

Response to the Request for Public Comment  
on the  
PCAOB's Concept Release on Audit Quality Indicators

My name is Robert Conway. I am a licensed Certified Public Accountant in the United States and a retired Big Four audit partner. I am also a former employee of the Public Company Accounting Oversight Board ("PCAOB" or "the Board") with nine years of experience at the PCAOB, including six years as a Regional Associate Director with leadership responsibility for the PCAOB's Orange County and Los Angeles offices. Prior to joining the PCAOB in 2005, I had a 26+ year career with KPMG, including 17+ years as an audit partner.

I am also the author (identified at the time only as the "Anonymous Retired Big 4 Audit Partner") of the recommendation<sup>1</sup> to the United States Treasury Department's Advisory Committee on the Auditing Profession ("ACAP") that audit firms be required to publicly report certain operational metrics which I referred to as "Audit Quality Drivers." That recommendation, which I submitted in 2007 and shared with the PCAOB prior to submission, is attached in **Appendix 1** to this paper. The thinking behind this recommendation was that the operational metrics of competing audit firms would be of interest to the purchasers of audit services and competitive forces would drive audit firm leaders to improve their operational metrics in a direction conducive to improving audit quality. After all, what audit firm leader would want to be in last place when the metrics are published and what audit committee would desire to engage an audit firm with the least desirable blend of operational metrics? Additionally, what prospective CPA firm employee would seek employment with the audit firm with the least desirable blend of operational metrics? The six metrics I proposed in my ACAP recommendation and the desired direction of improvement are summarized below:

<u>Audit Quality Driver / Metric</u>		<u>Desired Direction of Improvement</u>
Years experience after CPA licensing	>>>	More experienced professionals
Percentage staff turnover during year	>>>	Better continuity year over year
Chargeable hours per professional	>>>	More reasonable staff workloads
Chargeable hours managed per partner	>>>	More reasonable partner workloads
Ratio of audit staff to partners	>>>	Better supervision
Training hours per professional	>>>	Increasing technical excellence

My recommendation to ACAP has been widely regarded as having provided the impetus for ACAP's recommendation that the PCAOB determine the feasibility of developing key indicators of audit quality and the effectiveness of requiring audit firms to publicly disclose these indicators. Damon Silvers, Chairman of ACAP's Subcommittee on Concentration and Competition noted during the PCAOB's October 22, 2008 Standing Advisory Group discussion on audit quality metrics, "I could say that our [ACAP] subcommittee came up with this recommendation out of the fullness of our imaginations. It really is not so. It came from a comment letter that we received from a retired audit firm partner who chose to remain anonymous -- and it is really a tribute to the quality of that letter that it drove this recommendation."<sup>2</sup> While my recommendation focused on input measures of audit quality, the ACAP discussion expanded the recommendation, asking the PCAOB to consider both input and output indicators.

<sup>1</sup> Referred to in the ACAP Final Report in Chapter XIII, page 16, footnote #56. I also submitted a similar paper to IOSCO in 2010 in response to IOSCO's request for consultation titled, "Transparency of Firms that Audit Public Companies." See <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD339.pdf>.

<sup>2</sup> See webcast at [http://pcaobus.org/News/Webcasts/Pages/10222008\\_SAGMeeting.aspx](http://pcaobus.org/News/Webcasts/Pages/10222008_SAGMeeting.aspx). Select Day 1 session at 2:02:45.

One of the best accolades I have received about my ACAP recommendation is that it is “actionable.” This has been borne out by PwC’s transparency report titled “Our Focus on Audit Quality 2014” that incorporates substantially all of the metrics I proposed and several more. In testimony before ACAP in December 2007, Dennis Nally, Chairman and Senior Partner of PwC LLP, stated, “We believe that public disclosure about key elements that drive audit quality would be a useful benefit to the capital markets. This public transparency we envision could include firm disclosure and discussion of the levels of partner and staff turnover, average hours of professional training, risk management and compliance measurements, and metrics related to the quality of management and firm governance processes.” I encourage the PCAOB and those commenting on this concept release to review PwC’s transparency report before formulating opinions about what is actionable and what is not.

On page 4 of my 2007 ACAP recommendation, I also suggested the need for audit firms to define “Safe Zones of Operation” using audit firm operational metrics. If certain operational metrics move beyond safe tolerances, mitigating or compensating action should be undertaken. Audit reports should not simply continue down the conveyor belt if safe zones of operation have been compromised. The concept of safe tolerances for the operation of equipment is fundamental to everyday life. This same concept should be applied to audits.

### **General Observations**

I commend Chairman Doty and the Board for identifying the Audit Quality Indicator (AQI) project as a strategic priority in 2013 and following through with the publication of its concept release on June 30, 2015. I am also encouraged by the indication in the concept release that the PCAOB intends to incorporate the monitoring of operational metrics into its planned revision to the existing quality control standards. These are high yield opportunities to improve audit quality.

### **What Problem Are We Trying Solve with Audit Quality Indicators?**

The PCAOB has done a good job of articulating the potential benefits that may result from providing more transparency to audit firm AQIs. However, the PCAOB has sidestepped a clear articulation of the problem that needs to be solved. It will advance the audit quality indicator initiative if we speak frankly about the problem that needs attention – the existing audit firm business model.

### **The Audit Firm Business Model**

Common complaints from public company CFOs and controllers about their audit firms regularly include the following:

- “We don’t have good continuity of audit team personnel from year to year.”
- “We are a training ground for young auditors.”
- “Your audit team doesn’t seem to understand what they are doing.”
- “I get asked the same questions over and over.”
- “I don’t see enough of the partner and manager.”
- “Why is this issue coming up at the last minute?”

A major contributing factor to these observations is the high workload / high turnover / low experience level / high leverage business model that the Big Four audit firms follow. The

combination of high workloads, high turnover, low experience levels, and high leverage were not conducive to audit quality. This business model is also inherently inefficient because just about the time young professionals achieve a higher level of proficiency and expertise, they tend to leave public accounting. The large firms have continued to follow the same business model that existed when I started my career in public accounting in 1978. Hire young adults just out of college, work them to hard, pay them less than they can make in industry – and sure enough – many leave the large audit firms not long after they get their CPA certificate. The one element that used to counter-balance this situation was that nearly everyone that started in public accounting years ago had the ambition of becoming a partner. Today, that ambition is waning because the audit partners are overworked and under a lot of stress. Very few of the younger people these days desire to become an audit manager in public accounting, let alone an audit partner.

The large firms all tend to run very lean on headcount – both at the staff level and at the partner level. This is largely because line audit partners and office and regional managing partners are measured on bottom line contribution. There is not much of a safety net when turnover runs high or unexpected new work comes in the door (which is why defining safe zones of operation is so important).

The truth is that young adults just out of college largely audit Corporate America. Many of these young adults are not yet licensed CPAs. This is particularly troubling when one considers that the less experienced professionals are still in their formative years for developing their professional skepticism. I have roughly estimated the weighted average experience of the auditors of corporate America to be only 2.6 years subsequent to CPA licensing (see **Appendix 2**). It is important that there be greater transparency to this reality.

The counter-balance to staff inexperience is the supervision and review by seasoned partners and managers. However, high leverage and heavy workloads at the partner and manager level threaten the quality of their supervision and review. In addition to managing a large number of audit hours, audit partners have demands on their time for non-audit activities such as proposals, recruiting, performance reviews, negotiating fees and overages, training, and participation in community activities. These demands create a heightened risk that the partner's review time will be less than adequate and untimely. A partner operating in "catch-up mode" (behind where he or she needs to be in the review cycle) is an accident waiting to happen.

The environment I am describing is not conducive to achieving high audit quality. My personal view is that a number of audit failures have had their roots in excessive workloads, high turnover, high leverage, and inexperience.

### **The Tension Between Audit Quality and Audit Firm Profitability**

I have asked myself why the Big Firms have settled into such an unhealthy equilibrium point. My conclusion is this: The leaders of the large firms are held accountable for current year profits – and they are not held accountable for reducing turnover, increasing the average years of experience of their professional staff or reducing the ratio of staff to partners. Granted, audit quality has an impact on profits – but the impact of legal settlements is typically not fully measured until several years have passed and the existing leaders have moved on.

The PCAOB inspection process is an important counter balance to motivate audit firm compliance with professional standards. There is little doubt that the PCAOB's presence has improved audit quality. However, it is also clear that further improvements to audit quality are

still needed. I firmly believe that Audit Quality Indicators present an enormous opportunity to take audit quality to the next level and, at the same time, create a more sustainable audit profession for the long haul.

### **The Adverse Effects of Commodity Pricing**

The complexity of today's financial and accounting world requires highly skilled professionals to conduct quality audits. These highly skilled professionals deserve to be well compensated. However, beyond expertise in selected industries, audit services are perceived as relatively undifferentiated services and, as a consequence, have fallen victim to the adverse effects of commodity pricing.

