

THE NEW MANIFESTO FOR ACCOUNTANTS

Transforming Audit for the Future

The Five Essential Attributes of
Audit Leadership

By Alan Anderson CPA



Transforming Assurance Services for the Future

How to Build the Value-Driven Audit *The Bold New Roadmap for Advisory and Assurance Services*

*As an accountant, I'm a financial statement historian. And as an auditor, I
validate that history.*

*But as an auditor, I'm also a change agent, searching for ways to do things
better and faster in all areas.*

By Alan Anderson

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The auditor as change agent

When people ask what I do, I say I'm an accountant. I'm a CPA and I'm an auditor. The next question is always, "What's an auditor?"

And I got to thinking about it. Accountants record history. Then auditors validate history. So, I say that as an accountant, I'm a financial statement historian. And as an auditor, I validate that history. But unlike many auditors, I'm also a change agent. I've been searching for ways to do things better and faster my whole life, in all areas of my life.

I used to drive my family nuts on long car trips by trying to find shortcuts. My kids would always say "Dad, you're going the long way. This is wrong." But I had to give it a shot just to see. And there were times they were right. My "shortcut" was far from being a shortcut.

Like looking for those elusive shortcuts, I've always been looking for better ways to do things. The entirety of my 17-year career at McGladrey (now RSM) and the nine years I spent at the AICPA, my mission was to push for change. To try to do things more efficiently and more effectively. And like seeking out those elusive shortcuts on car trips, I'm not afraid to be wrong.

Back in 1998, when I was still at McGladrey. I gave a presentation on the paperless audit and how audits needed to change at the AICPA Major Firms Group conference. Until that point, I had never been to an AICPA conference, and I hadn't been on any committees or anything. But as I heard later from Leroy Martin, the managing partner at McGladrey who had asked me to do that presentation, people couldn't stop talking about how we at McGladrey were doing audits without paper, and the potential for audit to transform businesses.

Barry Melancon found me at the conference, and we hit it off. At that time, he was using the example of a firehose in his talks. All the information available through technology was like drinking through a fire hose, but we as auditors were only capturing the trickle that was the financial piece. Even back then, he was pushing accountants to make our profession more vibrant by getting our arms around all of this stuff coming out of the firehose as much as possible.

I thought I could drive more change in the profession from a higher level.

Sadly, that change still hasn't happened.

Right there at the conference, the first time I met Barry, he asked me to join the AICPA's Information Technology Executive Committee. Eventually, the AICPA made me an offer I couldn't refuse, so I took a job as Senior Vice President of Technical Services at the AICPA.

They even let me telecommute, so I didn't have to move to New York. I took the job because I thought I could drive more change in the profession from a higher level.

Sadly, that change still hasn't happened.

Let's think about the current model for audit. The traditional audit is all about the past. Audits focus on a specific point in time in the historical cost base of an organization after all the financial activity has been aggregated. It's like looking in the tiny rear-view mirror, to see what's behind you, not what's ahead of you. You're always looking backward, instead of looking ahead, through the broad expanse of the windshield. Audit is a lagging indicator. It's not a leading indicator, which would help us make decisions about the future.

Remember that companies right now tend to only have audits because it's required. And the users of the audit reports say it doesn't provide a lot of valuable information. If anything, it provides an insurance policy.

Given that accounting standards are written from a one-size-fits-all perspective to create uniformity, regardless of industry, how does one really make meaningful comparisons across industries? For example, we're supposed to be able to compare a pharmaceutical company with a wholesale distributor with a franchisor using financial statements which haven't changed format in over a hundred years.

And we know that makes no sense. The traditional financial statement ignores financial and non-financial measures that are forward-looking. And we're auditing the historical results of the past decisions that have been made during the course of the year.

The time delay in delivering an audit report is another issue. What use, frankly, is a set of audited financial statements dated December 31, 2020, that's not delivered until April? The typical schedule means you do the fieldwork in the last week of February. Sometime in early April, you give them the A-OK and the audited financial statement.

How many decisions the client has made between the first second after midnight on December 31 and the time you deliver the financial statement?

Any firm that can actually provide real-time recommendations will have the ultimate competitive advantage.

All of their decisions and their approaches are absolutely positively time-dependent. But we are out of the picture with respect to being a catalyst or a tool to help with that decision process. Any firm that can provide real-time recommendations will have the ultimate competitive advantage.

Do we as auditors even use the product of our work to make decisions?

How many of us have retirement savings in an account that we can view online? Now, you can likely move your money from Fund A to Fund B at the click of the mouse.

How many auditors have ever looked at the audited historical financial statements before making that move? I've asked that question many times at conferences and more times than I can count, no one raises their hand.

Think about the information you use in your firm to make decisions about your business. You probably use various performance metrics. Most likely, you track utilization, check chargeability, and you talk about people keeping busy. But how often do you use that historical financial statement when you need to make a business decision?

We are in a real-time economy now and have been for quite some time. We must pay attention to the importance of this change. Everyone wants instant gratification. Decision-makers need information more timely.

Real-time accounting is here. It's been here for a long time and we as auditors have chosen to not pay attention to it. For the last several years, there have been rumblings about building momentum, and lots of "talk" about change and moving auditing into the future. I use quotes around the word "talk" because if those words were converted to action, then success would be fantastic. Imagine what would happen if we could accomplish that.

Audit in the future won't be limited to just the financial data.

But when people think about real-time auditing, they're not thinking about a whole new way to be auditors. Instead, they generally focus on doing the same things that we've done for decades but doing it faster. We've been talking about real-time auditing and real-time processes for years, but they've just been slow to develop.

The audit of the future: Mission, vision, and values

The future audit needs to be able to provide assurance on leading indicators on a much more on-demand, real-time basis. We need to take advantage of all the data within the organization. For driverless cars, what would be the purpose of a rear-view mirror? This same question holds true for audits of the future when access to real-time data and indicators will make it possible to view a company from more directions than just through the past.

