

Fostering a Healthy “Tone at the Top” at Audit Firms



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Introduction^[1]

Audit firms are private businesses with the same legitimate interest in making a profit that all private businesses have. But audit firms have also been entrusted to be essential gatekeepers in maintaining the integrity of our capital markets. The leaders of audit firms, and the tone that they set, play a central role in ensuring that professionals within audit firms do not sacrifice integrity and professionalism for profit and growth.

Picture the following scenario: An issuer’s audit committee solicits competitive bids from audit firms for the company’s independent audit work. In an effort to secure the lucrative engagement, a senior partner at an audit firm secretly promises the issuer’s CFO that if his firm is chosen as the company’s auditor, his firm would provide tax and other permissible non-audit services to the company at reduced rates. The audit firm wins the audit engagement.

Following an investigation by the SEC’s Division of Enforcement, the Commission institutes an administrative proceeding and finds that because of the mutual conflict of interest created by the audit firm’s provision of non-audit services at reduced rates in exchange for being chosen as the company’s auditor, the audit firm and audit partner were not independent within the meaning of Rule 2-01(b) of Regulation S-X. The Commission orders a censure, monetary penalties, and a suspension from appearing or practicing before the SEC for the audit partner.

In the aftermath of such an enforcement action, how might the audit firm respond?

The firm may opt to sweep the incident under the rug. It may treat the independence violation as an isolated incident—an efficient breach or just the “cost of doing business”—and wait things out by allowing the partner to focus on non-audit business development until being reinstated.

Alternatively, the firm may opt to address the incident head-on. Firm leadership may openly discuss among its personnel what went wrong; use the underlying violations as an opportunity to teach and instill in all staff the critical importance of professional integrity, ethics, and serving the public trust; and possibly internally sanction, terminate, or suspend the audit partner.

Without speaking to any specific matter, we have, unfortunately, observed situations in which audit firms chose the first option: accountants, including high-profile audit partners, remain in positions of firm leadership

following an enforcement action that results in discipline against the accountant with seemingly no professional repercussions while waiting for a prescribed reinstatement period to pass.

But what sort of tone does that response set at the firm? What message does it send to the accounting profession and firm staff, particularly less-experienced staff and staff in service lines other than audit? Does it teach them that skirting the rules is acceptable, as long as you don't get caught? And if you do get caught, is it simply the cost of doing business and the firm will take care of you until your "time out" from appearing and practicing before the Commission as an accountant is over?

Given the accounting profession's role of enhancing the public trust in corporate financial statements for the success of our capital markets, accounting is called to be a profession that holds its members to high standards of ethics and integrity.^[2] As the Supreme Court emphasized more than forty years ago, our profession's "public watchdog function demands that the accountant maintain total independence from the client at all times and requires complete fidelity to the public trust."^[3]

To be an effective public watchdog, audit-firm leadership must set the right tone at the top by always placing the public-interest obligations of our profession ahead of business interests and profits. Doing so is essential for educating and instilling in our young accountants the critical importance of acting ethically, with integrity and fidelity to the public trust in all our professional activities. These are core tenets of the accounting profession.^[4]

Why Does Tone at the Top Matter for Public Accounting Firms?

I have talked before about the importance of tone at the top at issuers.^[5] But a healthy tone at the top is of paramount importance at public accounting firms as well. Indeed, academic research has "long stressed the crucial role that tone at the top, set by leadership, plays in influencing firm culture and how it is ultimately reflected in the actions and behaviors of [auditors]."^[6] The tone at the top of an audit firm determines whether the culture is focused on delivering high-quality audits or is a profit-center chasing the short-term bottom line, and whether "top management extols the important role audits play in the capital markets" or acts as if audits are little more than compliance "commodities."^[7]

For example, setting a proper tone at the top is critical in supporting auditors' ability to exercise professional skepticism—having an attitude that includes a questioning mind and a critical assessment of audit evidence at all times.^[8] We understand that skepticism can prolong an audit by requiring auditors to obtain additional audit evidence and perform additional, but necessary, procedures to have sufficient appropriate audit evidence in support of the audit opinion. Such time pressures "can create an environment in which audit quality might be compromised if engagement team members, at any level, perceive that their individual performance is measured primarily by meeting time deadlines and budget estimates."^[9] So in order for a less-experienced accountant on an engagement team to be empowered to exercise such skepticism, they need the unwavering support of engagement team and firm leadership, who should shield members of the engagement team from client pressure and resist the desire to wrap up an engagement quickly so that they can move on to the next book of business.

Tone at the top is also critical for having an effective quality control system. Leaders who understand and are dedicated to their role in protecting the interests of investors through adherence to professional ethics, values, and attitudes—and instilling those priorities in their employees—are the foundation of a strong quality control system.^[10]

So when firm leadership fails to set a strong tone at the top—for example, by sweeping mistakes and bad behavior under the rug, treating violations of law as isolated incidents or the "cost of doing business," not holding wrongdoers throughout the firm and across service lines accountable, or changing their firm structures in ways that could pose future independence challenges for the firm with respect to its audit engagements—they risk eroding the firm's culture, professional skepticism, quality control systems, and public responsibility as gatekeepers of our capital markets.