PCAOB inspection reports provide some information to audit committees; however, those same reports caution against extrapolating the results presented in the public portion of inspection reports to broader conclusions about an individual firm's practice.

Even with the existing Big Four "quadropoly," downward pricing pressure continues to be intense. Audit firms are challenged to appropriately compensate highly technical professionals in a commodity-pricing environment. This has resulted in intense pressure for the Big Four firms to reduce costs. The firms have been diligent in this regard. However, most of the obvious opportunities to drive down cost (such as office space reductions) have been exhausted. Intense pressure within the audit firms to divert increasingly higher percentages of audit work to low cost offshore service centers (such as India) is symptomatic of commodity pricing. We should all be concerned.

### **Finding a Better Equilibrium Point**

I have often pondered whether there might be a better equilibrium point which generates the same level of profitability for the partners – but achieves higher audit quality, completes audits more efficiently, and incurs reduced practice protection costs (insurance premiums, legal fees, and settlements) due to more reasonable workloads, lower turnover, improved experience levels, higher staff continuity, and better staff-to-partner leverage ratios. The result might be a win-win-win for audit firms, audit clients, and investors. But how do we get from the current state to a better future state?

### **Enabling Free Enterprise and Competition to Work its Magic**

Informed consumers play an important role in our free enterprise system. Informed consumers thoughtfully evaluate the attributes of competing products and purchase the product that, in their eyes, provides them the best value for the need they are seeking to fulfill. This keeps competitors on their toes to innovate, manage costs, and meet consumer needs. Free enterprise and competition rewards the providers who deliver the best products and services at a good value. Highly differentiated products that are responsive to consumer needs can command higher prices and/or gain market share.

A critical prerequisite for free enterprise to work its magic is that consumers be informed. Audit Quality Indicators provide that opportunity.

It may be helpful to contrast the current void of information in the auditing world with the volumes of information available to consumers from resources such as Consumer Reports, JD Powers, and airline "on time arrival" statistics.

During ACAP's consideration of my ACAP recommendation at its April 1, 2008 meeting, ACAP Co-Chairman and former SEC Chief Accountant Don Nicolaisen stated:

“...the firms compete primarily on the basis of cost ... and it has been disastrous for investors and for the firms. I think it is in the best interest of everyone to identify some of those things that that would ... provide audit committees and investors an opportunity to better understand how firms compare amongst themselves – and what are some of those things that would lead you to engage an audit firm, other than price.”

I have long believed that audit committees would be willing to pay more if they had good reason to believe they were going to get more in return. Audit quality indicators create the opportunity for that to happen at the engagement level. All things being equal, audit committees will reward the firm that can deliver a better mix of specialists, partners, managers, and experienced senior time relative to less experienced professionals. A better mix means better supervision and review by the most experienced professionals. As the PCAOB notes, this can facilitate a discussion at the audit committee level that will lead to more informed decisions about auditor selection and retention.

### **Healthy Competition for Audit Clients and Audit Professionals**

The PCAOB's concept release and my discussion herein have been principally focused on competition for audit clients. There is another competition that should not be overlooked – the competition among audit firms for talented professionals. The PCAOB has overlooked this angle in its concept release – but it promises to have an enormous impact. What aspiring audit professional (or seasoned audit professional for that matter) wants to work at an audit firm that stands out with the heaviest workloads, the highest turnover, the lowest experience levels, the highest leverage ratio, and the lowest investment in training per professional? Such indicators would be a red flag to prospective and existing employees.

### **Another Potential Benefit from Audit Quality Indicators**

An important element of the Sarbanes-Oxley Act of 2002 was a provision assigning the audit committee with clear responsibility for engaging, retaining, or dismissing the auditor. The expectation was that this arrangement would make the auditor more beholding to the audit committee and less beholding to management. The unfortunate reality, however, is that audit committees still rely heavily on recommendations from management on auditor retention due to the audit committee's lack of insight into how the auditor executes the audit. The audit quality indicator initiative should enhance the audit committee's effectiveness by enhancing the auditor's independence and objectivity toward management.

### **AQIs Should be Evaluated in the Context of an Audit Quality Framework**

I think it is important, once the final list of AQIs has been determined (if not sooner), that the AQIs be mapped to an audit quality framework to help users understand the areas where AQIs provide insight as well as help users understand the areas where the AQIs may provide no or little insight. This will help the users of AQIs understand the areas where they will need to conduct their own analyses or make their own inquiries in an effort to formulate reasoned conclusions.

I mention this because, in my own efforts to advance my ACAP recommendation, I found it useful to develop my own audit quality framework to put into perspective what portion of the audit quality framework was addressed by the metrics I proposed. The framework I developed is depicted in a graphic identified as the “Audit Quality Pyramid” (see **Appendix 3**). You will see that the metrics I advanced in my ACAP recommendation are identified at the base of the pyramid as “Audit Firm Basic Operational Input Metrics.” These metrics generally match the following AQIs listed in the PCAOB’s concept release as follows:

- # 1 – Staffing leverage
- # 2 – Partner workload
- # 3 – Manager and staff workload
- # 6 – Experience of audit personnel
- # 8 – Turnover of audit personnel
- #10 – Training hours per audit professional

It is useful to think of these metrics as “foundational prerequisites for achieving audit quality.” They do not by themselves assure audit quality. However, without the proper “foundation,” one would find it difficult to conduct a high quality audit.

The Audit Quality Pyramid also serves to highlight those items that are part of the audit quality framework that cannot be measured readily -- such as “Professional Skepticism” or “The Fortitude To Do The Right Thing.”

### **The Overarching Principles Guiding My Response to the Concept Release Questions**

My response contemplates that AQIs should be required for audit firms with 100 or more “issuer” audit clients and should be voluntary for audit firms with less than 100 “issuer” audit clients. I drew this conclusion with the knowledge that the AQI project will inform all audit committees about questions they should be asking. There is nothing to stop an audit committee from making reasonable information requests to its auditor or a prospective auditor – irrespective of whether the audit firm audits 100 or more public companies.

My general view is that the AQI effort should focus on providing transparency to existing information. I have also excluded certain AQIs in areas that already receive a fair amount of attention on internal inspections and PCAOB inspections. My thinking is that if there are issues in these areas (including items in the Part 2 (QC) section of PCAOB inspection reports, they should be described in the audit firms’ transparency report (similar to the manner PwC already describes on such matters). If not reported in the audit firm’s transparency report, the audit committee best practice would be to ask about the existence of any such items.

I have also excluded certain AQIs that I believe can be satisfied by existing information compiled by the audit firms to comply with the New York Stock Exchange Listing Standards.

Trying to create a balanced scorecard is an admirable goal. However, I am concerned that a balanced scorecard implies that audit quality can be measured (which it cannot). The end game is not to measure audit quality. The end game is to realize the benefits that typically result from providing greater transparency. Such transparency better informs the purchasers of audit services and will facilitate competition in a manner that should yield improvements over time to elements affecting audit quality.

In certain instances (such as industry expertise), I believe the consumers of audit services are already alert to the importance of industry specialization and they know what questions to ask incumbent and prospective auditors. Accordingly, I concluded that the creation of AQIs for industry specialization would not be cost-beneficial.

The PCAOB has a better chance of success with this initiative if it focuses on 1) providing transparency to information that already exists and 2) focusing on elements that are truly actionable at minimal cost.

My response to the concept release questions is attached in **Appendix 4**.

If invited, I would be pleased to participate in the roundtable discussion of the concept release contemplated for later this year.

Sincerely,

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A Recommendation to The Treasury Department's  
Advisory Committee on the Auditing Profession

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Improving the  
Transparency and Sustainability  
Of the Audit Profession

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November 2007

I am a recently retired audit partner from one of the Big Four audit firms. My observations and recommendation are based on my personal experience in public accounting as well as the discussions I have had with CFOs and controllers of both clients and non-clients.

Common complaints from public company CFOs and controllers about their audit firms regularly include the following:

- “We don’t have good continuity of audit team personnel from year to year.”
- “We are a training ground for young auditors.”
- “Your audit team doesn’t seem to understand what they are doing.”
- “I get asked the same questions over and over.”
- “I don’t see enough of the partner and manager.”

A major contributing factor to these observations is the high turnover / high workload business model that the Big Four audit firms follow. This was one of the primary reasons I retired from public accounting when I did. The combination of high workloads, high leverage, low experience, and high turnover were not conducive to audit quality. The large firms have been following the same business model that existed when I started my career in public accounting over 29 years ago. Hire young kids just out of college, work them to death, pay them less than they can make in industry – and sure enough – they leave the large audit firms once they get their CPA certificate. The one element that used to counter-balance this situation was that nearly everyone that started in public accounting 29 years ago had the ambition of becoming a partner. Today, that ambition is waning because the audit partners are overworked and under a lot of stress. Very few of the younger people these days desire to become an audit manager in public accounting, let alone an audit partner.

