent third party.

² The eight firms are listed on page 2 of this report.

From the evidence obtained, and using the FRC's Corporate Culture and the Role of Boards report (2016)³ as guidance, our review has identified different approaches to establishing, promoting and embedding a desired culture which we considered to be either innovative or particularly responsive to a recognised cultural need. We have identified a number of examples across all the firms to share within this report. We also identified a number of key areas where the firms should focus greater attention.

This is the first time we have undertaken a study of audit culture. It is a broad, complex subject and will require further exploration in our pursuit of audit quality improvement. We will ask all firms involved in this thematic to take actions to continue to enhance the design, implementation and monitoring of their audit culture and to seek to identify the cultural and behavioural root causes behind our inspection findings. As part of our audit monitoring and supervisory approach⁴ we will develop an assessment of the culture at the largest firms. We will also encourage investors and other stakeholders to continue the debate on culture and its link to audit quality.

1.2 Why culture is important to high quality audit

High quality audit is supported by fundamental principles, rigorous standards, due process and mandated quality assurance. However, auditing, by its very nature, is judgemental and based on human decisions and actions. There are many factors that influence the environment within which auditors make their decisions and act. There can be tension between these factors and auditors are faced with competing priorities.

Wider public confidence in audit remains vulnerable to evidence of inappropriate decisions or actions by auditors and of poor quality audit work. This is particularly true where circumstances indicate a failure by auditors to be sufficiently independent or professionally sceptical about the entities they audit.

However, independence cannot be assured through rules and standards alone. Instead auditors need to apply the principles and live by the spirit intended, in accordance with legitimate public expectation.

In this context, it is important that firms create a culture where achieving high quality audit work is valued and rewarded, and which emphasises the importance of 'doing the right thing' in the public interest. Auditors must also consider it their duty to serve the needs of shareholders, rather than management of the audited entity.

In our review we have considered how firms identify and pay attention to such challenges in their culture and take positive action to address them to promote and sustain improvements in audit quality.

³ Corporate Culture and the Role of Boards (2016) available at: www.frc.org.uk/getattachment/3851b9c5-92d3-4695-aeb2-87c9052dc8c1/Corporate-Culture-and-the-Role-of-Boards-Report-of-Observations.pdf

⁴ FRC Strategy 2018/21 & Budget and Levy 2018/19 (published March 2018), and Press notice "FRC to enhance monitoring of audit firms" available at: [https://www.frc.org.uk/news/april-2018-\(1\)/frc-to-enhance-monitoring-of-audit-firms](https://www.frc.org.uk/news/april-2018-(1)/frc-to-enhance-monitoring-of-audit-firms)

Our review of culture is prompted by seeking to understand what drives the actions and behaviours of auditors. The firms included in this thematic are professional services firms with an audit practice; the percentage of total fee income arising from audit services across the eight firms ranges from 16% to 23%⁵. Accordingly, in this thematic, we have considered the culture of the firm as a whole (at times extending our scope wider still, looking at elements of culture across the firm's global network), then, in certain areas, focusing on initiatives aimed predominantly at the audit practice.

1.3 Our key messages

Findings

We found evidence that the firms are investing considerable time and effort on their firm-wide culture. There are examples in this report for other firms to consider adopting, including how firms relate their purpose, values and encouraged behaviours to day-to-day activities. We also identified areas of common strength, such as firms having well established accountability frameworks and robust processes to sanction poor quality work or behaviour.

Whilst progress made by individual firms may differ, there are a number of key areas where more should be done by the firms to establish, promote and embed an appropriate audit culture. These include the following areas, each of which is explained further in section 3 of this report:

- Giving additional prominence to audit specific behaviours and values within the firms' cultural design, including the fundamental principles of integrity, objectivity, independence and professional scepticism that underpin high quality audit;
- Ensuring that all audit partners and staff appreciate that a good audit is of significant societal value and helps to underpin transparency and integrity in business;
- Balancing the firms' robust processes to sanction poor quality work or behaviour with better recognition of positive contributions to high audit quality;
- Further developing the firms' root cause analysis ("RCA") techniques to identify the behavioural or cultural factors that contributed to good and poor quality outcomes; and
- Improving the firms' monitoring of how successful they are at embedding their desired culture, including the INEs of the firms being more proactive when performing their assessment of the steps being taken by the firms to embed an appropriate culture.

⁵ Key facts and trends in the accountancy profession (2017) available at: <https://www.frc.org.uk/getattachment/771c8390-d0d1-4bfe-9938-8965f72b1b2/Key-Facts-and-Trends-2017.pdf>

We also encourage firms to provide more extensive and transparent public reporting on their cultural assessment to facilitate greater engagement between the firms and stakeholders. Some stakeholders are sceptical about aspects of audit culture and this should help build confidence and trust.

We have also made suggestions within this report for how stakeholders, such as investors and audit committees, could engage more on audit culture.

Next steps

Establishing, promoting and embedding culture takes time. The key evidence of success will be improved stakeholder confidence and improved audit quality findings.

We plan to report publicly within the next three years on the actions firms have taken in relation to the findings of this thematic review. We will also consider culture where it is relevant to our planned 2018/19 thematic reviews on audit quality indicators (“AQIs”) and transparency reports. In addition, we will regularly follow up on aspects of this thematic review through our new audit monitoring and supervisory approach. The work will include monitoring in relation to values and behaviours.

1.4 Summary of our findings

The table below summarises our findings. Our further observations are set out in Section 3.

Area	Sub-section	Summary of our findings
Design	3.2	<p>Culture has been designed (being purpose, values and encouraged behaviours) for the whole multi-disciplinary firm. There are good examples of firms keeping their cultural design current. In some firms, audit specific values such as objectivity and independence are not sufficiently prominent.</p> <p>All firms could do more to promote to partners and staff the purpose of an audit and the societal value that it brings.</p>
Implementation	3.3	<p>The performance management and reward processes at firms are generally aligned to their values and encouraged behaviours.</p> <p>There are good examples of firms being innovative in order to relate their purpose, values and encouraged behaviours to day-to-day activities.</p> <p>All firms have robust processes to sanction poor quality audit work or behaviour. More could be done to balance this with recognising positive contributions to high audit quality.</p>

Area	Sub-section	Summary of our findings
Monitoring	3.4	<p>Firms have well embedded staff survey and listening processes. Whilst good examples of using other techniques such as AQIs and RCA to monitor behavioural or cultural factors have been identified in some firms, many of these initiatives are still in their infancy and will require continued focus.</p> <p>Firms could enhance the public reporting of their assessment of how they are promoting an appropriate culture within transparency reports. Stakeholders consider this topic to be important but feel there is little visibility on what firms are doing.</p>
Tone at the top	3.5	<p>Our evidence shows that partners and staff consider the tone at the top of their firm to be strong, with leaders visibly living and demonstrating the firm's core values.</p> <p>Audit remains a core service line for all firms with representation from auditors in senior leadership positions. Four of the eight firms prominently included improving audit quality within their whole-firm strategies, four did not. More could be done to promote audit specific values and make auditors feel valued for the work they do.</p> <p>Given the prevailing public scepticism about audit culture, firms need to do much more to convince other stakeholders about the tone at the top. This links to the points above regarding public reporting.</p>
Independent Non-Executives	3.6	<p>The INEs are becoming better established in their roles⁶. There are good examples of INEs increasing their visibility across the firm by meeting a wider selection of partners and staff. This provides the INEs a broader insight into the culture throughout the firm.</p> <p>There is scope for INEs to do more in meeting their responsibility to be involved in the firms' review of the effectiveness of their promotion of an appropriate culture. The INEs could broaden the range of tools, indicators and information that allow them to gain an independent view of the culture of the firms and, where necessary, to challenge the firms' leadership. Improvements to the firms' own monitoring of culture will assist with this as more cultural indicators will be available for INEs to use.</p>