Audit in the future won't be limited to just the financial data. We need an extremely comprehensive approach. No human can comprehend that firehose of data – which keeps getting bigger and bigger as the internet of things expands – so we will need to leverage data analytics. Ultimately those data analysts will be AI-enabled. And we'll be forward-looking.

To move audit leadership forward, we must be much more future-oriented.

We must focus on methods to measure and track situations and scenarios in real time.

We must identify the leading indicators and link those indicators across the whole organization.

And, we must connect those indicators to the mission, vision, and values of the company.

Then let's make those the analytics that we use to tie to success factors.

So if something suddenly pops out of line with those analytics, a red flag goes up for our attention. And when we alert our client to that red flag, we move decision-making criteria to a real-time process. It makes a huge difference in this process. But it only helps our clients make decisions if we can get them the new intelligence as it's happening. Not tomorrow. Not next week. Or in three months. But in real-time. As it's happening. And when they can address the issue.

Think for a moment about the value that a perspective like that would bring to our profession as CPAs, and how that would continue to drive the success of the audit. If we can change the perspective of audit to be real-time and forward-looking, then what we do would be more relevant in society.

To remain a viable profession, we must address the value of the audit. We're in a situation where everybody blames somebody else for the commoditization of the audit. I believe we all ought to look in the mirror because we as professionals have helped promote the audit as a commodity.

The minute we feel any fee pressure from a client, the first thing we do is look for ways to lower the price, as opposed to talking to the client about the value that we just demonstrated in this audit process. Part of the reason we don't take the time to talk to the client about the value that we delivered in the audit process, is because we have not actually delivered any value. I find that most unfortunate.

The five attributes of audit leadership

As I've worked with firms around the country, I've developed a framework of the five attributes of audit leadership that are needed to move audit from a rear-view mirror perspective to a future-focused front windshield perspective. Applying these five attributes will help your firm actually provide value in audits, and will move your firm from a commodity, low-cost provider to a trusted advisor to your clients. Those five attributes, in order of importance to your clients, are:

1. **Relevance.** Relevance is understanding what is important to the client and incorporating relevant ideas and insights into every audit.
2. **Business-mindedness.** Business-mindedness has two major components. The first is about making sure the work the firm does makes sense from a business point of view. The other is thinking about our clients and how we would improve their businesses if we were running them.
3. **Quality.** Quality in audit comes from developing a deep understanding of the standards, the industry and the client. A quality-focused culture means first-time-right: It means making sure the work gets done right the first time and not just reviewing and catching the mistakes at the end.
4. **Innovation.**
Innovation includes using new technology, but it also means simply being willing to try doing things differently. Innovation is leveraging technology to get insights into our clients' operations and sharing those insights to deliver value.
5. **Empowerment.**
Empowerment means giving our teams permission to try new things and to utilize their intellect beyond filling out endless checklists.

For nearly a decade, I've been talking and writing about this framework in short articles and keynotes for state societies. With this book, I'm taking a deep dive into that framework and offering up actionable ideas that audit leaders can use to help move audit into the future.

By the time we're finished, you'll have a roadmap of the possibilities to move audit from a commodity in danger of becoming irrelevant to a valuable service that clients will gladly pay for.

Three important questions

We learn from history that we don't learn from history.

– Desmond Tutu

The other day, I picked up a college textbook on auditing from 2001.¹ Even back then, that book listed these as “critical forces on the profession:”

- Increasing market saturation with relatively little opportunity for growth
- Perceptions that financial statement audits have become a commodity
- Price competition and continual pressure to reduce fees
- Cost pressures that have resulted in the reduction of time devoted to engagements
- Perceptions that the incidence and severity of alleged audit failures have increased

In the 20-plus years since that book was published, not much has changed. Today many of the college students who learned auditing from that textbook are in leadership positions at audit firms. They were warned what we were up against. That we are still facing those same “critical forces,” which have only exacerbated since then, is an indicator of the ossified state of leadership in the audit profession.

Today, the current state of the audit is in jeopardy, and our profession has had a big role in putting it there. Audit has evolved into what I call “chopping down trees.” Auditors spend an awful lot of time ticking and tying and tracing amounts from an invoice to a ledger sheet or to a printout or a spreadsheet, without really understanding what business the entity is in, or whether a particular transaction makes sense for a client. We have driven down the value to a series of checklists. We don't make the time to communicate with our clients and our staff to find out what really matters to them. Clients don't receive anything remotely of use to them to make their businesses better.

A recent report by the World Economic Forum² puts audit as number four in the top twenty jobs with decreasing demand by 2025 through advances in automation and AI. Now this report was looking at tasks in different occupations that can be automated, and not on the totality of the work. That report also says “The tasks where humans are expected to retain their comparative advantage include managing, advising, decision-making, reasoning, communicating and interacting.” That means that to remain a viable profession auditors will need to get better at the kinds of tasks that machines can't do as well as humans.

Audit is seen by many as a commodity, or if not, it's well on its way to becoming a commodity. Tech changes that are already here pose an existential threat to audit.

Yet most auditors are keeping their heads in the sand, ignoring the coming tsunami of change that is changing almost

everything about the world of accounting. Who will need an audit of a historical financial statement when bots, AI, and blockchain provide all the assurance that lenders and stakeholders currently get from their auditors?

Our clients are leveraging technology to run their businesses. Financial dashboards give them an almost-real time view into their business' performance, and they can monitor many of those dashboards from their phones. According to a recent EY survey³ of 1,000 CFOs and finance professionals from around the world, over half think that over the next three years bots and automation will be performing about half of the accounting tasks that humans currently do.

If that's the future on the industry side, what does the future on the audit side look like? Will there even be a need for audit if innovations in technology can monitor transactions in real-time?

Some of these innovations are not new. A good 25 years ago, I was working with a sunflower seed broker, who matched companies that grew sunflower seeds with companies that bought sunflower seeds as a component for the birdseed they made. The banker that was providing financing for their line of credit connected the bank's system to the client's general ledger system. The banker could constantly monitor what was happening in the general ledger and was tracking the difference between payables and receivables. Each transaction was quite large and each one of those transactions impacted the line of credit use.