The end result is high turnover and higher workloads at all levels. The environment I am describing is not conducive to achieving high audit quality. My personal view is that a number of audit failures have their roots in excessive workloads, high turnover, and inexperience.

I have asked myself why the Big Firms have settled into such an unhealthy equilibrium point. My conclusion is this: The leaders of the large firms are held accountable for current year profits – and they are not held accountable for reducing turnover or increasing the average years of



experience of their professional staff. Granted, audit quality has an impact on profits – but the impact of legal settlements is typically not fully measured until several years have passed and the existing leaders have moved on.

I've thought about measures that could make the leaders of the large firms more accountable for turnover, reasonable workloads and retaining more experienced professionals. I think I have a simple solution that can have a profound effect.

### **Measuring and Reporting Audit Quality Drivers**

Each of the large audit firms distribute information to the audit committees of their public company audit clients describing their processes to ensure audit quality. This information is distributed pursuant to the requirements of the New York Stock Exchange Listing Standards. This information includes, among other things, the audit firm's commitment to hiring, training, performance evaluation, and compensation. The information provided by the Big Four audit firms leads the readers of this information to conclude that each firm is completely committed to quality and implies that each firm must truly be a wonderful place to work. Unfortunately, I believe the large firms are painting an incomplete picture. Each firm does not talk about the relatively low experience levels of its professional staff, the heavy workloads, the high turnover, and the high ratio of professional staff to experienced audit partners.

Audit quality is not easily measured. However, I believe there are six drivers of audit quality which can be measured readily and publicly reported by each audit firm on an annual basis. These statistics will enable the consumers of audit services to gauge the degree to which each audit firm has created an environment conducive to audit quality. Competition will drive each of the Big Four audit firms to alter their business models to improve the reported statistics. I suspect that none of the Big Four CEOs will want to be in last place when these statistics are reported. I also believe that audit committees will be reluctant to hire an audit firm that does not compare favorably to the statistics achieved by the other large audit firms. The end result is that competitive forces will drive improvements to each firm's business model – resulting in a healthier balance between profitability and the audit quality drivers. The six audit quality drivers and a brief description of their importance are summarized below:

- **The average years of experience of audit professionals** – The experience level of the audit professionals is a key driver of audit quality. The complexity of accounting and high public expectations all point to the need for more experienced professionals. By and large, corporate America is audited by young men and women just out of college – supervised by a limited number of experienced partners. My preference would be to measure this statistic only counting years of experience subsequent to the employee becoming licensed as a CPA. This will draw attention to the fact that much of the audit field work is conducted by employees who have not yet become CPAs. It will also drive the large Firms to encourage their employees to become licensed CPA's sooner and will reinforce the importance of technical excellence.
- **Ratio of professional staff to audit partners** (using FTEs) – A favorable ratio of audit professionals to audit partners can be a good indicator of an appropriate level of partner involvement and partner supervision of less experienced employees.

- **Chargeable hours per audit professional** (using FTEs) – When the staff workloads become excessive, audit quality suffers. The old saying, “The devil is in the details,” is especially true about auditing. When workloads become excessive, attention to detail suffers. This means less attention is paid to critical items such as contract reviews, complex accounting matters, and supervisory reviews of the work conducted by lower level professionals.
- **Professional chargeable hours managed per audit partner** (using FTEs) – The average hours managed per audit partner is a critical metric. It speaks volumes about the reasonableness of the partner workloads. When the audit partner workloads are excessive, audit quality suffers because the audit partner doesn’t have enough hours in the day to assure that a suitable level of audit quality has been achieved.
- **Annual professional staff retention** (i.e., What percentage of professionals employed a year ago are still employed today?) – The reason the experience level is so low among the Big Four audit firms is because of high staff turnover. The lack of work life balance, high stress and lower than market salaries cause many employees to leave public accounting after just 3 to 5 years of experience – just when they start to possess a meaningful level of experience. The downside to high turnover is 1) low audit team continuity from year to year and 2) reduced experience levels. This increases the risk that audit work is conducted by less experienced audit team members who may be unfamiliar with the business being audited or the issues encountered on the audit in the prior year.
- **Average annual training hours per audit professional** – When workloads become excessive, audit professionals tend to cancel scheduled training because completing existing assignments is seen as a higher priority. This might seem like the right thing to do in the short run, but insufficient training undermines audit quality over the longer term.

These statistics should be reported by each large audit firm on an annual basis with comparison to the prior year’s statistics. This would enable the consumers of audit services to judge whether the trend is favorable, neutral, or unfavorable. I would welcome each audit firm to provide their own Management Discussion and Analysis of these statistics. I would imagine that it wouldn’t take long for the financial press to provide side-by-side comparisons of each of the firm’s metrics for the audit quality drivers.

If I were on an audit committee and was considering alternative proposals from competing firms, I would certainly favor the firm that brought the most experience to the table, set reasonable workload expectations, achieved a suitable level of continuity year over year, provided for a high degree of partner involvement in the audit process, provided for proper supervision of its professionals, and invested appropriately in the training of its younger professionals.

The airlines publish “On Time Departure Statistics” to help consumers make more informed choices about which airline to fly. Consumer Reports publishes a wealth of information to help consumers make informed buying decisions about cars, appliances and consumer electronics.

Shouldn't audit committees be entitled to receive better information about the audit services they are procuring?

One of my favorite sayings is "That which gets measured – improves." In this case, I am confident that competition will motivate a change in each firm's behavior. None of the big firm leaders will want to be in last place when the statistics on audit quality drivers are published.

I would anticipate that several computational issues may arise impacting the reliability and comparability of these statistics between firms. However, I am confident that these issues can be resolved with appropriate oversight from an independent third party.

### **Defining the Safe Zone of Operation**

The large firms all tend to run very lean on headcount – both at the employee level and at the partner level. This is largely because the office and regional managing partners are measured on bottom line contribution. There is not much of a safety net when turnover runs high or unexpected new work comes in the door. One of the ironies here is that the audit firms tend to be the most profitable when turnover is at its highest. The revenues are relatively fixed in the near term based on the client book of business. If turnover is high, two factors drive down payroll costs and increase profits. The obvious factor is lower headcount which lowers payroll costs. The less obvious factor is that the departed experienced employees (who tend to be more expensive) are replaced by less experienced employees who are less expensive.

To better manage the risks described above, I am recommending that the large firms use the metrics I have described herein to define **safe zones of operation** at the office and individual partner level. When the metrics indicate operation outside the safe zone, I would expect the firm to implement safety measures to mitigate the risk associated with operating outside the safe zone. Such measures might include expanded second partner concurring reviews equivalent to the review expected of the engagement partner – to assure that audit quality has not been compromised.

### **The Audit Firm Quadropoly – Sustainability and Transparency**

Much has been said in the financial press about the dangers of having only four large audit firms. There is criticism about the lack of competition, escalating fees and deteriorating service due to the so-called "quadropoly." There is also concern about "What happens if one of the Big Four should go out of business?"

Publication of the metrics I am recommending will drive the large audit firms to improve how they perform with respect to the drivers of audit quality described herein. This means that service levels and audit quality will improve, benefiting the consumers of audit services. It also means that the probability of audit failures will be reduced – thereby enhancing the long term sustainability of each firm.

Much has also been said about requiring the audit firms to provide transparency about their financial results. It is already well known that the large CPA firms are very profitable. I do not foresee that the publication of the large firm financial results will accomplish a lot. On the other

hand, providing transparency to the metrics impacting audit quality has the potential drive fundamental changes to the large audit firm business models which can significantly improve audit quality and long term sustainability.

We all agree that monopolistic situations require regulation. Otherwise, service levels deteriorate while monopolistic pricing generates excess profits for the monopoly owner. I am not suggesting full scale regulation, merely the reporting of information which will enhance competition and drive the audit firms toward a **safer zone of operation**. I am not denying that the large audit firm partners should be well compensated for their expertise and hard work. But there needs to be a balance between the profitability of the quadropoly and finding the **safe zone of operation**. This not a time to be sheepish about asking for more information (aka regulation) which will benefit the consumers of audit services and make the audit firms safer and more viable in the long run. The consequences of not acting now are far too grave to continue with business as usual.

**Advisory Committee on the Auditing Profession**

**Thoughts About the Webcast of the April 1, 2008 Telephonic Meeting**

**Linkage to Audit Partner Judgment**

One of the Advisory Committee members noted that a recent study on restatements suggested that a significant root cause of restatements had to do with audit partner judgment. The Advisory Committee member expressed concern that the audit quality drivers proposed for disclosure did not link back to audit partner judgment. My contrary view is that there is very solid linkage between partner judgment and the audit quality drivers. I'll explain why.