⁶ The role of the INEs is set out in the Audit Firm Governance Code (revised 2016) available at: www.frc.org.uk/getattachment/8e2026c0-cac0-4faa-8326-4713511f139a/Audit-Firm-Governance-Code-July-2016.pdf

Area	Sub-section	Summary of our findings
Specific challenges	3.7	<p>We have seen examples of some firms taking positive action to encourage an environment where individuals feel that achieving consistently high audit quality is valued and rewarded above other performance considerations.</p> <p>While most firms recognise that the existence of multi-disciplinary firms contributes to cultural challenges, few firms have clearly articulated those challenges or taken specific, explicit actions to address them.</p> <p>We have seen good examples of firms taking a global approach to elements of culture through global initiatives and, in many instances, setting global values. However, many of the firms have designed their purpose, behaviours and strategies for the UK firms and not for the global network. Firms could consider the benefits to audit quality of having closer cultural alignment and integration of cultural design, focussed on the underpinning audit principles of integrity, objectivity, independence and professional scepticism, across their global network.</p>
Implications for stakeholders	3.8	<p>There is an opportunity for stakeholders to engage more in the subject of audit culture. Although the investors we spoke to recognised culture as being important to audit quality, their interaction with audit committees and the firms on the topic was limited. They felt that audit culture would be a greater factor in their appointment of an auditor if it had more visibility in the first place.</p> <p>The investors we spoke to identified professional scepticism and an appreciation that the auditors are working primarily for shareholders rather than management as key cultural attributes they look for.</p> <p>We have made suggestions for how investors could increase their interaction on the subject of audit culture. We have also made suggestions for how audit committees can more directly raise the subject with the firms.</p>

2 Background to this report

2.1 Background

Investors and other users of financial statements rely on auditors to give them confidence that the information on which they base their economic decisions gives a true and fair view of an entity's performance, that they have been prepared in accordance with applicable law, and that company annual reports are fair, balanced and understandable. Confidence in the financial information companies present to the market is fundamental to the functioning of our capital market, and to ensuring that the UK remains an attractive and competitive destination for international investment. High quality audit also provides a strong deterrent effect against actions which are not in the public interest. Audit underpins transparency and integrity in business.

The FRC has a strategic objective to promote justifiable confidence in audit in the UK. Such confidence is underpinned by the commitment of auditors to deliver high quality audits. While progress made by individual firms may differ, all firms are investing significantly in audit quality and have set out further actions to deliver quality outcomes on a consistent basis. However, high profile failures, as well as the results of our audit monitoring, continue to identify cases where auditors have failed to meet the requirements of standards or have failed to meet public expectations of audit.

In July 2016 the FRC published a report on Corporate Culture and the Role of Boards. The report looked at the important role that corporate culture plays in delivering long-term business and economic success. In its research for the report, the FRC saw abundant evidence that companies and boards are taking action to shape their culture. The FRC commended and encouraged those companies to maintain this focus, whilst encouraging those companies yet to take action to consider the benefits of addressing this important issue.

Recognising that audit quality is not yet consistently and sufficiently high, we aim to promote continuous improvement through a range of means, including thematic reviews which make comparisons between firms with a view to identifying both good practice and areas of common weakness. This thematic review therefore follows on from the FRC's report on Corporate Culture and the Role of Boards and sets out our principal observations on what actions firms are taking to shape their culture, with a particular focus on the promotion of high quality audit.

In addition to drawing on our broader work, we also had regard to the well-developed professional standards that underpin auditor behaviour based on the fundamental principles of integrity, objectivity, independence and professional scepticism.

2.2 Objectives of this thematic review

Introduced in 2013, our thematic reviews supplement our annual programme of reviews of individual audit firms. The reviews are deliberately focussed in scope, considering a selected area in greater depth than is generally possible in our review of audit engagements.

In 2008, we published our Audit Quality Framework, which identified an appropriate culture within a firm as a key driver of high audit quality. The need to promote an internal culture recognising that quality is essential in performing engagements is also incorporated within international auditing standards (ISQC1, paragraph 18). The FRC's Audit Firm Governance Code, updated in 2016, notes that firms and their INEs should, at least annually, conduct a review of the effectiveness of the firm's system of internal control, including an assessment of the promotion of an appropriate culture, underpinned by sound values and behaviour within the firm. Such evaluations should be reported to stakeholders in the firm's annual transparency reports.

The objective of this thematic review is to gain an understanding of, and provide transparency to, the actions that firms are currently taking to establish, promote and embed such a culture. By comparing and contrasting actions at different firms we aim to identify and report areas of good practice and, where necessary, provide encouragement for firms to do more.

Whilst there are some audit specific behaviours and values that all firms should give sufficient prominence to within their cultural design, such as the fundamental principles of integrity, objectivity, independence and professional scepticism, we recognise that firms are likely to have other aspects to their culture that are different. This should be a healthy means of competition and differentiation in the audit market and this thematic review is not an attempt to stipulate a particular target culture based on FRC expectations. This is similar to the view of Chairmen interviewed during our 2016 project on Corporate Culture and the Role of Boards, where the strong consensus was that there is no single culture that should be aspired to.

This report has been prepared to assist the firms to develop or enhance their activities to embed a culture that supports the delivery of consistently high quality audit. It should also be used more widely to stimulate discussion on audit culture with stakeholders. We have provided stakeholders, such as investors and audit committee chairs, with some insight on firms' activities to assist them in their interactions with firms on the subject of audit culture.

“Chairmen felt strongly that there is no ‘one-size-fits-all’ when it comes to culture. What matters is that the culture is appropriate for the context in which the company is operating and that there is internal alignment between company purpose, values, strategy and business model(s)”
FRC's Corporate Culture and the Role of Boards Report

2.3 Scope & evidence base

Scope

The scope of this thematic review covered the eight firms⁷ which have adopted the Audit Firm Governance Code (“the firms”).

We structured our review of audit culture into five key areas, being design, implementation, monitoring, tone at the top, and independent oversight. These areas were further split into sub-sections as shown in the diagram below. Each sub-section is an important aspect of how firms can promote, monitor and assess their culture, with a particular focus on the implications for audit quality.

In addition to the five key areas, we also considered:

- Some specific challenges to achieving an appropriate audit culture, including what firms are doing to address those challenges; and
- What stakeholders, namely investors and audit committee chairs, thought of audit culture and how they can enhance their engagement in the subject.