What I thought was, if they just had some metrics to kick out a notification when there was a deviation, then why would the banker need an audit? By connecting to the sunflower seed broker's general ledger, the banker was already essentially performing a continuous, real-time audit.

Just think – the financial services industry had the means 25 years ago to move to real-time GL connection with banking customers but hasn't yet taken advantage of the opportunity to move banking into the modern world. It's a matter of time before audit is disrupted out of existence. As Pascal Finette said in a keynote at Digital CPA in 2019, "What kills you does not look like you."

Yet we're still auditing like we have for decades.

To understand how we got here, let me do a little history lesson.

Arts and crafts accounting

When I started at McGladrey (now RSM), we wrote audit programs out by hand, and we thought about what it was we needed to do to carry out our audit procedures. And then, the firm got a copy machine. That started the arts and crafts period of public accounting. Because we were going to do the same as last year every year, we would make a copy of last year's hand-written audit program, cut out the sign offs, tape that on a new page, make sure to draw the lines for the signoffs, and then we'd make a copy of that. Then we had our audit program for the new year.

So, that served as the springboard to the standardized audit program. At the same time, the standards were starting to grow, so we needed some way to make sure we were covering the voluminous requirements.

While I was learning to be a better auditor, technology was advancing. And we auditors started throwing some computers at the way we did audits. We put our audit programs in Word documents, and we made them more legible than the handwritten copies. Then we didn't need the copy machine anymore.

Checklists don't make an audit

Technology evolved some more, and we developed paperless ways of doing the work. No more lugging heavy binders of paper. No more camping out at the client's photocopying machine. We jettisoned our red pencils and two-hole punches. But what did we really accomplish with that?

What we've done is reproduce in a paperless environment what we used to do in paper. If you printed out the electronic file of your workpapers, wouldn't that electronic file be almost a 100% replica of what that paper file looked like 25 years ago? We threw technology at the audit without really thinking that maybe something needs to change. Is that really a good return on our investment in technology?

Then at the same time, the fixed fee in the marketplace became much more prevalent. Now we're stuck in a fixed fee environment. Efficiency matters now. So what we're doing in today's world of the audit is teaching our staff to fill out forms faster, as opposed to thinking about the audit. Instead of learning to ask the next best question, staff are just focused on asking the one question and getting the yes/no answer so they can move on.

We've created an environment of filling out forms and filling out checklists, and if I fill out enough checklists, I certainly must have done an audit. The result is that our staff is not really getting the mentoring and coaching that they need to really help them understand this process.

When the staff accountants in your firm do fundamentally the same work as last year every year, they don't really learn how to audit. What they learn is how to fill out the forms repetitively every year. After five years of doing that, these staff accountants don't really have five years of experience. They have one year of experience repeated five times.

If I had to fill out all the forms that audit staff fill out today, I wouldn't be in public accounting. I didn't get into accounting to fill out forms. I actually went into public accounting because I thought it was the best place to learn about business. I thought the best businesspeople were CPAs in public practice.

We've evolved from paper and pencil to technology, but we're not teaching the staff what audit is about. Their focus is on the forms, and not on what matters most to the client – the bottom line.

The three questions

When I started noticing this disconnect between what audit staff focused on, and what audit was supposed to be, I started asking three questions. First, it was just one, then it was two, and now it's three.

What was the bottom line on your last audit?

I've asked over 400 people that question, and so far, only one person has known the answer. And of course, at the end of the session, the individual came up to me and said, "Al, I'll have to be honest with you. They told me you always ask that question, so I went and looked."

Managers and partners are relying on the work of those staff auditors, and they don't know this one key metric. Back when I was a staff auditor, this was something we paid attention to as a team. This was important to know. So, I started asking a second question.

How many pages were in the disclosure checklist?

Out of the 80-plus people I've asked this second question, none of them knew what the bottom line was on their last audit, but over half knew the answer to this question. Does this sound like a group that is focused on the client, or on the checklists? So, then I added a third question.

How does the client make money?

Of the 60 people I've asked, one gave me this answer: "That wasn't my audit section. I don't have to know." How can you possibly do work in audit and not know what a client's organization, their business or their goals are?

I don't believe it's the staff's fault. I believe the leadership of that audit, and maybe of the whole firm, dropped the ball. And it's not just that firm.

Audit leadership has failed to ensure that audit continues as a valuable service for our clients.

We, as audit leaders, are not helping our staff to better understand what an audit is all about, and what a client is all about.

What are we as a firm, as professionals, when we deliver audit services by just filling out forms?

The failure of leadership

*You build on failure.
You use it as a steppingstone.
Close the door on the past.
You don't try to forget the mistakes, but you don't dwell on it.
You don't let it have any of your energy, or any of your time, or any
of your space.*

– Johnny Cash

Before we start talking about how audit leadership has failed, let's back up and talk about the goal of the audit. Now the overarching goal of audit is to issue the correct audit opinion. But what else do we expect from audit?

The word “audit” comes from a Latin word that means “to hear.” Originally, the official examination of accounts – what we would call an audit – was an oral procedure. And, for many centuries, listening was a primary way of gathering information in an audit. The Merriam Webster dictionary defines audit as “a formal examination of an organization's or individual's accounts or financial situation” or as “a methodical examination and review.”⁴

The expectations gap

But does the perception of audit reflect that definition? If our perceptions define reality, then what is the perception of reality for audit? Everyone has a different view of what the audit should accomplish and often those goals are not aligned. This creates marketplace confusion. The unmet “perceived” expectations end up being referred to in audit profession as the “expectation gap.”

Very few companies would get an audit of their financial statements if it was not a requirement from a regulator or another user, such as a bank or an investor. When I speak to groups of CFOs and ask if they use GAAP financial statements to make business decisions. The resounding answer I almost always receive is, “NO.”