For an audit to detect material errors, there must be an appropriate amount of partner involvement at each stage of the audit, including during the planning and the execution stages of the audit. The audit partner is not, however, the sole identifier of material issues. The audit firm model relies heavily on a team approach to test records, identify issues and elevate those issues in a timely manner to the audit partner. For that to happen, the audit team must be appropriately staffed with the right quantity and caliber of skilled professionals. The professionals (including the audit partner) must be focused on the task at hand and attention should not be diverted by the demands and deadlines of other clients.

Summarized below are certain of the "Key Ingredients" for a successful audit and how those "Key Ingredients" link to the audit quality drivers:

<u>Key Ingredient</u>	<u>Relevant Audit Quality Drivers</u>
Experience and Knowledge	1. Years of experience 2. The rate of turnover 3. The amount of training per professional
Time to Do the Job Right (And in a Timely Manner)	4. Chargeable hours managed per partner, 5. Chargeable hours per partner 6. Chargeable hours per professional
Adequate Supervision	7. The ratio of staff to partners

When the workloads are excessive, the audit partners are generally in a "catch up" mode – meaning the partner is trying to catch-up to where they need to be – but they may be days or even weeks behind schedule. This means that the audit partner may not be appropriately involved in the planning or the execution of the audit. This also means the audit partners don't spend as much time in the field as they should -- and when they do spend time in the field, the time spent occurs

later than it should -- often just before sign-off deadlines. Reduced time in the field means less time in the work papers -- and the heightened prospect that issues may be missed. These circumstances lead to greater reliance on the rest of the team to identify and elevate issues. The next line of defense below the audit partner is the senior manager -- but the senior managers are often in "catch up" mode too. And below the senior manager level, the model is relying heavily on relatively inexperienced personnel to identify and elevate issues.

There is an interesting dynamic at work which puts a premium on the timely identification of issues. Audits are generally conducted under considerable time pressure to meet earnings release deadlines. If issues are identified by the auditor early in the audit process, it is much easier for the audit partner to insist that the issue be satisfactorily resolved. However, if the issue comes up late, largely due to the fact that the audit partner is in "catch up" mode, the audit partner may experience hesitation to insist that an issue be resolved. Among the many retorts the audit partner may hear are "Why am I only hearing about this now? Your team has been out here for eight weeks." CFOs and Audit Committees are fanatical about not wanting to be surprised at the last minute. Audit partner fortitude is important to handling these situations.

Another interesting dynamic concerns the identification by the audit team of a prior period error. Oftentimes, the audit partner may feel guilty about not detecting the error in a timely manner (perhaps partner "catch up" mode was a contributing factor). CFOs and Audit Committees may consciously or unconsciously add to the audit partner's guilt by questioning the audit partner's failure to identify the error in a more timely manner. These pressures can adversely impact judgment, sometimes leading to the compounding of errors through poor audit partner judgment.

The bottom line is this: It is extremely important that the audit team conduct its work, including the partner review, in a timely manner -- so that issues, if they are identified, can be resolved without the audit client doing anything to cloud the auditor's judgment.

### **The Annual Capital Budgeting Exercise**

At the end of every fiscal year for each of the large accounting firms, the partners decide how much of the Firm's profit should be distributed out to the partners and how much should be reinvested in the business. Generally, the year end profit distribution sweeps all of the profits out to the partners with very little reinvested in the business. My sense is that partner distributions have gone up significantly post-Enron without appropriate investment in right-sizing the workloads. Granted, improvements have been made to staff compensation. But high workloads and the absence of work-life balance continue to be issues which undermine audit quality. The transparency resulting from publishing the audit quality metrics may drive the firms to invest more in the business to reduce workloads (by hiring more people). This would seem to be particularly important given the existing quadropoly situation where many are concerned that Big Four firm profits have increased without a commensurate increase in audit quality. I continue to believe that consequential change can be achieved by requiring transparency (but without dictating minimum or maximum thresholds for any of the audit quality drivers).

## **Attracting Young People to the Profession**

I know that the Advisory Committee on the Auditing Profession is very much concerned about attracting more young people to the auditing profession. While compensation levels have become more attractive, I remain concerned that the workloads continue to be excessive. Information about the poor work-life balance finds its way back to the college campuses quickly and this discourages many good candidates from choosing public accounting as a profession. While the Firms all talk about work-life balance, until they do something meaningful about workloads, they will not make a meaningful dent in the work-life balance issue.

As it currently stands, the Big Four Firms may look pretty similar to prospective candidates. They do the same work, they pay same, and they all offer similar opportunities for career advancement. Candidates choose from competing offers based on intangibles – often linked to the amount of wining and dining during the recruiting process. If prospective candidates for employment had comparative information about workloads (i.e., chargeable hours per professional), training investment (as evidenced by training hours per professional) and supervision (as evidenced by staff to partner leverage ratios), the prospective candidates could make more informed employment decisions. Perhaps more importantly, it puts the audit firms in the position of competing for talent based on metrics which are also conducive to audit quality. This will further motivate the large firms to pay close attention to these metrics. Over time, I would expect these metrics to improve as the firms compete for talent increasingly based on observable metrics and less on wining and dining.

## **Finding a Better Equilibrium Point**

The existing public accounting large firm model is based on heavy workloads, high turnover, low experience levels, low staff continuity and a high leverage ratio of staff to partners. This model is conducive to lower audit quality, low efficiency and higher practice protection costs (settlements, legal fees, and insurance). I have often pondered whether there might be a better equilibrium point which generates the same level of profitability – but achieves higher audit quality, higher efficiency and reduced practice protection costs due to reduced workloads, low turnover, improved experience levels, higher staff continuity and better staff to partner ratios. The result might be a win-win situation for all concerned.

## Appendix 2

### Estimated Average Years of CPA Experience on a Typical Audit Team

	Percentage of Total Time*	Average Years of Experience	Less Two Years Until CPA License	Weighted Average Contribution
Partner	8%	20.0 yrs.	18.0 yrs.	1.44 yrs.
Managers:				
Senior Manager	8%	10.0	8.0	0.64
Manager	7%	6.0	4.0	0.28
	15%			
Audit Staff:				
Senior Accountants	15%	3.5	1.5	0.23
Staff Accountants	31%	1.5	0.0	0.00
Entry Level staff	31%	0.5	0.0	0.00
	77%			
-	100%			

Audit team weighted average years of CPA experience: 2.59 years

\* Based on my recollections of common staffing ratios while at KPMG.  
Equates to an 11.5 to 1.0 staff to partner leverage ratio  $[(15\% + 77\%) \div 8\%]$ .





Robert Conway's Response to the Concept Release Questions

I have repeated the PCAOB's questions in the pages that follow. My responses are in blue typeset. I have highlighted instances where I believe audit committee or audit firm best practices are important using yellow shading.

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**Question 1.** Is increasing knowledge about, and use of, the audit quality indicators discussed in this release likely to provide insights about how to evaluate, and ultimately improve, audit quality? I wholeheartedly agree.

If so, why? Transparency of AQI's will enable competitive forces to drive improvements in areas that are important to the consumers of audit services.

If not, why not? NA

**Question 2.** Are the AQI project, and some number of the 28 specific indicators described below, likely to build a strong knowledge base to enhance discussions of audits among those involved in the financial reporting process or other users of AQIs? Yes.

**Question 3.** Can the development of audit quality indicators, as described in this release, have unintended consequences, either positive or negative, for audit committees, audit firms, investors, or audit or other regulators? What are they? Can any negative consequences be alleviated? How?

Naysayers will quickly assert "unintended consequences" as an excuse for doing nothing. A good response to this point is to consider the adverse effects of doing nothing. The quotation I sited in the body of my written response bears repeating. ACAP Co-chair and former SEC Chief Accountant Don Nicolaisen stated as follows during the ACAP deliberations: "...the firms compete primarily on the basis of cost ... and it has been disastrous for investors and for the firms. I think it is in the best interest of everyone to identify some of those things that that would ... provide audit committees and investors an opportunity to better understand how firms compare amongst themselves – and what are some of those things that would lead you to engage an audit firm, other than price."

**Question 4.** What is the nature of the context that those using AQIs as a basis for analysis and discussion will generally require to be able to benefit from that use? Is the information required to build that context available? Is access to the necessary contextual information feasible?

At the engagement level, I would begin by seeking comparison of contemplated service levels (as measured by expected operational AQIs – referred to by the PCAOB as “Audit Professional AQIs) against actuals AQIs at the end of the audit. Simply put, this is about comparing what was promised at the start of the audit to what was delivered. This can be particularly important with respect to time commitments by the partners, managers, and internal specialists.

Another dimension to provide context would be to compare office metrics for the major participating offices to engagement team metrics. It is important to understand office trends because sooner or later, they will impact individual audit engagements.

Firm-wide AQIs also provide context. Is the local office faring better, worse, or about the same as firm-wide? This is useful information to understand about the local office environment. As I said earlier, sooner or later, office wide trends will affect individual engagements.