We drew on our report on Corporate Culture and the Role of Boards (2016) in determining the structure of this review.



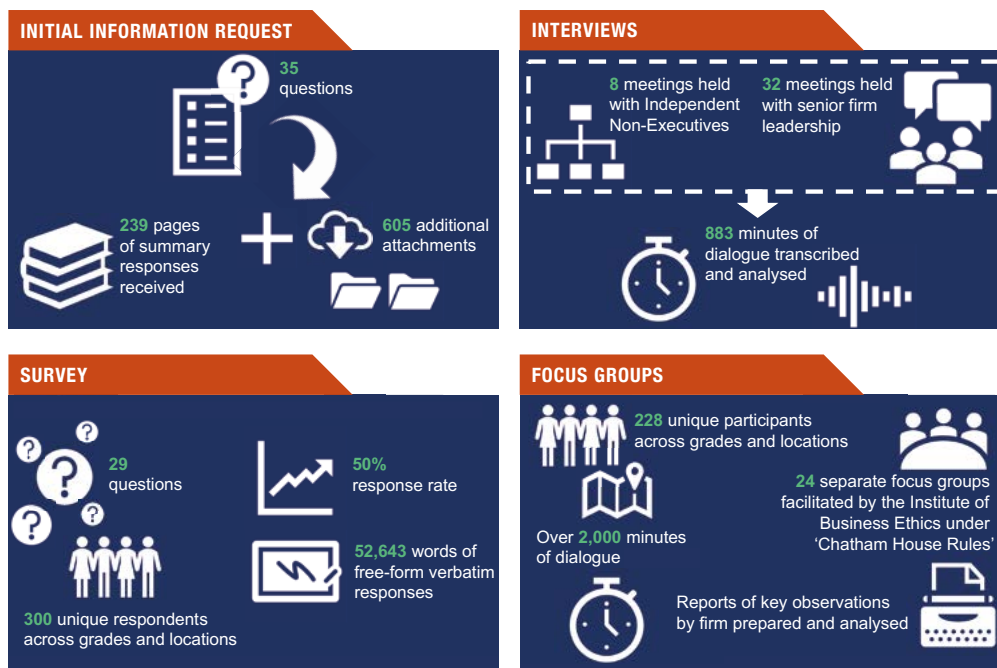
⁷ The eight firms are listed on page 2 of this report.

Evidence base

We gathered evidence for this thematic review from four key sources, being:

- Firm documents, both internal and those that are publicly available;
- Interviews with INEs of the firms and members of the firms' senior leadership teams;
- Sending our own independent survey to a sample of audit partners and staff; and
- Engaging the Institute of Business Ethics ("IBE") to run a series of focus groups on our behalf. The focus groups were attended by audit partners and staff.

We also held discussions with investors and audit committee chairs.



2.4 Acknowledgements

We would like to thank those that contributed to this thematic review, in particular the:

- Individuals who attended the focus groups and completed our survey;
- Firms for their co-operation;
- Investors and audit committee chairs who met with us; and
- IBE for facilitating the focus groups and providing us with comprehensive feedback. We paid IBE a fee of £19,000 for their assistance.

3 Thematic review findings

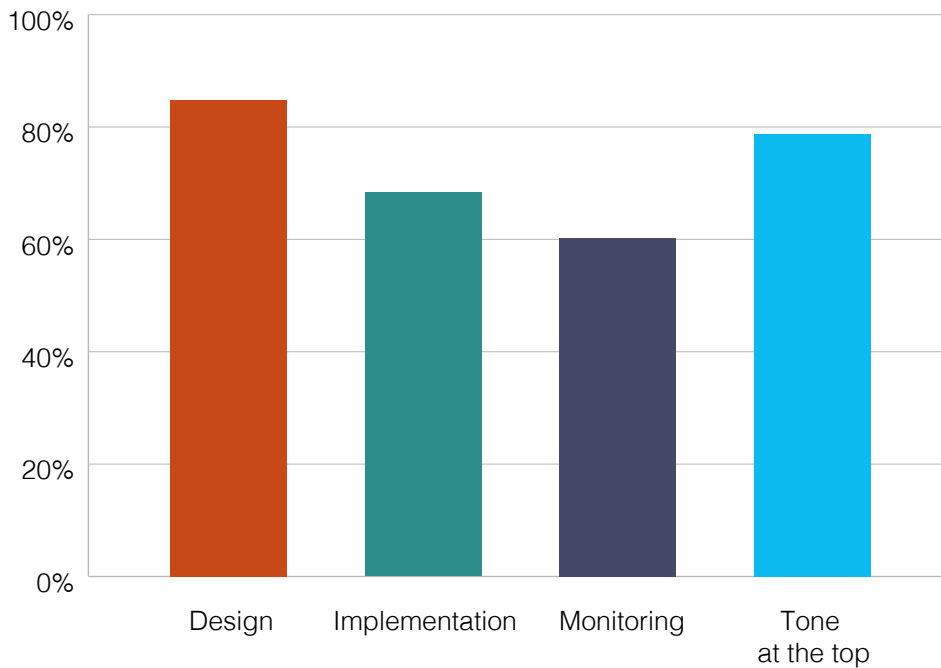
3.1 Introduction

The chart below plots our survey results for four of the key areas reviewed, being design, implementation, monitoring and tone at the top. It shows that the partners and staff that responded to the survey had the highest sentiment scores (meaning they most strongly agreed) to statements relating to firms having good cultural design and tone at the top. The sentiment scores then decreased for implementation and decreased again for monitoring.

This perspective is useful context for the remainder of the report as it reflects our view from other sources of evidence gathered that, whilst firms have invested in cultural design, there is less consistency across the eight firms in their implementation methods and that monitoring is the area with the greatest need for improvement.

Partners and staff that responded to the survey had the highest sentiment scores for statements relating to firms having good cultural design and tone at the top

Overall sentiment by cultural pillar based on survey responses



3.2 Design

Why is this important?	<p>Values are a key building block of culture. Rules and sanctions have their place, but principles based values are more enduring. Values should link to a set of common behaviours that are meaningful to the firm and those who work there. Establishing the firm’s overall purpose is crucial in order to align its values and encouraged behaviours with a common cause.</p>
Summary of key findings	<p>Culture has been designed (being purpose, values and encouraged behaviours) for the whole multi-disciplinary firm. There are good examples of firms keeping their cultural design current. In some firms, audit specific values such as objectivity and independence are not sufficiently prominent.</p> <p>All firms could do more to promote to partners and staff the purpose of an audit and the societal value that it brings.</p>

We found there to be a strong consensus amongst firms that promoting an appropriate culture was important to achieving consistently high audit quality

Our survey results demonstrate that partners and staff understand their firm’s purpose to be consistent with performing high quality audits

Purpose

We found there to be a strong consensus amongst firms that promoting an appropriate culture was important to achieving consistently high audit quality.

Firms have generally used similar techniques to promote their desired culture. For instance, seven out of eight firms have articulated firm-wide purpose statements, these are shown below.