Audit standards talk about the audit as providing relevant information for users of financial statements. Who are those users, and what are their goals?

External users and conflicting goals

Typically, users of audited financial statements can be categorized as either internal or external. Internal users include company management, owners and directors and employees.

External users can be further divided into three groups:

1. **Regulators**, such as the DOL, GAO, SEC, and the IRS, that are focused on compliance with laws and regulations.
2. **Commercial and investment bankers, insurance companies, leasing companies, vendors and suppliers** that are primarily focused on the company's collateral and credit worthiness.
3. **External shareholders and potential investors** that are typically more focused on price per share, dividends, and future cash flows.

While all three groups want assurance that a company will remain a going concern, their different desires may result in opposing pressures on a company.

I've always felt that the best counterbalance to make sure companies get their numbers right, or at least reasonably correct, is the conflict that clients have between the IRS and the bank. The IRS wants to maximize taxable income to collect more tax. The bank also wants income to support the loan payments. The client doesn't want to pay more taxes than they must. If they overstate their income, they pay more taxes. But if they understate their income, the bank might call the loan.

What do the regulators want? Mainly, they want to be sure that organizations are complying with the relevant laws and regulations. The IRS wants to be sure that what was reported to banks and investors is consistent with tax returns. The DOL wants assurance that companies are safeguarding their employees' retirement accounts. The SEC wants to protect investors and make sure the capital markets function adequately.

When auditors are presented with an opportunity, by the time they've analyzed it sufficiently, the opportunity is gone.

Do the banks and investors get useful information from historical audited financials? In their book, *The End of Accounting and the Path Forward for Investors and Managers*, Baruch Lev and Feng Gu researched the relationship between changes in stock prices and the dates that corporate financial reports were released. In the 1950s and 1960s, roughly 90% of the market value of public companies could be directly attributed to the earnings and book value reported in their financials. By 2013, that percentage had dropped to just 50%.⁵ Personally, I'm surprised it's even that high. The historical financial statement does not serve the needs of the users of those statements.

The crisis in audit

The entire profession of stock and investment analysts arose because the audit community did not leverage the opportunity to become the trusted resource for investors. While auditors do perform analysis, they rarely take that analysis beyond the numbers recorded in the financials. Auditors placed themselves firmly in the box of auditing historical financial statements, not in performing the analysis that decision-makers need. Because investors needed information that audited financial statements were not providing, the analyst community developed. And since they had no paradigm of what should be analyzed, they started looking at relationships between financial and non-financial data. They looked at what was happening in the business and the world at large, and what might be happening in the future.

Our profession lost that opportunity that was there for us. A CEO of a company once told me, “When auditors are presented with an opportunity, by the time they’ve analyzed it sufficiently, the opportunity is gone. Sometimes you just don’t have the time to analyze it to death.”

More recently, a survey by EY of CFOs and controllers around the world found that in the wake of the coronavirus pandemic, stakeholders were increasingly looking for insights “beyond the numbers.” A full two-thirds of respondents said the demand for “forward-looking financial analyses and forecasts” had increased over the previous 12 months.⁶ The financial leaders surveyed echoed what Lev and Gu described in *The End of Accounting*: 65% of respondents in the EY survey said, “there is significant value for our organization that is not measured or communicated using traditional financial KPIs, such as brand value and human capital.”⁷

This disconnect between the value of audited financials and stakeholder interests is nothing new. In the wake of the 2008 financial crisis, Steve Goldstein at MarketWatch, had this to say:

“What precise purpose does it serve to have a supposedly independent auditor (paid for by the company) sign off on accounts? From Enron to Lehman to Satyam to Parmalat, it’s clear that the major accountants lack either the skill or the determination (or both) to ferret out fraud.”⁸

Auditors, when asked, have a difficult time explaining what an audit is all about. It has been my experience that the auditor spends most of their time explaining what an audit is “*not*” versus what the audit “*is*” when asked about the goal of the audit. For example, they will quickly say an audit is not an absolute assurance that the numbers are correct and the opinion is not a guarantee and so on.

So, to recap:

- Most companies only get an audit because they are required to have one.
- Users of the audited financial statements say the audit doesn’t provide valuable information.
- And the auditor cannot effectively explain what an audit is all about.

If everyone can’t agree on what an audit is, then no wonder we’re in a crisis with the audit.

No way to run a firm

The value of what we provide to clients has declined until it has become a commodity, which drives our fees down. The lack of innovation means that our clients can't tell the difference between the audit we do, and one done by the firm down the street. None of them provide relevant information or any value to our clients. If our clients don't see value, then the audit is only being done to meet a regulatory or banking requirement, and in that case, the cheapest option that meets that basic requirement is the one they choose.

It's not our clients who drive commoditization of the audit. It's our failure to provide any kind of value. We participate in that commoditization every time we lower our fees when we're under a little fee pressure from our clients. Quite often, whether you are aware of this or not, you probably haven't delivered anything more than 24 pages with an audit report on it.

We also drive commoditization when we rely on checklists and SALY for our audit programs. If I fill out enough checklists, I certainly must have done an audit. When audit staff have a better memory of the number of pages in their checklists than the bottom line for their last audit, that's a clear sign that we're sending the wrong message to our teams.

If we want to change that, it's up to us to make that happen.

The downward trend in fees means that audit firms need to rely on volume, at the expense of client service. But because most firms are atrocious in managing workflow, the emphasis on volume means marathon workweeks for our staff. Firms aren't just operating at capacity – they're operating beyond reasonable capacity.

While it may still be a badge of honor in the Big Four to see who can log the most billable hours, generational changes in the workforce and scarcity of talent mean that's no longer a reasonable way to run a firm.

Where are the mentors?

I was lucky in the entirety of my career to have been empowered to try doing things differently. I had mentors who encouraged to keep learning. But today, this forms-filling exercise that audit has become discourages people like me from staying. The ones who stay in audit are the ones who like filling out those forms.