**Question 5.** Should any indicators be omitted from the list proposed in this release? Which indicators? Why?

The focus of the AQI undertaking should be on providing transparency where information is generally available but has not been made available to audit committees.

I would exclude AQI # 7, “Industry Expertise of Audit Personnel.” Audit committees already appropriately consider the industry expertise of the auditor during the auditor selection / retention process. Conversion of industry expertise into an AQI does not provide incremental benefit. The audit committee can adequately evaluate for itself the degree of industry expertise offered by its incumbent auditor and competing alternatives. Audit firms are also well aware that delivering the right industry expertise is essential to winning and retaining audits where industry expertise is relevant. I think the existing market mechanisms function effectively to assure that the audit firms devote appropriate attention to cultivating industry expertise. Once the auditor is selected, the bigger issue is whether the audit firm is delivering the industry expertise it was promised. The audit committee should hold the auditor accountable for delivering the promised resources. I would characterize “holding the audit firm accountable for delivering promised resources” as an audit committee **best practice**.

I would exclude AQI # 11, “Audit Hours and Risk Areas.” While these are important elements to evaluate, I believe they are best evaluated by individual audit committees as **best a practice** on individual engagements (considering the facts and circumstances applicable to each audit). Such information across offices and the firm is of less value.

I would exclude AQI # 12, “Allocation of Audit Hours to Phases of the Audit” for the same reasons described above in the discussion of AQI # 11. It is best for the audit committee to make this inquiry at the engagement level (again as part of a **best practice** inquiry).

I would exclude AQI # 13, “Results of independent survey of Firm Personnel” as there is some duplication with the PCAOB inspection team’s evaluation of these elements during the quality

control portion of the PCAOB's inspection. PwC's 2014 Transparency Report provided an overview of the quality control related criticisms it received in Part 2 of its most recent inspection report. I think that is sufficient. I would hope and expect that the other Firms will eventually follow PwC's lead in making information from part 2 available to the public. If others do not follow PwC's lead, the audit committee **best practice** should be for each audit committee to ask each audit team about the PCAOB findings in Part 2 of the inspection report. Ultimately, the Firms will likely recognize the need and benefit of making such disclosures on an annual basis. Some kind of independent verification of tone at the top and leadership, in the form of a survey, is getting beyond what I see as the fundamental scope of the AQI endeavor – to provide transparency to that which is generally available. On the other hand, I see PwC's use of a survey as a **best practice**; otherwise, how does leadership know that the right message is being received?

I would exclude AQI # 14, "Quality Ratings and Compensation" for the same reasons described in AQI # 13 above. As suggested above for AQI # 13, this element is part of the PCAOB inspection process. I favor the firms providing a summary of Part 2 Inspection report issues. If the Firm does not disclose the Part 2 findings systematically, audit committees should ask for such disclosures (**as part of best practices**) until the audit firm realizes that a summary of part 2 findings in its Transparency Report is reasonable, appropriate, and necessary.

I would exclude AQI # 15, "Audit Fees, Effort, and Client Risk" on the basis that the utility of this AQI is trumped by the audit committee's dialog with the issuer's auditor about the risk assessment and scope of work planned for the specific individual audit (**a best practice**). If I was an audit committee member, I would be more concerned about the conduct of my company's audit (with respect to audit fees, effort, and client risk) rather than the conduct of other audits. As an audit committee member, my bigger concern is about being sure the audit plan was executed as planned and that the level of effort expended was as planned (or greater if circumstances warranted). Apart from the AQI project, the PCAOB should be alert for instances where audit fees are so low that it raises questions about whether the scope of the audit work is appropriate. A predictive model for audit fees by industry would be a useful tool in this regard.

AQI # 16, "Compliance with independence requirements," receives some attention already through the PCAOB's inspection process. Infrastructure to deal with independence is discussed in the Big Four audit firm transparency reports published in 2014, but only PwC disclosed an affirmative statement that, "...we concluded – and the respective audit committees agreed – that none of the noncompliance matters we identified for our current clients involving SEC and PCAOB independence requirements compromised our objectivity." Additionally, any enforcement proceedings pertaining to independence would be picked up in AQI # 27 – which I believe is required for audit committee disclosure pursuant to the New York Stock Exchange Listing Standards in Section 303A.07, "Audit Committee Additional Requirements" (more specifically subsection (b)(iii)(A)). These disclosures do not appear in any of the Big Four 2104 transparency reports, so I am unclear as to how NYSE Listing Standard disclosures are being satisfied by the Big Four. I encourage the PCAOB to look into the manner in which such disclosures are communicated so as to avoid any duplication.

I would exclude AQI # 17 – "Investment in Infrastructure Supporting Quality Auditing." There is some duplication between AQI #17 and the benefits that can be derived from AQI # 4, "Technical Accounting and Auditing Resources" and AQI # 10, "Training Hours per Audit Professional. AQI # 4 and AQI #10 are much more easily measured. AQI # 17 may be difficult to develop and there may be a host of comparability issues. With these issues in mind, I do not see the incremental benefit of developing and reporting AQI # 17 as justifying the cost.

I would exclude AQI # 20 – “Technical Competency Testing.” I think this is a very good concept to consider in the long term and I believe it should receive attention and discussion outside the context of the AQI project. I am concerned that the AQI discussion could bog down and get distracted by the discussion of competency testing with the context of the AQI project. Competency Testing would be costly (but that doesn’t mean it shouldn’t be done). I believe the near term focus on AQIs should be on providing transparency to that information which already exists.

I would exclude AQI # 22 – “Fraud and other Financial Reporting Misconduct.” Financial reporting fraud is an important issue and should continue to get a high level of scrutiny outside the scope of the AQI project. However, I do not see a direct way to create a relevant AQI on this subject. Indirectly, restatements and enforcement proceedings (AQIs # 21 and # 27) will provide useful information to audit committees about whether the auditor is appropriately alert to fraud (albeit on a lagging indicator basis).

I would exclude AQI # 23, “Inferring Audit Quality from Measures of Financial Reporting Quality.” I see such measures as a tool to inform a risk assessment. I do not believe such information can be used to compare the audits of one firm to the audits of another, nor do I believe such information can be used to validly assert that one audit firm’s client portfolio is riskier than another audit firm’s client portfolio.

I would exclude AQI # 24, “Timely Reporting of Internal Control Weaknesses.” I think a more straightforward way to get at this issue is the disclosure of restatements of ICFR opinions (perhaps as a percentage of total ICFR opinions issued in the most current year), with separate disclosure of the number of ICFR restatements detected as a result of PCAOB inspections.

I would exclude AQI # 26, “Results of Independent Surveys of Audit Committee Members.” By its nature, the survey involves subjective assessments. Furthermore, communication is a two-way process and, in some instances, the audit committee may bear some responsibility in failing to set expectations if communications are perceived as deficient. Unfortunately, if there are perceived problems with an audit, the root cause issue may be something other than communication (for instance – a late surfacing issue that might be more a function of the partner operating in “catch-up” mode than truly a communication issue). For these reasons, I do not support the survey of Audit Committee members as a proxy for assessing audit committee communications.

#### Alternative Approaches to Certain Proposed AQIs

In lieu of AQI # 16 as defined, “Compliance with Independence Requirements,” I think it would be more cost effective to address this need in the manner PwC follows. In PwC’s 2014 “Our Focus on Audit Quality 2014, PwC stated:

“Questions involving compliance are generally either self-identified or identified through the firm’s audits of individuals’ personal independence compliance. Once such a matter arises, we address and resolve it promptly, including discussing the matter with the audit committees for which SEC and PCOAB independence requirements apply. In fiscal year 2014, we concluded – and the respective audit committees agreed – that none of the noncompliance matters we identified for our current clients involving SEC and PCAOB independence requirements compromised our objectivity.”

In lieu of AQI # 24, “Timely Reporting of Internal Control Weaknesses,” I favor information about the frequency of restatements of audit reports pertaining to internal controls over financial reporting. In this manner, the frequency of ICFR restatements would be measured in the same manner proposed for the frequency of financial statement restatements.

In lieu of AQI # 27, “Trends in PCAOB and SEC Enforcement Proceedings”, and AQI # 28, “Trends in Private Litigation,” I recommend using the material that audit firms provide their clients to comply with the NYSE Listing Standards in Section 303A.07, “Audit Committee Additional Requirements,” subsection (b)(iii)(A). That provision requires audit committees to obtain information from their auditor about “any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm...” Please see my response to Question 8 for further details.

I strongly believe that AQI # 6, “Experience of Audit Personnel,” should only count years of experience subsequent to CPA licensing. It is important to shed light on the fact that auditors who are not yet licensed conduct a significant portion of audit work. An alternative or supplement to this suggestion would an AQI disclosing the percentage of professional audit staff who are not licensed CPAs (as of an agreed upon date on the calendar).