Make an im**P**act that matters

Building tr**U**st in society and solving important problems

Inspire Confidence Empowe**R** Change

Sha**P**ing a vibrant economy

Building a better w**O**rking world

Helping you **S**ucceed

Make a tangible diff**E**rence to our clients by providing quality solutions with unparalleled client service. Build a growing and sustainable business where our people thrive and our values endure. Play an active role in the support and development of our communities.

Our survey results demonstrate that partners and staff understand their firm's purpose to be consistent with performing high quality audits.

We found less clarity on why achieving high quality audit is important to each firm's purpose. The focus groups found that auditors did not have a strong sense of the societal value of their task. Only in one firm was there a clear sense of audit being there to provide confidence in the capital markets. Instead, the very strong emphasis on achieving high quality tended to be directed towards managing reputational risk for the firm and helping clients achieve compliance. There is an opportunity for firms to strengthen how well the link between their purpose and the broader societal importance of audit is communicated and understood, particularly the importance of high audit quality to business or capital market confidence.

FOCUS GROUP FEEDBACK

"Participants at every level showed very limited awareness of either purpose or firm-specific values, although their responses showed that generic values such as integrity and reliability were generally well-embedded in the way they approached their work."

"Vagueness about purpose and values meant that auditors we talked to did not have a strong sense of the social value of their task. Only in one of the firms was there a clear sense of audit as being there to provide confidence in the capital markets."

"In contrast to the lack of clear focus on purpose, there was generally a very strong emphasis on quality. Firms are acutely aware of the reputational risk of being seen to fail on quality. This is a strong driver of culture and behaviour."

A culture that is 'purpose-led' has the ability to inspire actions that are aligned to desired outcomes as a collective team effort. Employees as stakeholders are the most important customer-base in terms of culture; if they aren't buying it, nobody else can be expected to.

CASE STUDY 1

Purpose-led culture

One firm's stated purpose, GT, was supported by a wide range of initiatives, stories and role models consistently striving towards a goal, that was as much a benefit to others as it was to partners and staff of the firm. The sense of stewardship and contribution to something of greater value than the commonly transactional nature of professional services was very clear. Further, the firm sought ways to integrate the purpose into day-to-day auditor considerations, a demonstration of the culture being 'purpose-led' and applying both the spirit and the letter of relevant standards.

Values

All firms have defined values and these are aligned to their stated purpose (for the seven firms that have one). In all but one instance, the firms promote “acting with integrity” or “doing the right thing” within their core values. In all instances, acting with integrity is prominent either within values or encouraged behaviours.

Three firms have recently undertaken extensive cultural audits to refresh and re-affirm their values. Those three firms, and others, have held regular training courses on their values and have undertaken significant promotional campaigns. Such initiatives are welcome. However, our evidence shows that some auditors still had relatively little awareness of the firm specific values. Instead, generic values such as integrity and reliability were well embedded in the way they did their work and, at the individual operating level, participants in the focus groups displayed a high level of integrity and desire to do the right thing. This may indicate that whilst the audit profession has a strong sense of its values, individual firms can do more to promulgate their own values within the organisation.

One firm specifically identifies independence as a core value explained as “We always think independently, and in our roles as auditors and advisors we always act independently.” Whilst independence is generally encapsulated within “Integrity” and “Doing the right thing” within the values of other firms, it was notable how much more prominence it gained by being a value on its own.

A recent refresh of values at one firm saw the introduction of a “Care” value. This emphasises the importance of understanding every individual, recognising their contributions and supporting one another. This value has a strong link to the firm’s well-being agenda. In the implementation section of this report (3.3), there is another example of an increasing focus on wellbeing. Two other firms had similar values around respecting the individual and mutual respect and support. A further two firms had specific values in relation to diversity.

The ‘word cloud’ opposite presents the words that are most commonly expressed in the firms’ stated values. The font size represents how often the word has been expressed. Integrity is the word most commonly used, followed by respect and teamwork. Note that where very similar words have been used by different firms, we have grouped them together under a single word.

We note that many, but not all “audit specific values” are in the word cloud. Firms should consider other audit specific values such as those set out in the Audit Firm Governance Code and the Ethical Standards.⁸



Acting with integrity and doing the right thing is emphasised by seven of the eight firms within their core values

There are a number of good examples of firms having recently refreshed their cultural design

⁸ The Audit Firm Governance Code includes: integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour; the Ethical Standard includes integrity, objectivity, and independence.

Encouraged behaviours

All firms have translated their values into a comprehensive set of expressed behaviours that appear to be meaningful to the firm and those who work there. 94% of survey respondents either agreed or strongly agreed with the statement “It is clear how I am expected to behave to live up to the firm’s values.”

Three firms explicitly recognise the value and importance of learning from mistakes within their encouraged behaviours. We consider this to be valuable to promoting a culture of continuous improvement. Two firms outlined their encouraged behaviours using a “do’s and don’ts” framework which outlined their expectations with greater clarity.



3.3 Implementation

Why is this important?	Having an appropriate cultural design is not enough. In order to have a positive impact on behavioural outcomes and influence the way auditors conduct themselves, the values of a firm need to be embedded into regular activities. In particular, the performance management and reward systems should encourage behaviours that are consistent with a firm’s desired culture.
Summary of key findings	<p>The performance management and reward processes at firms are generally aligned to their values and encouraged behaviours.</p> <p>There are good examples of firms being innovative in order to relate their purpose, values and encouraged behaviours to day-to-day activities.</p> <p>All firms have robust processes to sanction poor quality audit work or behaviour. More could be done to balance this with recognising positive contributions to high audit quality.</p>

Incentives and rewards

Many firms have established methods to link performance management and reward back to values and encouraged behaviours. This is typically achieved through the use of balanced scorecards and requiring objectives to be set in relation to each of the firm's values.

One firm provides a specific quality rating within partner appraisals, from which a partner's overall rating cannot deviate by more than one point up or down. This system reinforces the importance of high quality and the behaviours that are necessary to achieve it. It also formalises what we are often told by firms, which is that quality is the most important consideration within an appraisal process. At another firm, there was clear evidence that they had increased the performance rating and associated reward for a number of partners, specifically as a result of them delivering exceptionally high quality in the year. The reason for each reward was publicised amongst the partner group as an example of 'best practice'.

We had several discussions on how firms assess the quality of an individual's behaviour when performing their work, in addition to the quality of the outcome of their work. An example we heard was that, within a firm's year end appraisal process, participants in moderation meetings were asked to talk about instances of behaviour that were either well aligned or not aligned to the firms encouraged behaviours. Such discussions can allow performance managers to calibrate how prevalent and consistent certain behaviours are and to take actions accordingly.

All firms have rigorous processes for assessing partner promotion candidates, including a significant emphasis on assessing the quality of their work. However, for three of the firms reviewed, the non-partner promotion process did not include a clear assessment of quality. We also identified via our survey that junior staff, being those not yet at manager grade, perceive very little differentiation in their reward in relation to quality.