Indeed, we have seen how an unhealthy firm culture at audit firms can manifest itself in ways that directly undermine the public trust. For instance, we have seen accounting firm scandals involving cheating on professional ethics exams by firm partners and professional staff,^[11] firms using confidential information to sell

tax avoidance services, and accounting firm leadership viewing accounting errors and the subsequent restatements as business opportunities—all of which are contrary to the trusted role that public accountants occupy as gatekeepers. As these examples demonstrate, violations of auditing standards may not just be the result of a few rotten apples or individual failings on one audit engagement; rather, they could reflect a systemic and deficient firm culture and failure of ethical leadership.[12]

Audit firms have also sought investments from third parties, such as private equity firms, that have not been subject to the same independence and ethical responsibilities as auditors.[13] Depending on how those investments are structured, they could lead the firm's professionals to question the firm's commitment to both independence and high-quality audits. Firm leaders need to be sensitive to the message such arrangements could send and stand ready to correct any such misimpressions.

Instilling a Healthy “Tone at the Top”

An accounting firm's leadership team is ultimately responsible for the culture that they create and the tone that they set. Promulgating appropriate policies is important, but establishing a strong tone at the top requires more than just words, codes of conduct, and compliance checklists. Senior partners in firm leadership across all service lines must lead by example, through their *actions*.

After all, almost all audit firms have a written “code of ethics” or “code of conduct.” And almost all audit firm leaders extoll the importance of ethics and integrity. However, all those words and policies can easily be diluted or undermined by leadership's “tone,” which is exhibited by actions.[14] For instance, does firm leadership support their staff when tough calls need to be made in compliance with ethical and professional obligations? When mistakes are made or bad behavior is uncovered, does leadership candidly admit those mistakes, take corrective action, and share lessons learned with staff? When a top-earning partner that wins engagements has been suspended in an enforcement action for unethical behavior, does firm leadership hold that partner and themselves accountable in a transparent manner to mentor and cultivate ethics and integrity in the next generation of partners? Do the firm's expectations about ethics and integrity apply to all professionals in the firm, and not just to those who provide audit and attest services?

Less-experienced staff watch what their managers do. If they see their managers bend the rules or make exceptions for profitable partners who engage in inappropriate conduct, less-experienced staff may assume that this behavior is the path to rise through the ranks. This is why firm leadership must make ethics and character a fundamental part of the firm's hiring, retention, and promotion criteria for all professionals, regardless of service line within the firm—even at the expense of a more profitable bottom line in the short-term. Professionals trained to conduct themselves, and to expect others on their team to conduct themselves, with integrity in an ethical and professional manner reinforce one another with the support of firm leadership. By contrast, leadership that encourages corner cutting to save time on audit engagements, promotes individuals that do not exhibit key indicia of professional ethical conduct, and fails to support and defend professionals that make difficult decisions in favor of high audit quality will, in the end, fail in their role as public watchdogs.

Therefore, professional integrity and ethics should be an integral part of the promotion and compensation process. Leadership should reward individuals or engagement teams that took difficult stands and sacrificed short-term profitability in order to preserve independence and other professional responsibilities of the firm.[15] Technical excellence and integrity should be rewarded at least as much as billing, profitability, and business development.

Candor and transparency are also critical for establishing a healthy tone at the top. Employees should be able to share their views confidentially on the company's culture and climate. Survey results should be shared throughout the organization in a way that maintains the anonymity of respondents. Staff also should be empowered—or perhaps even *required*—to report misconduct when they're aware of it. And of course, retaliating against or threatening a whistleblower should never be tolerated.

Finally, how firm leadership plans to structure their future business reflects the tone at the top. For example, selling a portion of the business to an external party while retaining an equity interest or other involvement in that business, or creating alternative practice structures from the infusion of capital designed to grow the non-

attest practice, can send a powerful message about the firm's priorities. As we have previously cautioned, such alternative practice structures may pose serious challenges for the audit firm's future ability to comply with independence rules.^[16] As such, they risk sending a message to staff that complying with professional standards, providing high-quality audits, and fulfilling its public watchdog role are not the firm's highest priority. Audit firms should guard against any such inadvertent messaging and double down on their communications to staff about the firm's steadfast commitment to independence and high-quality audits.

Conclusion

Accountants serve a trusted public role in promoting the integrity of our markets and the protection of investors. The value of an audit and auditors depends on their credibility and trustworthiness. Audit professionals in particular have a difficult job—they sometimes must make difficult determinations that pit the public interest against self- or firm-interest. But that is precisely how public accountants fulfill their gatekeeping function to help protect investors: by ensuring that issues are promptly identified and addressed. To maintain that function, and in training the next generations of public accountants, it is critical that leaders of public accounting firms lead by example and foster a healthy tone at the top by prioritizing integrity and professionalism over profit and growth.^[17]

[1] This statement is provided in the author's official capacity as the Commission's Chief Accountant but does not necessarily reflect the views of the Commission, Commissioners, or other members of the staff. This statement is not a rule, regulation, or statement of the Commission. The Commission has neither approved nor disapproved its content. This statement, like all staff statements, has no legal force or effect: it does not alter or amend applicable law, and it creates no new or additional obligations for any person. "Our" and "we" are used throughout this statement to refer to the staff of the Office of the Chief Accountant ("OCA").