**Question 6.** Should any indicators be added to the list? What are they? Why? How would they be quantified?

I favor including each firm’s three-year moving average of practice protection costs as a percentage of audit revenues (with “practice protection costs” defined as settlements, malpractice insurance, and legal fees). This is admittedly a lagging indicator; however, the cost of quality is frequently measured by the cost of defects – which is essentially what practice protection costs are – the cost of defects. The three-year moving average will dampen the timing of individually significant events and serve to mitigate any concern that settlements might be deferred due to the reporting of this statistic. Most settlements are reported publicly anyway, so I do not see this statistic as cause for concern by the audit firms.

As noted at the end of my response to Question 5, I favor incorporating into the AQI disclosures the disclosures the audit firms are already making to their public company clients pursuant to the New York Stock Exchange Listing Standards regarding “material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years.

**Question 7.** Which indicators are likely to be the most useful in evaluating audit quality and informing discussions of audit quality? Why? The least useful? Why?

I have listed the useful indicators in Question 8 (including those that I believe should be added or modified). My response to Question 5 identifies the indicators I believe should be discarded.

**Question 8.** Which indicators, including any mentioned in response to Questions 6 and 7, are in use today? How are they being used? Which ones are relatively more effective? Less effective?

I will begin by describing the metrics I favor which are all currently disclosed in PwC's 2014 transparency report (titled "Our Focus on Audit Quality 2014"):

<u>PCAOB AQI #</u>	<u>PCAOB AQI Description</u>	<u>PwC Ref #</u>
1	Staffing Leverage	5
2	Partner Workload	4
3	Manager and Staff Workload	4
4	Technical Accounting and Auditing Resources	7
5	Persons with Specialized Skill and Knowledge	8
8	Turnover of Audit Personnel	3
9	Amount of Audit Work Centralized at Service Centers	*
10	Training Hours per Audit Professional	6
13	Tone at the Top / Leadership Survey (optional - see Q#5)	1,2
16	Compliance with Independence Requirements	**
18	Audit Firms' Internal Quality Review Results	10,11
19	PCAOB Inspection Results	12
21	Frequency of Financial Statement Restatements	9

\* Disclosed on page 14 of PwC's report

\*\* PwC makes an affirmative statement about whether any matters of noncompliance with the independence rules violated objectivity and whether the related audit committee agreed with that conclusion.

I commend PwC for taking a leadership position with the transparency they have provided at a firm-wide level. To enhance transparency further, I recommend addition of the following PCAOB AQIs:

<u>PCAOB AQI #</u>	<u>PCAOB AQI Description (modified as noted in parentheses)</u>
6	Experience of Audit Personnel (subsequent to CPA licensing)
21	Frequency of ICFR Restatements (refer to response to Question 6)
25	Timely Reporting of Going Concern Issues

<u>Conway AQI Ref.</u>	<u>Additional Proposed AQIs</u>
A	Three-year moving average of Practice Protection Costs as a percentage of Audit Revenues (with "practice protection costs" defined as settlements, malpractice insurance, and legal fees).
B	The information the audit firms are already required to provide pursuant to the New York Stock Exchange Listing Standards,

Section 303A.07, "Audit Committee Additional Requirements," subsection (b)(iii)(A), which requires audit committees to "at least annually, obtain and review a report by the independent auditor describing: the firm's internal quality-control procedures; any material issues raised by the most recent internal quality-control review, or peer review, of the firm, or by any inquiry or investigation by governmental or professional authorities, within the preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues; ..."

The above list contemplates that the need for certain AQIs may be mitigated by other information that can be obtained by audit committee **best practices** as described below:

- Inquire as to the existence of PCAOB Part 2 findings or internal inspection findings pertaining to the audit firm's 1) tone at the top, 2) independence processes, 3) training, 4) employee ratings on audit quality and linkage to compensation, 5) use of affiliated foreign audit firms, and 6) monitoring of audit performance.
- Inquire about industry expertise (and related qualifications as an expert) on the audit team and the expected amount of time to be expended by each industry expert. Inquire at the conclusion of the audit about the amount of industry expertise actually delivered during the course of the audit.
- Inquire about the use of specialized resources, specialist qualifications, and the expected amount of time to be devoted to the audit by each specialist. It is also anticipated at the conclusion of the audit, the audit committee will make inquiries about the whether the specialists were involved in the audit as planned and the level of effort actually expended.
- Inquire about the audit approach, the areas of significant risk, principle procedures to be performed, the use of specialists, the timing of each phase of the audit, and the amount of time expected to be devoted to these activities by phase. It is also anticipated at the conclusion of the audit, the audit committee will make inquires about whether the audit plan was executed as planned and the level of effort actually expended (including the timing of such effort).
- If the audit is a large audit, the audit committee should inquire about the size of the audit relative to the local office and the audit firm (being mindful that economic independence on an individually significant audit may have a bearing on independence).

**Question 9.** Definition of the Indicators.

a) Are the indicators clearly defined? **Generally yes.**

b) Which indicators would benefit from a clearer definition?

I find the definition of AQI # 24, "Timely Reporting of Internal Control Weakness," to be a little confusing.

c) Are the suggested methods for measuring each indicator clear? **Generally yes.**

d) Are there other ways to measure particular indicators that would be more effective? **See my response to Questions 6. Additionally, please see the final page of my response to Question 8 (immediately above) that describes how the need for certain proposed AQI's can be mitigated by certain audit committee best practices.**



- e) While most indicators depend only on data from a firm's public company practice, some include information concerning workload from both public company and non- public company practice. Are there other indicators that would be more useful if they were extended to the breadth of an audit firm's practice?

I think trying to segregate public company data from private company data would drive up implementation costs without much incremental benefit.

**Question 10.** Do particular indicators risk becoming too complex in operation to reflect the reality of particular audit situations?

The industry expertise indicator may not be cost-beneficial to produce because I believe the buyers of audit services and the providers of audit services are already keenly aware of the importance of industry specialization at the individual engagement level in situations where industry specialization is important. I think the bigger action item for audit committees (a best practice) is to assure that the specialized resources expected to be utilized get delivered and, if not, why not?

**Question 11.** Does the time lag between an audit year and the availability of information for many of the results indicators (e.g., whether a restatement has occurred) affect their value? How?

There will inevitably be some time lags. I do not see this as a concern.

**Question 12.** Are there one or more indicators among the 28 that are superior to other indicators on the list and cover the same subject or subjects, so that one or more indicators are unnecessary for that reason? Please identify the redundant indicators and explain.

I do not see any indicators as being redundant other than some overlap of AQI # 17, "Investment in Infrastructure Supporting Audit Quality" with AQI # 4, "Technical Accounting and Auditing Resources" and AQI # 10, "Training Hours per Audit Professional."

**Question 13.** Are data available for each of the indicators? To what extent, specifically, is the data already broken out in audit firms' operating systems?

I believe that the data for the AQIs I favor for disclosure may be readily available in the audit firm's system; however, you will want to confirm that with the nine largest audit firms (auditing 100 or more public companies). The only item that may result in some significant cost to produce concerns the experience level of professionals subsequent to CPA certification. The information exists, but retrieving and calculating the information may require some effort. If the audit firms must incur some incremental cost to compute the metric, I believe that the incremental cost will be justifiable, as this is perhaps one of the most revealing AQIs. An alternative would be to supplement the proposed AQI (as is) with the percentage of audit professionals who do not have a CPA license.

**Question 14.** The indicators operate at the engagement level, the firm level, or in most cases both.

- a) How should "engagement level" be defined in the case of a global audit in which work is referred to one or more "other auditors" (whether or not the firm or firms involved are part of the engagement firm's global network)? Who should make that determination?

In the case of a global audit, I think the evaluation would need to be made on a country by country / auditor-by-auditor basis.

- b) Would one or more of the indicators be more useful if it also operated at an audit firm's "office" or "regional" levels, not merely at "engagement" and "firm-wide" levels (so that, e.g., the percentage of an office's work devoted to a single large client would be known)? Which indicator or indicators?

Office level indicators are relevant for AQIs # 1, 2, 3, 4, 5, 6, 8, 9, 10, 21, 24, and 27.

- c) Would one or more of the indicators be more useful if it also operated at the level of the audited company's industry or economic sector (so that, e.g., indicators for the audit of a particular bank could be compared with the average of indicators for all of an audit firm's banking clients)?

No. I do not believe that the incremental cost to develop the information along industry lines would be worth the incremental effort.

**Question 15.** What are the elements of "context" required for successful analysis of the 28 potential AQIs? Are those elements ordinarily available to AQI users? If not, is it feasible to make the elements of context available?

The AQIs will not automatically speak for themselves. I have always expected that the audit firm will need to provide commentary about the AQIs, much in the same manner an issuer provides commentary about its financial results in MD&A. This may entail MD&A at the national level, at the office level, and at the engagement level.