There are well established processes in place at all firms to sanction poor quality work or behaviour. We have seen examples of these sanctions being used appropriately. All firms have told us that it is difficult to balance their sanctioning regime with appropriately recognising and rewarding positive behaviours or contributions to quality. This bias toward sanctioning the bad more than rewarding the good presents a risk that, within the culture of firms, quality considerations may be seen as something to be feared as opposed to an opportunity to shine. Firms are partially tackling this by providing recognition to those who deliver audit quality improvements. They do this through story-telling and recognition awards. However, more still needs to be done to recognise and reward contributions to high quality to ensure this aspiration is achieved.

The performance management and reward processes at firms are generally aligned to their values and encouraged behaviours

All firms have robust processes to sanction poor quality work or behaviour. More could be done to balance this with recognising and rewarding positive contributions to high audit quality

CASE STUDY 2

Non-monetary rewards

One firm, EY, created a recognition scheme that focusses on non-monetary reward for those that embodied the firm's values and commitment to audit quality. The awards are limited in number and are distributed by those who received recognition in the previous quarter, therefore passing on the kudos of recognition to their peers. Recipients of the award have their stories publicised nationally within the firm, providing others with examples of 'what good looks like' and an affirmation of the benefit of 'living the values'. The frequency of the award keeps it fresh, whilst not devaluing the accolade and, although the award and stories are personal, the social recognition that the scheme provides helps to promote a sense of camaraderie and a collective celebration of success.

A number of firms are looking carefully at the need to support and mentor their partners when issues relating to audit quality arise, including learning lessons from mistakes

Accountability and responsibility

A number of firms are looking carefully at the need to support and mentor their audit partners when issues relating to audit quality arise, including learning lessons from mistakes. All firms have introduced formalised accountability frameworks for partners and staff. Some firms are using these in combination with RCA to ensure that lessons are being learnt where quality issues have been identified and that individuals are being held accountable in a fair way. As a key foundation, of what is sometimes described as a "Just culture", certain firms provide coaching and support for teams throughout the process and some firms reduce the size of a sanction when the individual has engaged in the RCA process in an open and constructive way. This maximises the firm's ability to learn from mistakes and is recognised accordingly. Importantly a "Just culture" does not shy away from ensuring that individuals are held to account, instead the focus is on an outcome that is fair, transparent, consistent and evidence-based.

FOCUS GROUP FEEDBACK

"Positively, there does not appear to be a "blame culture" within the industry as a whole. In one firm we were told that where people did make mistakes they were put into a lower risk environment and monitored before moving back to where they were previously."

Embedding purpose, values and encouraged behaviours into audit

Firms are developing methods to embed their purpose, values and encouraged behaviours into day-to-day processes. This is a valuable implementation technique that relates what has been learnt on training courses and seen in promotional material, back to individual engagements. Good examples include:

- Before accepting an engagement, one firm asks teams to articulate why the engagement will contribute positively to the firm’s purpose and values;
- One firm provides engagement leaders with a toolkit to lead discussions with the team on how they will relate the firm’s values to that engagement; and
- Another firm asks teams at the outset of an engagement to set a clear plan, including measurable actions, for how encouraged behaviours such as providing on the job coaching will be implemented on the engagement. This was determined to be a key area of focus for the firm following the completion of RCA on previously identified quality issues.

We have also seen prominent examples of firms having an increased focus on the wellbeing of partners and staff. This is crucial in order for firms to deliver high audit quality in a sustainable manner. One firm has reduced its number of appraisal managers, keeping only those that display a strength and passion in caring for and nurturing others. This core population has then been provided with specialised training to enable them to identify potential mental health issues and engage appropriately in conversations.

There are good examples of firms being innovative in order to relate their purpose, values and encouraged behaviours into day-to-day activities

3.4 Monitoring

Why is this important?	It is inherently difficult to measure intangibles such as behaviour and culture. A determined effort is required to build a picture from various (sometimes indirect) indicators of the prevailing behaviour and culture at different levels of an organisation. Such an undertaking is necessary to enable firms to design appropriate actions to promote their desired culture.
Summary of key findings	<p>Firms have well embedded staff survey and listening processes. Whilst good examples of using other techniques such as AQIs and RCA to monitor behavioural or cultural factors have been identified in some firms, many of these initiatives are still in their infancy and will require continued focus.</p> <p>Firms could enhance the public reporting of their assessment of how they are promoting an appropriate culture within transparency reports. Stakeholders consider this topic to be important but feel there is little visibility of what firms are doing.</p>

Staff surveys

All firms have well embedded staff survey processes that include running focus groups to understand better the themes arising from the survey and the potential causes. Two firms made the complete set of survey results available to everyone in the firm, allowing them to analyse the information and ask questions accordingly. This is indicative of an open and transparent culture. We also noted good examples of firms conducting additional, more focussed surveys in response to specific themes.

For most firms the process for agreeing actions as a result of staff survey results is informal and it is not clear how progress against actions is being monitored.

Leavers can provide another source of feedback on culture. Response rates to leavers' surveys vary significantly between the firms, the lowest being 27% and the highest 89%. This demonstrates that, at some firms, much more can be done to encourage feedback from leavers and to consider taking appropriate actions as a result.

Listening

Firms use a number of different channels to encourage two-way communication between the leadership of the firm and partners and employees. Firms consistently expressed the importance of their line management structures where leaders and managers listen to and actively encourage employees to speak up. This is supplemented by well-embedded whistleblowing policies at all the firms. 77% of respondents to our survey either agreed or strongly agreed with the statement "I feel able to "speak out" where others' behaviours are inconsistent with the firm's values."

Some firms go further and we have seen good examples of:

- Employees having direct feedback mechanisms to the board through elected representatives; and
- Firms creating anonymous reporting channels for matters that people may be reluctant to report to the "whistleblowing hotline", due to doubts of the significance of their concern. To encourage all such matters to be raised, some firms have set up separate helplines or used intranet portal sites to create greater opportunity for all concerns to be reported.

Many firms are promoting the use of internal 'social media' channels as methods of communication and listening. The real-time and collaborative nature of such tools encourages partners and staff to "speak up" and share their views. There is an opportunity for firms to make increased use of such platforms to provide regular insights into the sentiment of their partners and staff.



CASE STUDY 3

“Speak up” culture

The ability for partners and staff to provide their views directly to the leadership of the firm demonstrates an openness and transparency which is conducive to a healthy culture.

One firm, Mazars, established an advisory committee to the UK executive, which includes elected employee representatives for a term of two years. The committee focusses on understanding where the firm’s culture is now and how it should evolve to ensure all team members have a sense of belonging, can maximise their contribution to the firm’s stated purpose and realise their individual potential.

Good examples have been identified of using other behavioural or cultural monitoring techniques such as AQIs and RCA. Many of these initiatives are in their infancy and would benefit from continued focus

Audit Quality Indicators

All firms have made investments in identifying and monitoring AQIs. Firms have told us that their goal is to identify “leading indicators” that spot potential quality issues before they arise and allow for early intervention.

