Like banks, audit firms will face culture scrutiny and conduct risk assessments

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A prevailing assumption in many C-suites is that cultural influences on misconduct and poor performance outcomes can be identified only after harm is done: a "detect and correct" mindset. Bank regulators are now insisting upon a higher standard of care: a "predict and prevent" approach to such risks. Audit industry overseers will follow suit.

On its website, the UK arm of audit firm KPMG refers to "unique risk assessment and diagnostic tools" — tools that allow clients to evaluate the effectiveness of conduct and financial crime risk mitigation. The firm's "conduct risk and remediation" practice promises that its services will help clients to reduce the likelihood of "financially costly and reputationally damaging downstream remediation". One feels for the leaders of that practice group, who seem not to have been consulted by KPMG itself.

Misconduct

Earlier this month, the firm admitted misconduct in the course of its work for two audit clients, Carillion and Regenersis. The industry's principal regulator, the Financial Reporting Council (FRC), had announced a formal complaint against KPMG and several of its staff last September; among them former partners Peter Meehan, who led the audit of Carillion, and Stuart Smith, who led the Regenersis audit. The FRC alleges that KPMG intentionally provided it with false and misleading information during quality inspections of KPMG's work at both companies. Amid a continuing disciplinary tribunal, Jon Holt, chief executive of KPMG in the UK, said it was clear that "misconduct has occurred and that our regulator was misled".

In a settlement agreement with the FRC, Smith has now admitted either making, or being responsible for, misleading representations to the FRC's audit quality inspectors. He was fined £150,000 and is banned from the industry for three years. As this now opens the door to sanctions imposed directly on KPMG, its lawyers have sought to assert that any misconduct was individual in nature, rather than systemic to the firm.

Five others named in the FRC's complaint are contesting its accusations. Meehan, for instance, has said he knew nothing about the alleged forgery of documents until he was let go by the firm, and that he is "shocked and devastated and angry". His lawyers say Meehan "felt let down" by his junior colleagues, in whom he had "placed trust and confidence".

Those junior colleagues, however, claim to have been unaware that they had acted wrongly, as they had relied on the judgement and direction of their senior leaders. Finger-pointing in cross-directions appears set to continue, as those caught up in the mess seek to evade accountability.

Culture of fear

KPMG is not alone. A 2019 investigation (paywall) by the Financial Times recounts details of a "culture of fear" across the audit industry, with whistleblowers sharing harrowing tales of bullying, sexual assault, sexist and homophobic abuse, and more. Appeals to HR from aggrieved employees often result in victim-blaming, and efforts to shield senior leaders and high fee-earners from potential legal action and reputational harm. The whistleblowers report feeling ignored, ostracised and pushed out. They complain of trust betrayed.

With some 80% of the market capitalisation of the S&P 500 today made up of intangible value, trust in a company's brand — among customers, investors and employees — is an essential corporate asset. Poor culture, and the poor conduct that it may permit, puts that intangible value at very tangible risk. Yet many firms regularly fail to inquire deeply enough to assess these risks, and indeed this is the raison d'être for KPMG's conduct risk and remediation practice. Where firms may fear to tread, however, regulators are now wading in.

Following the example of banking regulators in recent years, audit sector regulators have begun to study links between an audit firm's culture and its typical work quality. Misconduct scandals are seen in every industry, but in the financial sector they seem almost commonplace. Financial sector regulators have thus come to the view that misconduct follows from "toxic cultures", and are increasingly turning their supervisory attention to culture during oversight activities.

Some now require firms to run regular self-assessments of their culture and to assess implications for the governance of conduct and other non-financial risks. In many jurisdictions, regulators will hold individuals accountable for conduct risk management failures that take place on their watch, regardless of whether they were complicit in, or even cognisant of, underlying circumstance.

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Bank regulators, meanwhile, are exploring the supervisory capabilities permitted by a combination of ubiquitous data and powerful artificial intelligence tools, showing particular interest in the efficiency and effectiveness gains promised by supervisory and regulatory technology (suptech/regtech).

Banking sector regulators, boards and management have tended to focus efforts and resources on risk governance "inputs" such as values statements, ethics training, governance processes and systems, with the assumption that the right inputs will produce desired performance "outputs" reliably. They are regularly surprised when this expectation goes unmet. Why does this cycle of disappointment persist?

"Predict and prevent" approach

A prevailing assumption among both banks and their regulators is that culture and conduct-related risks are discoverable only after harm has been suffered. Culture is taken to be too woolly to submit to quantitative and predictive behavioural metrics, meaning that responsibility for culture is shunted over to HR, while risk and compliance teams opt for a "detect and correct" standard of care, emphasising surveillance and monitoring systems that aim to discover bad actors in the act, so that wrongs can be remedied after the fact.

This "detect and correct" mindset is a wholly unacceptable standard of care in other industries such as nuclear power, aviation and pharma, where waiting for harm to occur may imply waiting for people to die. Regulators in these industries therefore insist that firms identify and respond to signals that foretell mission-critical organisational failures. Banking sector regulators are beginning to adopt this more rigorous and proactive standard. Travails in the audit sector suggest that its regulators will follow suit.

"The role of the regulator is essential in promoting and monitoring culture," the FRC wrote in a recent report.

The conduct risk and remediation practices among the Big Four have been eager to support financial sector clients in their efforts to address new supervisory priorities regarding culture and non-financial risk. They might instead look to those same clients for guidance as they seek to put their own houses in order.

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