**Question 16.** Comparability.

- a) How important is comparability to the value of AQIs? **Very important.**
- b) What are the most important elements of comparability in the analysis of AQIs? **All material elements of comparability are important.**
- c) Is comparability more likely to be fostered by firm-wide data (either within or among firms) or data focused on industry, regional, or office practices? **Comparability among the nine largest firms should be achievable at a firm-wide and office-wide or region-wide basis. Once the computation issues have been ironed out, the computational guidelines should be share with all others interested in making similar AQI data available.**

- d) Does the existence of differences among firms in the way certain matters (e.g., classification of personnel) are measured affect the value of AQIs if those differences are disclosed? Disclosure mitigates some of the adverse affects associated with measures that are not comparable. If they are not disclosed? If the differences are material, non-disclosure should not be an option.

**Question 17.** How should audits of different size and complexity be weighted in the calculation, analysis, and discussion of firm-level data?

Rather than “weighting” in the calculation, I think context you may be in search of should come through in the “MD&A-like commentary” I referred to in question 15 above.

**Question 18.** What are the costs and obstacles to audit firms of compiling the relevant data? Can data be created at reasonable cost for any indicator for which they are not now available? If not, is there another indicator of comparable scope, either among the 28 or otherwise, for which it would be less costly to obtain the necessary data?

I like what PwC has done in their 2014 transparency report (titled “Our Focus on Audit Quality 2014”). It looks to me like everything PwC has reported on a firm-wide level used data that was already available. The one data point that is important to add that may require some effort to calculate is the “average years of experience (post CPA certification).” The raw data already exists at the firm, however, some effort may be required to make and refine the calculation. Some effort may also be required to break the firm-wide data (where relevant) down to office-wide and engagement level data. The fact that PwC has already done the hard work at the firm-wide level signals that this is all very actionable.

**Question 19.** In what situations could generation of AQI data impose collection or evaluation costs (whether involving specific indicators or the use of AQIs generally) without commensurate benefits? Could those costs be reduced? How?

PwC’s efforts indicate that the AQIs they disclosed are actionable and cost-effective to produce. A contributing factor may be that PwC worked with information that was readily available.

**Question 20.** Could the collection and evaluation costs of AQIs be a greater economic burden for smaller audit firms than larger audit firms? Could this burden disadvantage smaller firms in competing for audit business if perceptions of quality are driven by the indicators?

The AQIs should be required for the auditors with 100 or more issuers and optional for auditors with less than 100 issuers.

**Question 21.** In what ways should the various indicators be evaluated or field-tested?

It may be beneficial to field test in a small to medium size office of each large firm in a geography where the office functions relatively autonomously.

**Question 22.** For what class or classes of users would AQIs be most valuable? Would some AQIs be more valuable than others to various classes of users?

I think the focus should be almost exclusively on audit committees. I am excluding investors because the audit committees essentially represent the investors.

**Question 23.** Are there one or more groups, in addition to audit committees, investors, audit firms, and the Board and other regulators, that the Board should consider to be primary users of audit quality indicators? If so, what are they? Does their need for the indicators, in each case, differ from those of other primary users?

Please refer to my response to the next question.

**Question 24.** Does the discussion of the uses of the indicators identify all likely uses? **No.** If not, what other uses should be considered?

The PCAOB overlooked the value of the operational metric data to prospective and experienced employees who are seeking work-life balance and an atmosphere that provides the time and resources (including supervision and training) to achieve a suitable level of quality. A corollary benefit may be reduced anxiety from audit professionals subject to inspection because they had a suitable amount of time to achieve the level of quality expected by the PCAOB.

**Question 25.** How important to the usefulness of the indicators by audit committees and other users is AQI engagement-level data? AQI firm-level data for the audit engagement firm?

The engagement level data is perhaps most important. Office-level and firm-level data provide much needed context to the engagement level data. The office-level and firm-level data is also very important (virtually essential) to those who may be considering an auditor change.

**Question 26.** To what extent do audit committees already receive AQI- like information from their audit firms? What are the most significant gaps in the information they receive compared to the information that could be contained in the potential AQIs?

See my response to Question 8 re PwC's "Our Focus on Audit Quality 2014."

**Question 27.** To what extent would engagement-level AQIs be useful to investors? AQI firm-level data for the engagement firm? What AQIs would be most useful? Why?

As I noted in my response to question 22, I believe the focus needs to be audit committees because they are acting on behalf of the investors in the execution of their duties.

**Question 28.** Should engagement level AQI data be made public in whole or part?

**No.** I think the public should trust the audit committee to follow up as appropriate in response to important information that can be discerned from the engagement level data.

Should firm level AQI data be made public in whole or part?

Yes (in part to assure that prospective employees have access to the data).

**Question 29.** How important to the usefulness of the indicators by, audit committees, audit firms, investors the Board and other regulators, and others is the public availability of firm-wide AQI data for the audit firm that performs a particular engagement? How important is the public availability of AQI data for other audit firms of comparable size?

I am operating on the premise that the nine largest audit firms (that audit 100 or more public companies) should be required to provide the AQI's and that the requirement should be optional for all other audit firms. It is important for all nine firms to provide the same information. Slightly smaller firms that see themselves as competitors of the nine largest firms for certain audits will likely feel compelled to follow suit with the larger audit firms. Others, including small audit firms, may see merit in voluntarily providing some or all of the disclosures required for the nine largest audit firms. I favor this approach, in part, because some of the smaller firms may see the AQI requirements as unduly burdensome while others may see such disclosures provide a competitive advantage.

**Question 30.** To what extent would firm-level data be more useful, for all or some indicators, if it were broken out in industry categories?

I see the primary objective of the AQI initiative as providing information that will drive competitors in a direction of improving their AQIs. I do not believe it is necessary for the information to be sorted by industry to accomplish that objective. Bear in mind that I recommended exclusion of the industry related AQI (# 7) because I believe audit committees can already assess industry expertise applicable to their incumbent auditor and alternative auditors without using industry-based AQI data.

**Question 31.** Would it be useful to phase in any ongoing AQI project? For example, should the project be voluntary for at least some period? If phasing is a good idea, what steps should the phasing involve? How should any phasing of the project be monitored?

I encourage the PCAOB to speak with PwC to get a general understanding of what it took to get to point of publishing their 2014 Transparency Report. Under the assumption that this should be mandatory only for the nine largest firms, the PCAOB should confer with the other large firms to get a sense of the time needed to comply.

Because there are bound to be comparability issues, I believe it would be beneficial for sharing of the computational aspects for each AQI for each of the nine largest firms so that significant comparability issues could be resolved before the information is released publicly. It is conceivable that the sharing of the AQI results among the audit firms (without public distribution) could raise some antitrust issues. The antitrust concern should be evaluated.

**Question 32.** How should AQI data be made available, either during a phase-in or ultimately? Which of these approaches is preferable?

- a) By audit firms voluntarily to audit committees, at the engagement level, the firm level, or both? See "d" below.
- b) By audit firms voluntarily to the public, at the engagement level, the firm level, or both? See "d" below.

- c) By audit firms on a required basis to audit committees, at the engagement level, the firm level, or both? See “d” below.
- d) By audit firms on a required basis to the public (whether directly or through the Board), at the engagement level, the firm level, or both?

Public disclosures should be limited to firm-wide and office-wide (or region-wide). I think the engagement level data should only be made available to the respective audit committee.

Would disclosure by audit firms directly or by the Board be preferable?

Disclosure directly by the audit firms (as done by PwC) would be preferable.

**Question 33.** Should the Board consider steps to require audit firms to make engagement- and firm-level AQI data available to audit committees?

Yes (but I would include office-wide or region-wide data).

To investors?

No. Distribution to investors would not be necessary since the audit committees exist to act on behalf of investors.

**Question 34.** Should distinctions be made, in the timing or nature of AQIs, among the audit firms that audit more than 100 public companies? What potential distinctions would be most useful?

My general reaction is that AQIs should be required from audit firms with 100 or more audit clients and the requirements should be optional for issuers with less than 100 audit clients.

**Question 35.** Should smaller audit firms be treated differently than large ones in designing an AQI project? Yes. What would small mean for this purpose? “Small” equates to less than 100 issuers. Having less than a certain number of auditors? No. Auditing 100 or fewer public companies per year and not being part of a global network of firms? Yes.

**Question 36.** Should the size of the audited company set a limit on initial application of an AQI project? No. What would an appropriate size be? NA. Should the fact that a public company is not a listed company affect the way AQIs apply to it? No, because AQI’s are optional for the audit firms that tend to audit non-listed companies.

**Question 37.** How should the nature of the industry affect the design of an AQI project? For example, is the nature of audits of investment companies or employee benefit plans sufficiently different than that of other public companies that the former require their own set of AQIs?

Similar to my response to Question 36, I believe this concern is best dealt with by commentary provided by the audit firms that it believes is important to the users understanding of the AQIs being reported.

**Question 38.** Would excluding certain types of audits from an AQI project distort the results of firm-wide public company audit comparisons, or suggest that only industry-based comparisons are valid?