However, we have seen few examples of such indicators being used in relation to cultural or behavioural matters and there is much for firms to do in this area. The inclusion of such indicators in “cultural monitoring dashboards” would allow firms to monitor factors that specifically influence audit quality, alongside general cultural health.

One firm has established some statistical relationships between certain indicators and cultural health. By monitoring these indicators, the firm expects to have a positive impact on cultural health and audit quality. These indicators are disclosed in the firm’s transparency report. They include factors such as female employee ratio and illness proportion.

We found the firm’s work on female employee ratios particularly interesting. The firm identified a correlation between well-performing teams with low dysfunctional levels and there being a good proportion of female team members. While identifying a correlation does not imply causation, the firm thinks this could be interesting information when creating team mixes going forward. We encourage other firms to consider this matter, particularly as it may add additional emphasis to the importance of addressing the current gender imbalance at senior levels in the firms.

We are performing a thematic review on AQIs in 2018/19 and will report on their use in more detail, including in relation to cultural or behavioural matters.

Root Cause Analysis

All firms have made advances in RCA since our 2016 thematic review. However, there is still more for firms to do, particularly regarding identifying the cultural or behavioural factors that impact performance.

One firm has made good progress by performing a detailed exercise using external behavioural psychologists to identify the root causes of success for teams that have produced high quality audits. This information has been used by the firm to better enable other teams to exhibit the same positive behaviours. Other firms have begun using behavioural psychologists to train their RCA teams in how to identify behavioural root causes where quality issues have been identified.

CASE STUDY 4

“Root Cause Analysis feedback loop”

Where firms have invested in RCA sufficiently to understand the behavioural antecedents to the issue identified, it is essential that a feedback loop is created to implement changes in design which focus on reducing, and hopefully eliminating in time, the causes of such behaviour in the future.

An example of this iterative approach to continuous improvement was displayed by one firm, BDO, which identified that the perception of junior staff was one of a lack of accountability in respect of quality. This cause of behaviour was addressed promptly by explicitly including an assessment of quality in the appraisals of junior staff and reiterating responsibilities through additional training.

Public reporting

The FRC’s 2016 report on Corporate Culture and the Role of Boards identified a strong consensus among investors that there is a need for companies to improve reporting on culture and communicate openly about the impact of culture on the business. These views were shared by the investors that attended our roundtable on audit culture (see section 3.8 of this report).

We included in the Audit Firm Governance Code (2016) a “comply or explain” requirement that firms applying the Code should include in their transparency report details on what the board and the INEs have done to satisfy themselves that an appropriate culture exists throughout the organisation.

Our review of recent transparency reports shows that the firms need to improve the public reporting of their cultural assessment significantly. Except for one firm, where good progress has been made, very little is being disclosed on the process the firms have gone through to assess their culture, the findings of their assessment or the actions taken as a result. For some firms this was a missed opportunity to report on the cultural ‘audits’ they had performed.

Firms could do more to identify cultural or behavioural root causes

Transparency reports could provide information on the actions firms are taking and their recent monitoring results towards achieving their desired culture

In particular, we suggest that firms acknowledge what they have identified as their key challenges to audit culture, explain what steps have been taken to address those challenges to ensure an appropriate culture exists that is committed to delivering consistently high quality audits, and how they are monitoring progress in achieving that desired culture. We believe that such transparency will be of considerable value to stakeholders and will facilitate greater engagement between stakeholders and the firms.

We are conducting a thematic review on transparency reports in our 2018/19 cycle and will include an updated consideration of the firms' reporting on culture.

Our evidence shows that partners and staff at all firms consider the tone at the top to be strong

3.5 Tone at the top

<p>Why is this important?</p>	<p>Culture is much more about people than it is about rules. The alignment and consistency of behaviours of leaders, and how they communicate through words and actions is an essential starting point. In this context partners should lead by example and ensure that good standards of behaviour permeate throughout all levels of the organisation and that auditors feel valued for the work they perform.</p>
<p>Summary of key findings</p>	<p>Our evidence shows that partners and staff consider the tone at the top of their firm to be strong, with leaders visibly living and demonstrating the firm's core values.</p> <p>Audit remains a core service line for all firms with representation from auditors in senior leadership positions. Four of the eight firms prominently included improving audit quality within their whole-firm strategies, four did not. More could be done to promote audit specific values and make auditors feel valued for the work they do.</p> <p>Given the prevailing public scepticism about audit culture, firms need to do much more to convince other stakeholders about tone at the top. This links to the points above regarding public reporting.</p>

Tone at the top

There is good evidence of firms using a variety of communication channels to deliver open and consistent messages. From our discussions with senior leaders at the firms, we know that sharing stories and experiences is often used to demonstrate how senior management and, in some cases, all staff are living the values and encouraged behaviours. There was good evidence of this occurring.

Members of senior leadership teams also commented on the importance of being role models and observed that in their leadership position, what they do can often be more important than what they say. In this regard, 82% of those who responded to our survey either agreed or strongly agreed that the firm's leadership visibly live and demonstrate the firm's core values. Most of the other responses were neutral with only a small minority disagreeing. This is a good result. However, the firms could consider why a small minority of people feel unable to agree with such an important statement.

SURVEY RESPONSE

82%

of those who responded to our survey either agreed or strongly agreed that the firm's leadership visibly live and demonstrate the firm's core values. Most of the other responses were neutral with only a small minority disagreeing

Four of the eight firms included improving audit quality within their whole-firm strategies, four did not

More could be done to make auditors feel valued for the work they do

SURVEY RESPONSE

79%

of those who responded to our survey either agreed or strongly agreed that Business Unit Leaders (or their equivalents) do enough to emphasise the importance of the firm's values

We also asked in our survey whether Business Unit Leaders (or their equivalents in the firm's management structure) do enough to emphasise the importance of the firm's values. Of those who responded to our survey, 79% either agreed or strongly agreed. Again, most of the other responses were neutral. This suggests that the firms are managing to consistently emphasise the importance of their values which is an important step towards achieving their cultural ambitions.

Two of the firms, Mazars and RSM, are not within the expressed scope of the Audit Firm Governance Code. We consider their willingness to adopt the code to be good practice and indicative of the firms having a desire to set a strong tone at the top of the organisation.

Auditor status

Audit remains a core service line for all firms, with representation from auditors in senior leadership positions. Our survey results demonstrate that this is recognised by those within the firm and that auditing is identified as a good career path.

In our meetings, the Senior Partners of the firms consistently emphasised the importance of audit to the firm's identity and brand. We did however observe that only four of the eight firms prominently included achieving improvements in their audit quality within their whole-firm strategies. There was also some negativity in the responses to our survey in respect of lower pay for auditors compared to other service lines.

In the Design section of our report we identified an opportunity for firms to strengthen how well understood the link is between their purpose and society, and in particular high audit quality and business or capital market confidence. Similar to this, we also feel there is an opportunity for some firms to be clearer on the value and importance of audit within the firm and to provide greater prominence to the positive messages being given in this area within the firm's overall strategy.