New audit staff rarely have a mentor who gives them the big picture of what audit is supposed to be. Instead, they learn how to fill out the forms better and more accurately. They don't get review notes that ask them to think about what they're doing. They get review notes about the way they reference their supporting documentation.

This lack of mentorship means that the best and brightest, the ones who like to keep learning, eventually leave. We are making the problem worse for future generations.

The enduring war for talent

Back when I was coming up through the ranks, there were always plenty of talented young people coming on board, and there were always plenty of people to fill in the spots in a firm's org chart. But today, we don't have that luxury.

Most people did not get into public accounting to make sure that the right numbers are in the right box for the entirety of their careers.

For years, the Journal of Accountancy, Accounting Today and all the major accounting news sites have been warning about an impending talent shortage. At least as far back as 1998, the Journal of Accountancy has been running articles about the current "staffing crisis."⁹ According to the latest report from the AICPA, the number of accounting degrees awarded has been trending down over the last several years. And the number of people sitting for the CPA exam is also down, from a recent high of 48,004 in 2010 to 36,827 in 2018.¹⁰ For the 2017-2018 academic year, enrollment in intermediate accounting at James Madison University in Harrisonburg, Va., was down 34% compared to four years earlier.¹¹

Starting on Jan. 1, 2011, and for 19 years after that, 10,000 Baby Boomers turned 65 every day.¹² The pandemic accelerated retirements among Boomers, with 3.2 million more retiring in the third quarter of 2020 than in the same quarter of 2019.¹³ There just aren't enough younger people to replace the retiring partners at firms.

Plus, these younger generations have very different attitudes toward a career. They demand a better work-life balance. They're not going to work the crazy long hours that my generation willingly put in as the price of moving up the ranks. They want work that's personally fulfilling, and many prefer to do business with companies that share their values. They're not going to be willing to sit in a cubicle working on disclosure checklists.

COVID-19 brought unemployment to historic levels. But before that hit, the unemployment rate for accountants was 1.4%.¹⁴ We can only assume that when the economy levels out again, we'll be back where we started.

If they are honest with themselves, the leadership in audit has known about these issues for decades, but nothing has happened.

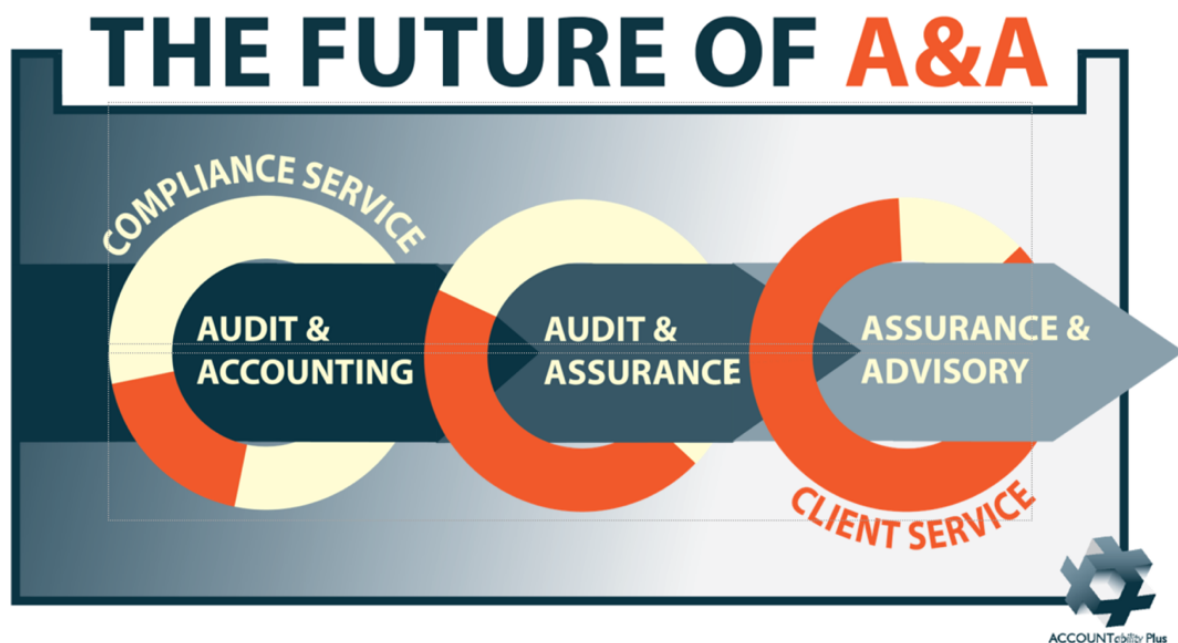
The new vision for audit

The future is not something to predict. The future is something to build.

-Franco Ongaro

Audit is at a crossroads. On one path, audit will keep going the way it has for the last decade or so. It will become so irrelevant and commodified, that it will vanish. Fees will drop so low that no one will be able to afford to be in the audit business. Plus, technologies like artificial intelligence and blockchain will be able to do what we're doing now, only better, faster and cheaper. That might not happen for another 15 years, but it is on the way.

There's another solution: We can drive positive change for our profession. It won't happen overnight. But as a profession, we must drive the change. We must, and we can.



I like to use the diagram above when I talk to firms about what moving into the future of what A&A looks like.

In the current state, audit has been heavily focused on compliance, so A&A is "Audit and Accounting." Auditors are the resource to make sure companies are doing their accounting correctly and are complying with GAAP and the rules set out by the various regulatory agencies.

There's not a lot of value or customer service included in what Audit and Accounting provides. The product of your work is not terribly distinguishable from the audit firm down the street. It's a commodity. And if your firm remains here, it won't be around much longer because pure compliance work is on the way out.

Moving into the future of Audit and Assurance means that your orientation shifts from pure compliance to client service. You get there by applying a data orientation to your audit and by using tools that provide assurance. These data tools give you another way to look at a client's data in aggregate so you can see patterns and trends that are invisible when you just look at the historic financial statements. These data tools can be simple things like doing a regression analysis of inventory pricing in Excel. They can also be as complex as a data analytic algorithm or tools like Mindbridge and Info that look for outliers in a data set.