[2] See Paul Munter, *The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession* (June 8, 2022); *Revision of the Commission's Auditor Independence Requirements*, Rel. No. 33-7919 (Nov. 21, 2000) [65 FR 76008 (Dec. 5, 2000)].

[3] *U.S. v. Arthur Young & Co.*, 465 U.S. 805, 817–18 (1984) (internal quotation marks omitted).

[4] See *American Institute of Certified Public Accountants Code of Professional Conduct*, Sec. 0.300, available at <https://pub.aicpa.org/codeofconduct/Ethics.aspx#>.

[5] Paul Munter, *The Auditor's Responsibility for Fraud Detection* (Oct. 11, 2022) (discussing how tone at the top of a company appears to be a key factor in either exacerbating or mitigating pressures, opportunities, or rationalizations for fraud).

[6] Jonathan S. Pyzoha, Mark H. Taylor, & Yi-Jing Wu, *Can Auditors Pursue Firm-Level Goals Nonconsciously on Audits of Complex Estimates? An Examination of the Joint Effects of Tone at the Top and Management's Specialist*, *The Accounting Review* (Nov. 2020) at 368; see also Wayne Tervo, L. Murphy Smith, & Marshall Pitman, *Dysfunctional Auditor Behavior: The effects of tone at the top on supervisors' relationships*, *Research on Professional Responsibility and Ethics in Accounting* 47-77 (Sept. 2013) (explaining that a firm's tone at the top has a significant effect on auditors' behaviors).

[7] *The Panel on Audit Effectiveness Report and Recommendations* (Aug. 31, 2000) at 4.2, available at https://egrove.olemiss.edu/cgi/viewcontent.cgi?article=1351&context=aicpa_assoc; see also Lindsay M. Andiola, Denise Hanes Downey, & Kimberly D. Westermann, *Examining Climate and Culture in Audit Firms: Insights, Practice Implications, and Future Research Directions*, *Auditing: A J. of Prac. & Theory* (Nov. 2020) at 1, 10 (discussing research indicating that a strong ethical culture is a critical component to achieving high-quality audit work, and engagement leaderships' tone, messaging, and behaviors are influential on lower-level auditors' judgments and decisions).

[8] Paul Munter, *The Auditor's Responsibility for Fraud Detection* (Oct. 11, 2022) (explaining that a strong tone at the top of the audit firm is fundamental to establishing the professionally skeptical mindset that auditors need to fulfill their professional responsibilities).

[9] *The Panel on Audit Effectiveness Report and Recommendations* (Aug. 31, 2000) at 4.24, available at https://egrove.olemiss.edu/cgi/viewcontent.cgi?article=1351&context=aicpa_assoc.

[10] See Public Company Accounting Oversight Board (“PCAOB”) Quality Control Standard 20, *System of Quality Control for a CPA Firm’s Accounting and Auditing Practice*, available at <https://pcaobus.org/oversight/standards/qc-standards/details/QC20>, and, subject to approval by the SEC, QC 1000, *A Firm’s System of Quality Control*, approved by the PCAOB on May 13, 2024, with an effective date of December 15, 2025; International Auditing and Assurance Standards Board International Standard on Quality Management 1, *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements*, available at <https://www.iaasb.org/publications/international-standard-quality-management-isqm-1-quality-management-firms-perform-audits-or-reviews>.

[11] See, e.g., *In re KPMG LLP*, SEC Release No. 34-86118 (June 7, 2019); see also Paul Munter, *The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession* (June 8, 2022).

[12] As the role of global firm networks continues to evolve—including changes in the extent of resources supplied by networks and the development of policies, procedures, and methodologies at the network level rather than the member firm level—the establishment of a strong culture of ethical leadership at the network level becomes increasingly important.

[13] See Paul Munter, *Auditor Independence and Ethical Responsibilities: Critical Points to Consider When Contemplating an Audit Firm Restructuring* (Aug. 29, 2022).

[14] See Alfredo Contreras, Aiyesha Dey, & Claire Hill, “*Tone at the Top*” and the Communication of Corporate Values: *Lost in Translation?*, *Seattle University Law Review*, 498 (2020).

[15] See *The Panel on Audit Effectiveness Report and Recommendations* (Aug. 31, 2000) at 4.5, available at https://egrove.olemiss.edu/cgi/viewcontent.cgi?article=1351&context=aicpa_assoc.

[16] See Paul Munter, *Auditor Independence and Ethical Responsibilities: Critical Points to Consider When Contemplating an Audit Firm Restructuring* (Aug. 29, 2022).

[17] See Paul Munter, *The Critical Importance of the General Standard of Auditor Independence and an Ethical Culture for the Accounting Profession* (June 8, 2022).