Within section 3.8 of this report we feedback some views of investors who specifically commented on their concerns that audit is generally a less profitable service line within the firms and observed there was therefore a risk of audit being relegated to a lower priority part of the business. We encourage the firms to acknowledge this challenge, and explain what they are doing to mitigate it, within their public reporting on culture.

3.6 Independent Non-Executives

<p>Why is this important?</p>	<p>Strong governance underpins an appropriate culture. It is essential that INEs can identify and challenge the firms on any misalignment between actions and the firm’s purpose and values. INEs also need to understand what drives the behaviours of partners and employees conducting audits. Without this understanding it is not possible to influence those drivers in a way that will promote audit quality improvements over time.</p>
<p>Summary of key findings</p>	<p>The INEs are becoming better established in their roles.⁹ There are good examples of INEs increasing their visibility across the firm by meeting a wider selection of partners and staff. This provides the INEs a broader insight into the culture throughout the firm.</p> <p>There is scope for INEs to do more in meeting their responsibility to be involved in the firms’ review of the effectiveness of their promotion of an appropriate culture. The INEs could broaden the range of tools, indicators and information that allow them to gain an independent view of the culture of the firms and, where necessary, to challenge the firms’ leadership. Improvements to the firms’ own monitoring of culture will assist with this as more cultural indicators will be available for INEs to use.</p>

“(Chief executives) we interviewed believe that NEDs have an important role in helping executives anticipate unintended consequences, including behavioural ones, of management proposals”
 FRC’s Corporate Culture and the Role of Boards Report

The INEs could broaden the range of tools, indicators and information that allow them to gain an independent view of the culture of the firms and, where necessary, to challenge the firms’ leadership

The INEs have an important role providing constructive challenge to the leadership of the firms. Their collective experience and expertise, combined with their independence, should enhance stakeholder confidence in the firms.

The role of the INEs includes a requirement to, at least annually, review the effectiveness of the firm’s system of internal control, including an assessment of the promotion of an appropriate culture underpinned by sound values and behaviour within the firm.

The INEs typically discharge their responsibilities through engagement with the firm’s leadership. However, we have also seen good examples of INEs building a picture of the prevailing culture at the firms by proactively meeting a selection of partners and staff, including visiting regional offices.

⁹ The role of the INEs is set out in the Audit Firm Governance Code (revised 2016) available at: www.frc.org.uk/getattachment/8e2026c0-cac0-4faa-8326-4713511f139a/Audit-Firm-Governance-Code-July-2016.pdf

As these good examples become more widespread, and the firms improve their own cultural monitoring such that better information becomes available, INEs will be better enabled to perform their own assessment of the promotion of an appropriate culture throughout the firms and to challenge the firms' leadership where necessary.

3.7 Specific challenges

<p>Why is this important?</p>	<p>Firms often utilise their global networks to audit international groups and in-house expertise from service lines other than audit to assist with complex matters. This approach is generally accepted as additive to high audit quality. However, there may be significant cultural differences between geographies or service lines that the firms need to manage.</p>
<p>Summary of key findings</p>	<p>We have seen good examples of some firms taking positive action to encourage an environment where individuals feel that achieving consistently high quality is valued and rewarded above other performance considerations.</p> <p>While most firms recognise that the existence of multi-disciplinary firms contributes to cultural challenges, few firms have clearly articulated those challenges or taken specific, explicit actions to address them.</p> <p>We have seen good examples of firms taking a global approach to elements of culture through global initiatives and, in many instances, setting global values. However, many of the firms have designed their purpose, behaviours and strategies for the UK firms and not for the global network. Firms could consider the benefits to audit quality of having closer cultural alignment and integration of cultural design, focussed on the underpinning audit principles of integrity, objectivity, independence and professional scepticism, across their global network.</p>

Commercial success and consistent high quality audit

It is imperative that firms create an operating environment where individuals feel that achieving consistently high quality is valued and rewarded above other performance considerations. We have seen evidence that the firms are taking positive actions to encourage this and we have identified several examples of good practice within the implementation section of this report.

At the same time, the focus groups identified a strong sense that auditing is under financial pressure with the demands on auditors growing but firms not being successful at increasing or in some cases, maintaining their fees. Cost and budget pressures may act as a disincentive to auditors doing the right thing.

The investors we spoke to as part of this thematic review commented that the way auditors are remunerated may not promote scepticism, as good auditing may incur additional costs that management are unhappy to pay. The investors also recognised that they had a responsibility to accept a higher fee where it is needed for a high quality audit to be performed. There may therefore, be an opportunity for auditors to be more transparent about instances where they have performed additional procedures but have been unsuccessful at increasing their audit fee. Whilst this may create tensions with management, it would provide investors with a greater appreciation that auditors are working on their behalf, not management's. This is one of the key cultural attributes investors are looking for (see section 3.8). There is also an opportunity for investors to engage more directly with audit committee chairs on this subject.

Our notes on best practice for audit tenders (published in February 2017)¹⁰ recommended that audit committees, not management, should conduct the fee negotiation when a new auditor is appointed. Similarly, the audit committee should be provided with information on the cost of any audit work performed over and above that envisaged in the original audit plan, so the audit committee can decide how this additional cost should be reflected in the final audit fee.

Multi-disciplinary firm model

The multi-disciplinary firm model has certain benefits for audit quality, most notably by providing ready access to expertise and experience beyond that of a typical auditor.

The multi-disciplinary firm model also presents some challenges to the prevailing culture at firms. Historically, one of the most significant challenges related to how auditors could remain independent of audited entities given that firms were often providing non-audit services to the company at the same time. This challenge, while still very relevant, has been reduced by more stringent independence rules that restrict a firm's ability to provide such services whilst being the auditor. The firms have also put in place more robust processes and, in recent years, we have observed improving levels of compliance in our monitoring of firm-wide procedures.

Other challenges remain and there is little evidence of firms having taken explicit actions to address them. These include:

- The tensions that can be created by audit sometimes being less profitable than other lines of service; and
- The extent to which the multi-disciplinary firm model contributes to a mindset of partners and staff that is focussed on providing the best possible client service, with the client defined as the company to which the service (including audit) is being provided. Such a mindset may make it more difficult for auditors to apply an appropriate degree of professional scepticism and challenge in their work. It also may increase the risk that the shareholders, the primary beneficiaries of the audit, may not be front of mind at all times.

The firms need to do more in these areas and should consider reporting their actions publicly to address this key area of stakeholder interest (see section 3.8).

¹⁰ Audit Tenders notes on best practice (2017) available at: https://www.frc.org.uk/getattachment/53c85956-d712-47d2-989f-2f8eff42be29/Audit-Tenders_notes-on-best-practice-Feb-2017.pdf

Global networks

Companies often have global operations and firms respond by forming international networks to mirror the corporate structures. Firms recognise the cultural challenges and quality impact of being part of a global network, including the significant reputational risk of inappropriate behaviour. We have seen good examples of global initiatives to align values and behaviours. However, there is opportunity for greater cultural alignment and integration of cultural design across the networks. This could begin with an assessment of what the cultural differences are across the network and how these differences could impact audit quality.