Assurance beyond the numbers

Sooner than we may want to believe, we will have tools that will allow us to provide real-time assurance, which will help us move into advisory. We'll have real-time dashboards that clients can use to monitor financial activity as it happens. Auditors will deploy AI bots in their clients' systems that will identify transactions that don't make sense as they happen. The auditor will get an alert so they can talk to the client about it and decide if a transaction is appropriate or not.

Assurance is more contemporaneous. Assurance goes beyond making sure the numbers are right and adds the component of "does this transaction make sense?" At this level, tech tools begin to replace the ticking and tying and the detailed manual work that's needed to accomplish the compliance part, while the auditor provides assurance on the outputs of those AI tools. Through the simple use of those tools, you automatically become more knowledgeable about the business. You communicate more ideas and suggestions to the client that become more of a value add. You're also moving the dial from less of a compliance focus to more of a client service focus.

As you move that dial of client service even more, you move fully into Assurance and Advisory. In that end state, you become what your clients really want, and that's the trusted advisor role. Your clients see more of the value that you bring to the table. The compliance part of what you do is significantly muted because in the future, compliance will be monitored by systems, whether it's bots or AI or something else, so there won't be much of a need for humans to verify that companies are in compliance. I guarantee that any company that's getting value from their auditor today has far less of an issue with the cost of an audit than a company that's just getting the basic compliance from their audit firm.

What about auditor independence?

Before we go any further, let's address the elephant in the room. Some CPAs say that auditors can't provide any kind of advice without harming our independence and violating our professional ethics. But remember, the pillars to our ethics as CPAs are objectivity and integrity. Independence is the measure chosen by our profession to measure our objectivity.

If we remind ourselves of those pillars, and make our decisions from that viewpoint, we'll be fine. You can offer advice and options for a client, but they must be the ones who make the management decisions. The decision-makers at the client must be the ones who choose an option and who implement that option. We can't choose and we can't implement.

To practice integrity and objectivity, you must also be willing to push back if a client asks you to overlook something. If you think that maybe you crossed the line of our ethical standards, then you probably did. Don't fear the standards but use them as a guide to help you know when you need to step back. Be always willing to step back and evaluate whether you are too involved. Good clients will respect you more when you're willing to push back and adhere to your professional judgment.

Evolve or disappear

If you don't evolve, then your business will erode. For the sustainability of the profession, if you don't evolve to provide what clients want, they won't need you anymore. Your services won't be relevant to what they want and need.

This shift is inevitable when you build the five attributes into the core fabric of your culture. But you're not going to get to that end state without a plan and without monitoring your progression along that spectrum.

Moving along this line from Audit and Accounting to Assurance and Advisory will mean our firms will look different. We'll need different skills. Today, new auditors learn to be auditors by spending hours ticking and tying and tracing invoices. But in the future, much of that will be done through automation, so we'll need to teach those new auditors more critical thinking and interpretive skills. While the bots and the AI can do the ticking and tying and will easily kick out the outliers, we'll still need humans to interpret whether those outliers make sense.

What will be audited in the future will change

We're on the cusp of a technological change in what will be audited. While we're still auditing historical financial statements, those are of decreasingly less utility to our clients. Technology means that data flows from transaction to accounting system are happening faster and faster.

Business owners rely on information that's updated quickly so they can make decisions in real time. What use is an audit report that's months out of date?

In the future, auditors will be performing audits of information flow. Here's an example of how that's happening today. Schwan's sells frozen foods that are delivered to homes by route drivers. These route drivers are paid by commission, so their pay must cover their gas and other driving expenses. When the company put GPS units on the delivery trucks, they could see exactly where their drivers were and how many stops they made. A driver in Minneapolis might be able to hit 25 homes in just two miles of their route, but a driver in upstate Minnesota can't. They might have to drive 30 or 40 miles to do that.

So, to keep it equitable, and to keep their drivers engaged in the business, they adjust their commission structure based on the kind of route a driver has. An auditor would see how Schwan's was managing their business off those information flows and see if those financial transactions made sense.

How we report to clients in the future will change

As I mentioned above, neither the users nor the stakeholders get what they need out of an audit. I mentioned the detailed research by Baruch Lev and Feng Gu which indicated that over the years, the usefulness of reported financials to investors has declined significantly. As more investors and stakeholders request information on non-financial metrics, especially in the areas of environmental, social and governance (ESG), even the SEC is stepping up efforts to make sure that what's reported in company disclosures is accurate.¹⁵

The reporting framework has not kept pace with the needs of the users, especially in the modern era, when much of the value of tech companies and pharmaceutical companies is contained in the intangible assets they create. When I was at the AICPA, I worked with the Enhanced Business Reporting initiative to develop a more meaningful reporting framework. Sadly, that initiative didn't really go anywhere.

Baruch Lev and Feng Gu also propose a new framework that highlights a company's efforts to create, develop, and preserve its intangible assets. Tech companies that use the SaaS (Software as a Service) model have developed their own KPIs and metrics since GAAP metrics are relatively meaningless for them. These metrics and a reporting framework for SaaS companies built around those metrics are described in the book *Subscribed*, by Tien Zuo, the founder of Zuora.

Auditors who embrace the changes and move through the continuum of A&A to Assurance and Advisory will have a brilliant future. I'm optimistic about the future because I know there are many out there who want to push for these changes.

How to build the audit of the future

The secret of change is to focus all of your energy, not on fighting the old, but on building the new.