CASE STUDY 5

“Global alignment of cultural design”

Working in a market where companies expect a seamless high quality audit that mirrors their multi-national enterprise, it is important for firms to design and promote a global culture and set of working practices that transcend geographical cultural differences, therefore setting teams up for success from the outset.

One firm, PwC, in refreshing its values, conducted a global survey which received responses from a significant proportion of their network-wide workforce. The results of this survey identified what was important to partners and staff and how that correlated with their perception of the existing values. The identification of a global consensus culminated in an update to the firm's values and a suite of training materials and events, such that all partners and staff in the global network had a consistent cultural foundation.

Impact of regulation

One of the external influences on audit culture is the impact of regulation. This manifests itself in a variety of ways, including auditors being fearful of the implications of delivering poor quality work. An appropriate degree of tension here is necessary to achieve consistently high quality outcomes. The FRC needs to ensure the outcomes of our regulation are fair, transparent, consistent and evidence-based. We place great emphasis on these matters and they are important elements of our own cultural design.

FOCUS GROUP FEEDBACK

“There was a universal view that regulatory pressure is promoting focus on process rather than encouraging judgement.”

“Large organisations, particularly those with global reach, will have sub-cultures which can reflect different geographies, business units and remits. Nevertheless it is realistic to aspire to a common set of expected behaviours based on company purpose and values”

FRC's Corporate Culture and the Role of Boards Report

Interestingly, whilst the focus groups discussed the impact of regulation on audit culture, they did not identify regulatory pressure as creating a fear factor amongst auditors. Instead, there was strong feedback that regulatory pressure is leading to increased focus on the audit process rather than on whether an auditor's judgement is sound, and that this was detrimental to audit quality.

This feedback was similar across all the firms and is something we will explore in greater detail to determine whether it is our procedures or the firms' own response to regulatory risk that makes auditors feel more process driven. Either way, an appropriate focus on both process and judgement is necessary to ensure consistently high audit quality, as robust processes are needed to obtain appropriate evidence upon which sound judgement is applied.

Public expectations

Public confidence in business has undoubtedly been damaged by the behaviour of some entities or individuals over the last decade. Linked to this, expectations of audit and assurance are growing. It is important that the requirements of auditors keep pace with those expectations. We will be working in coalition with investors, business and others to shape the future of audit to meet the public interest.

Technology

Our longer-term aim is that audit should be a sustainable profession and that it innovates to meet changing business and economic circumstances, such that high quality audit is enduring. We have seen good examples of firms promoting the importance of innovation within their values. We welcome this as we recognise that developments in technology will present opportunities to improve audit quality in the years ahead, as well as having a significant influence on audit culture.

Staff attrition rates in audit

The business models of the firms plan for high attrition rates, particularly as staff become qualified. As a result, the promotion of an appropriate culture requires constant attention as a significant proportion of audit staff at any one time will be relatively new to the firm. Current attrition rates at the firms are between 7% and 20% with no discernible upward trend, but such rates still indicate that the firms need to regularly revisit their activities to shape their desired culture.

3.8 Implications for stakeholders

Why is this important?	The role of audit committees is fundamental to ensuring that investors and other stakeholders can have confidence in the quality and independence of the audit work being carried out. An audit committee's evaluation of audit quality should include an assessment of the mindset and culture of the auditor. Investors also have a role to play here. Through engagement with audit committees on auditor culture, investors can influence how this key element of audit quality is being assessed.
Summary of key findings	<p>There is an opportunity for stakeholders to engage more in the subject of audit culture. Although the investors we spoke to recognised culture as being important to audit quality, their interaction with audit committees and the firms on the topic was limited. They felt that audit culture would be a greater factor in their appointment of an auditor if it had more visibility in the first place.</p> <p>The investors we spoke to identified professional scepticism and an appreciation that the auditors are working primarily for shareholders rather than management as key cultural attributes they look for.</p> <p>We have made suggestions for how investors could increase their interaction on the subject of audit culture. We have also made suggestions for how audit committees can more directly raise the subject with the firms.</p>

Investors

We held an investor roundtable on audit culture. Investors commented on the tension between firms wanting to keep their audit clients happy, whilst at the same time needing to be professionally sceptical and willing to have difficult conversations. They suggested that audit tender documents needed to focus much more on how the auditor would challenge management on behalf of the shareholders. One investor commented that "It was hard to envisage an audit tender document saying, 'Hire us because we are the most awkward firm', but that was the cultural change that needed to be achieved." The investors also commented on their concerns that audit can be a less profitable service line within the firms and observed there was therefore a risk of audit being relegated to a lower priority part of the business.

The investor community also has a role to play in relation to audit culture. Through active engagement with audit committees, investors can influence how this key element of audit quality is being assessed. The following is a list of questions investors could consider asking audit committees in respect of audit culture.

-
- How are you taking account of culture in your auditor effectiveness reviews?
 - Have there been any contentious matters discussed between the auditor and management? If so, how did they reach agreement?
 - What is the auditor's attitude towards regulation and continuous improvement in audit quality?
 - Have there been any discussions about ethical matters where the auditor appeared to be focussed on the application of rules alone, instead of remaining true to the principles underlying the ethical standards?
 - How does the audit fee compare to other similar entities? Have there been any instances where the auditor asked for an increased fee in relation to additional procedures performed, but the fee was not paid? If so, why was this justified?

Audit committees

The FRC's most recent Developments in Audit report (July 2017)¹¹ identified that audit committee reports now typically set out the criteria used in their assessment of external audit quality. From a desktop review of FTSE 100 company reports, there was a broad range of factors being considered, including increasing references to perceptions of an ethical audit culture.

Audit committees can consider culture and mindset within their assessment of external audit quality by reflecting on how the audit was conducted. We included examples for consideration in our May 2015 practice aid for audit committees¹², such as whether auditors are:

- Communicating key audit judgements and conclusions to the audit committee in a way that clearly demonstrates that they have exercised an appropriate degree of challenge to management and professional scepticism;
- Making decisions about ethical matters in a manner that demonstrates the auditor seeks to remain true to the principles underlying the ethical standards;
- Ensuring the audit committee is aware of significant evidence that is inconsistent with other evidence or calls into question the reliability of documents and responses to inquiries and explaining how this was resolved in making their judgements; and
- Clearly articulating their rationale for particular conclusions, what alternatives were considered and why the specific judgement was considered to be the most appropriate of the alternatives, having regard to the interests of stakeholders.

¹¹ Developments in Audit (2017) available at: <https://www.frc.org.uk/getattachment/915c15a4-dbc7-4223-b8ae-cad53dbcca17/Developments-in-Audit-2016-17-Full-report.pdf>

¹² Audit Quality practice aid for audit committees (2015) available at: <https://www.frc.org.uk/getattachment/1738ea4e-167a-41e5-a701-f169e6b7e264/Audit-quality-practice-aid-for-audit-committees-May-2015.pdf>

Audit committees may also want to increasingly ask direct questions of auditors, such as:

- How is your firm assessing its culture and how does it hold the executive to account?
- What are the cultural priorities within your firm?
- What do you consider to be the cultural challenges to delivering high audit quality and what is being done to respond to those challenges?

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