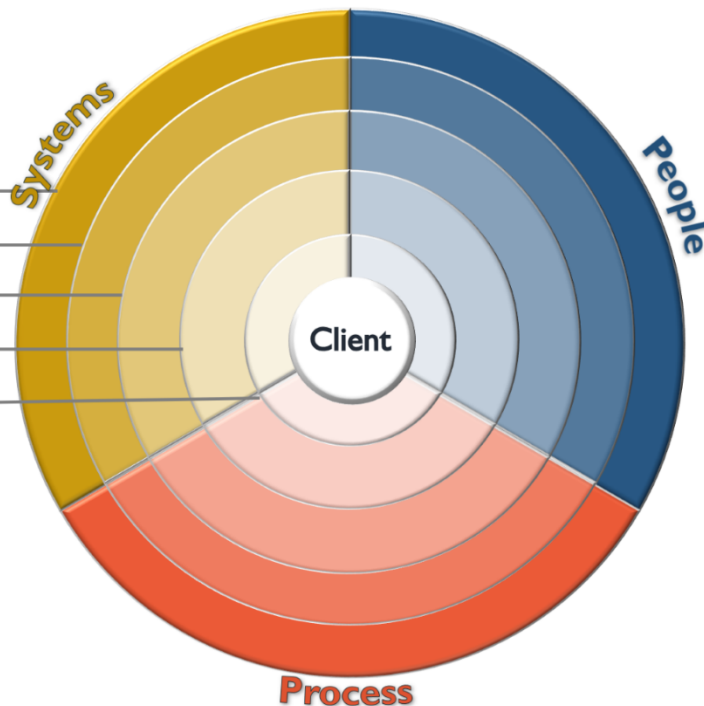
-Socrates

Consider a framework of five key attributes for successful leadership in audit. It's something I've developed in my work with auditors around the country, and as I've thought about where audit is headed.

If we focus on these five attributes, I truly believe we can transform audit from the checklist exercise that it's becoming into a service that genuinely adds value to our clients.

5 Crucial Attributes of Audit Leadership

Empowerment
Innovation
Quality
Business mindedness
Relevance



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1. **Relevance.**

The first attribute, which is closest to the client, is relevance. For audit to be relevant, you need to understand what's important to the client. What are their goals? What are they trying to accomplish, and how can we provide insights and ideas that help them with those goals? You've got to have leadership that actually believes that the audit is relevant, and you've got to communicate that belief and create actions that support its relevance. On the staff side, we create relevance through processes that let our staff understand how the piece they do relates to the whole business. For clients, as we deliver value, the commoditization of the audit diminishes dramatically. We demonstrate that value by our actions, not just by the words on our websites.

2. **Business-mindedness.**

Business-mindedness means looking both inward and outward. The inward focus means making sure the work the firm does makes sense from a business point of view. The outward focus involves thinking about our clients and how we would improve their businesses if we were running them.

3. **Quality.**

Quality in audit is more than just passing peer review, which is how many firms gauge their quality. Quality means really understanding the standards, the industry and the client. It means understanding how to do an audit and building a quality culture at your firm. A quality culture means first-time-right: It means making sure the work gets done right the first time and not just depending on review to catch the mistakes at the end.

4. **Innovation.**

Innovation isn't just about being on the cutting edge of the latest technology. Innovation is a mindset that you build into your culture. It means being willing to try doing things differently. Innovation means being thoughtful about what your people need so they can do the job first time right. Innovative uses of technology aren't just how many screens we have, but how can we leverage technology to get insights into our clients' operations. It's thinking, planning, communicating, acting, and delivering differently to give clients value.

5. **Empowerment.**

Our staff have so many great ideas and so much intellect, but we've created an environment where those who like to think and learn are leaving the profession. And those who stay are the ones who like filling out checklists. Empowerment means encouraging our staff to try doing things differently. It means making it OK to make mistakes and learn from them. Empowerment means we trust our teams to do the work appropriately because they've been trained well and have given them the tools and guidance they need.

None of these five attributes is more or less important than the others. They are an integrated whole. They all work together.

- You can't have quality if you don't have an empowered staff.
- You can't have relevance if you don't empower your team to think about what's relevant to the client and to be innovative in using new tech and new tools.

Business-mindedness is a double-edged sword: On one side you need to understand your client's business so you can give them relevant suggestions to improve their business. On the other side of that sword is the need to make the right decisions for your firm.

Underpinning all of that is quality. Obviously, as CPAs, we'll exercise due professional care in all we do, but when we perform audits, the bar is higher.

When you focus on all five, with the client at the center, you can't help but achieve the overarching goal of audit, which is to issue the correct audit opinion.

The bottom line to think about is this: Are we leaving the audit profession in better shape than it was when we inherited it?

Right now, we're not providing value, but I honestly believe it's not too late. The future of audit is ours to create or a future that will happen to us. To change the future of audit will take leadership. We must take ownership of the process.

Now I'm an optimist, and I think auditing can be fun. It can be at least challenging and rewarding, but you must have a passion and an intellectual curiosity to really understand your client's business. If you have that passion and intellectual curiosity, then when you come up as partners, you're to have a group of staff who get it because we brought them along.

But, before we get started on the framework, we need to build a foundation. This foundation is the four basic understandings that every auditor needs to master.

The four understandings

About six years ago, I was working onsite with a firm, and the managing partner came into the room. I asked him, "What's your goal for this operational project I'm doing for you?"

He said, "Al, I just want the silver bullet."

I basically closed my laptop and said, "I'm out of here. There's no such thing as a silver bullet. Instead of a silver bullet, think in terms of foundational understandings. You've got to understand your client. You've got to understand your industry and what you're dealing with. You need to understand the standards. And you really need to understand how to do the audit."

Let's delve into those four understandings in detail.

Understand the client

Every standard audit program has a section on Understanding the Client. And if this is a client you worked with last year, those answers get rolled forward. Usually, a staff auditor will get the job of updating that form. So that the staff auditor will sit with the accounting manager and go over the answers from last year. And then the understanding of the client stops there.

At best, that form just gives you a superficial understanding of the client. You know what industry they're in. You know what software they use for their accounting. You know the names and job titles of the people who do the accounting.

But that form misses some crucial items:

1. What are they trying to do?
2. Where does that client want to be in five years, in ten years?
3. Do the people doing the accounting tasks know what they're doing?
4. Do they have streamlined processes, or are they using lots of workarounds?
5. What about the way their software interacts with their other business modules and the other software they use to run their business?
6. Are they using automation, or are they doing lots of manual data entry for reconciliations and for calculations?
7. Where are the bottlenecks?
8. Where are the places where something might go wrong?

You can't really have a quality audit and your audits won't be relevant if you don't have a deep understanding of the client in these areas.

Understanding the client is crucial to planning the audit, which we'll discuss in Chapter 6. When you gain a deep understanding of the client, you can ensure that you're not doing too few procedures, and you're not doing procedures that don't add anything of value to the audit.

Understand the industry

I've seen way too many firms insist they can audit any balance sheet. That may be true, but you run the risk of missing something big that would only be clear if you know the industry well. And if you don't know the nuances of an industry, it's nearly impossible to provide relevant insights to your client, the ideas that will help the client make progress toward their business goals.

When you understand the industry, you know what the accounting issues are likely going to be. You know what's likely to be an area of risk, a place you'll need to look at closely. This means you need to send your people to industry-specific training, not just the CPE on accounting standards. Things change quickly today, so you need to make sure you and your team keep your fingers firmly on the pulse of any industries you specialize in.

If you jump into a new industry, you better be ready to learn everything you possibly can. Send your people to all the training in that industry that they can possibly go to. I've seen plenty of auditors get sued because they made a bad business decision. They thought that they could take on this unique industry and get it right without putting in the time to understand the industry. Some are "lucky" and their only punishment for taking on a client in a novel industry is getting reamed on peer review.

What are the repercussions if you don't have expertise in a specific area? As an example, let's look at employee benefit plan audits. It's an area many firms view as super easy, something to fill in the holes in your schedule.

Back in 2014, the DOL did a review of employee benefit plan audits for the 2011 plan year.¹⁶ They found that 39 percent had major audit deficiencies. They also found that as the number of employee benefit plan audits a firm performed decreased, the quality also dramatically slipped. For firms that did two or fewer per year, 75 percent of the audits had major deficiencies.

One of the best ways to set your firm apart from the competition is to develop an industry specialization. When you understand an industry, you can add insights for the client. You become a best-practices connoisseur for that industry and can recommend operational and back-office improvements that can make a big difference to their bottom line. You see where the risks are, and how to help your clients avoid them.

That industry expertise also means your fees can reflect the additional value you're bringing to a client's audit. Now, admittedly, the ones who make their decision solely on the basis of fees might not be willing to pay extra, but those aren't the ones you want to work with. The ones you want to work with are the ones who want more than just an audit. They want assurance and advice.

Several innovative firms have developed industry expertise to the extent that they have developed benchmarks among their clients for financial metrics. Think how valuable it would be for a client to hear how they rank among their peers.

Understand the standards

It is kind of amazing how little time we take to actually read new standards. We just assume it's somewhere on the checklist.

When we go see a doctor or a dentist, we assume that they've kept current with current best practices and any changes to the regulations that govern their practices. I would hope that my medical practitioner or my dentist keeps current with the rules, especially the new rules to keep patients safe in the wake of the coronavirus pandemic.

Why shouldn't we be held to a similar standard of keeping current and understanding new standards as they come out?

The leadership in A&A needs to drive the importance of quality into the fabric and the culture of the firm by understanding the standards. Most firms don't challenge their people to understand the audit standards.

Holding staff accountable for understanding the standards isn't as daunting as most CPAs seem to believe. In our conversations with staff, we must go beyond checking off the rule on the form. Instead, let's talk about the impact of the rule. Let's have frequent open-ended conversations about it so we really understand the intent of the standard and how we as a firm are going to embrace it. This practice will innately build quality into your audit practice and create a team of better auditors.

Firms might say, "Great idea, Al. We'll get to it just as soon as we have time."

And of course, most firms don't have time. But if you don't make the time, then your firm will become a dinosaur.

Auditing standards aren't black and white. There's a lot of room for interpretation and professional judgment. I won't tell anybody to not comply with standards, but sometimes you need to think about the principle that a standard is trying to cover. How does it apply to this context?

Understand how to audit

When I work with firms, I do what I call a plain paper audit. I bring a bunch of seniors into the room and the first thing they ask is, "Where's the manual?" I say that there's no manual, there's a notepad. And I have them write down how they would approach their audit.

Two things happen when they are forced to write it down. First, ideas start surfacing from the back of their brain and they realize that they know more than they give themselves credit for.

And second, writing it down helps them think it through. The one thing that is missing from checklists is the ability to think. We need to give our staff the license, the opportunity, and the responsibility to think.

If your staff cannot do a plain paper audit, you need to build that into your culture. Start with a lunch-and-learn, sit down and say: "Okay, here's a blank notepad. Write an audit program for inventory. Write an audit program for investments." Start getting them to think about what it is they're doing.

Winning the best and brightest

By understanding your client and their industry, you can make your audits relevant and provide value-added insights and services to your clients. When they see the added value, your firm stands out. You have the opportunity to make a difference to that business. You won't be racing to the bottom for fees.

It makes you more business-minded so you can help your clients improve their businesses, while strengthening your own audit firm. Because you understand the industry, you can see the ways that a client is doing better than the norm and areas that they can improve. Understanding your client and the industry lowers the risk for your firm that the audit will miss something crucial. You make decisions on whether to accept an engagement from a position of strength because you're not just trying to add more revenue to the top line.

The quality of your audits improves because you understand what the risky areas are and how to obtain the right amount of audit evidence. Understanding risk for a particular client will help you become more comfortable with innovation because you know what your audit methodology needs to discover.

Finally, by empowering your people to think deeply about their work, they'll feel excited and engaged about their work, much more so than if they are bogged down in endless checklists.

It makes the work more engaging and more interesting for your staff. And making the work more interesting is the key to making sure they stick around long enough to become leaders themselves.

It means you build a team of the best and brightest because those people will want to come work for you.