If there was any distortion, I would leave it up to the audit firm to explain the effects of such distortion in its commentary accompanying the AQIs.

**Question 39.** Should an AQI project apply to brokers and dealers in securities?

No, not at this time.

- a) Should the project apply to carrying brokers, introducing brokers, or both? Should it apply differently to broker-dealers that are subsidiaries of public companies than to broker-dealers that are privately-owned? NA
- b) What indicators would be most appropriate? Would indicators aimed at the special regulatory requirements for broker-dealer reporting be advisable? NA
- c) Who would the users of the information be? NA
- d) Do the variations within the audited population make comparability of information difficult? NA

**Question 40.** How might the description of each indicator and the illustrative calculation be improved or replaced by other approaches that would be more effective or easier to use?

I found the descriptions to be generally very good. The only one I found confusing pertains to AQI # 24, "Timely Reporting of Internal Control Weaknesses." As a result, I suggested an alternative approach which is described at the end of the my response to Question 5 under the caption "Alternative Approaches to Certain Proposed AQIs."

**Question 41.** To what extent should the description of one or more indicators and its illustrative calculation be revised to make clear that all indicators are evaluated in context?

No additional comments beyond those noted in my response to Questions 5, 8, and 40.

**Question 42.** To what extent could any suggested indicators produce uninformative results either because of the context in which they operate or because the variables they involve can be managed for results that emphasized form over substance?

To the extent any result is uninformative or might be misleading, it should be up the audit firm to add commentary to that effect.

There is potential that firms may try to manage to the numbers, but as Lynn Turner noted during the PCAOB's Standing Advisory Committee meeting on October 22, 2008:

"People already manage a lot by the numbers. I don't know why people are worried about putting numbers out there. Each of the firms manages to numbers anyway. They manage to budgeted numbers for revenue each year, labor costs as a percentage of revenue, partner contribution, rate per hour, [and] the number of billable hours each

partner is responsible for. They've already got those out there and they're already managing to them. So the fact that someone would say let's manage to something that related to audit quality only seems to be common sense and not rocket science. I wouldn't turn this into a rocket scientist exercise. I think this is very doable and I think it is good that people actually manage to audit quality."

There may likely be some oversight role for the PCAOB in this regard, but I do not see it being burdensome.

**Question 43.** How should the indicators be applied at the firm level? Are different "firm" perspectives (firm-wide, region, office, industry practice) appropriate for different indicators? Is firm-wide data always appropriate for those indicators that call for firm-level data?

I think the general approach should be to prepare the AQIs by engagement, office, and firm.

**Question 44.** Would addition of a calculation of staffing leverage indicators that measures the ratio of partner and manager hours to total audit hours be helpful?

Yes.

**Question 45.** How should technical accounting and auditing resources be measured in a situation in which those resources are retained from outside the firm conducting the audit?

Such resources may not be measurable unless they are billed on an hourly basis. If they cannot be measured, then the alternative is to disclose the nature of the situation with an explanation that the data is not readily available.

**Question 46.** How should this indicator count participation by audit firm personnel and managers who have dual skills (i.e., as accountants or auditors but also as experts in another relevant discipline)?

Some allocations may be necessary. If allocations have a significant bearing on the statistics, perhaps the allocations should be footnoted.

**Question 47.** In measuring experience, would overall experience (including auditing and accounting experience) in the relevant industry be the best measure? Would such a measure disadvantage smaller firms? Would a measure based on number of audits performed in a particular industry be a better indicator for smaller firms?

As I noted in my answer to Question 5, I explained why the disclosure of "industry experience related metrics" was not incrementally worthwhile (largely because audit committees can already reasonably evaluate the industry skills of engagement team personnel for the incumbent auditor and alternative auditors).

**Question 48.** Are there ways to measure the industry expertise of a firm's audit staff against its public company client base? How?

Largely NA based on my response to Question 47.



**Question 49.** Would adoption of the commonly-used Standard Industrial Classification ("SIC") codes issued by the U.S. Department of Labor be appropriate to define industries for purposes on the indicators? [NA based on my response to Question 47.](#)

**Question 50.** Should a distinction be made between partner retirements and other turnover in applying this indicator? [Yes.](#)

**Question 51.** Should training hours be computed on a per-person basis, by personnel class, or as an average by class? Should the size of the firm involved make a difference in this regard?

[Average annual training hours per person \(FTE\) is the target. Such information by major level of employee is not essential and may be burdensome to compile.](#)

**Question 52.** How can the effectiveness of a firm's training program best be measured?

[This is a fair question but I believe it is getting beyond the scope of the AQI initiative.](#)

**Question 53.** Should the effect of the way training is delivered (e.g., live, web-based, or self-study) be factored into the evaluation of a firm's training program? How?

[NA. See response to 52 above.](#)

**Question 54.** Does the "percentage of hours" metric at the firm level of this indicator provide a meaningful basis for comparison with the engagement level of the metric? Would it help to disaggregate the numbers by audit client size?

[I recommended the exclusion of AQI # 12, "Allocation of Audit Hours to Phases of the Audit" for the reasons cited in Question 5. I believe this issue is appropriately addressed at the engagement level by audit committee best practices. I also believe this information would be very time consuming to compile and not cost-effective.](#)

**Question 55.** Is there any way to expand this indicator to quantify audit personnel experience with audit clients, to provide additional context?

[NA. As I noted in the preceding question, I do not favor disclosure of this AQI.](#)

**Question 56.** Who should administer the survey described in this indicator? What steps would be necessary to assure that the results of anonymous surveys were comparable? Would the same set of questions be necessary? Would the same individual or organization have to administer each of the surveys?

[I see this as duplicating the PCAOB inspection team's evaluation of these elements. Please see my further thoughts in my response to Question 5 that explains in further detail my thinking on this subject \(including my view that the AQI project should, at least initially, be focused on making transparent that information that is already available\).](#)

[PwC has taken a leadership position by conducting and disclosing the results of its survey. I would anticipate that others will follow suit, but I would prefer to make the survey voluntary at this time. Any significant complaints about cost could undermine this project. I anticipate that](#)

there may be pushback on cost, when in reality, the real issue on cost for respondents may pertain to costs in other areas (unrelated to the AQI project).

**Question 57.** How often would a survey of this type have to be administered to retain its validity?

NA. I do not favor the disclosure of this type of information for the reasons discussed above and in Question 5 re AQI # 13.

**Question 58.** What other logistical issues might arise from a survey of this sort?

NA. I do not favor the disclosure of this type of information for the reasons discussed above and in Question 5 re AQI # 13.

**Question 59.** Can this indicator be applied to produce comparability among firms, e.g. in terms of definitions of "exceptional performance ratings" and "low quality ratings"? How?

NA. I do not favor the disclosure of AQI # 14, "Quality Ratings and Compensation", for the reasons described in the response to Question 5. This element receives attention as part of the PCAOB's quality control examination, the results of which are described in Part 2 of the PCAOB's inspection report. Audit firm disclosure of any issues identified by the PCAOB in this area should be sufficient.

**Question 60.** One issue that this indicator raises is how to fashion a workable definition of "high risk" that allows comparability among firms or even among engagements within a firm. Comment is specifically requested on that subject.

Please see my commentary about AQI # 15, "Audit Fees, Effort, and Client Risk" in my response to Question 5. I do not believe there is a metric for AQI # 15 that can be developed and implemented that would be cost-effective. Audit committee best practices and the PCAOB inspection process, including the related QC elements, may best satisfy your objective more cost-effectively. I have described this further in my response to Question 5.

**Question 61.** What other measures of independence, or independence issues, would be appropriate? Would information generated by this indicator be more meaningful if measurements were stratified by personnel level?

I believe the PCAOB is proposing more granularity than is necessary under the circumstances. Please see my comments at the end of Question 5 about an alternative approach.

**Question 62.** In what ways can investments in infrastructure that are relevant to improving audit quality best be defined?

There is some duplication between what AQI #17, "Investment in Infrastructure Supporting Quality Auditing," and AQI # 4, "Technical Accounting and Auditing Resources" and AQI # 10, "Training Hours per Audit Professional. AQI # 4 and AQI #10 are much more easily measured. AQI # 17 may be difficult to develop and there may be a host of comparability issues. With these issues in mind, I do not see the incremental benefit of developing and reporting AQI # 17 as worth the incremental cost.

**Question 63.** How should such investments be measured? Is measurement in dollar terms (or dollars per auditor) appropriate? Can such investments be measured at the engagement team level?

My response to Question 62 applies equally to Question 63. I do not favor the use of AQI # 17.

**Question 64.** How should internal quality inspection findings be compared to or analyzed alongside PCAOB inspection results in applying indicators 18 and 19?

I favor presentation of this information in the audit firm transparency reports. I have reviewed PwC's presentation of internal and PCAOB inspection report results in PwC's "Our Focus on Audit Quality 2014." I think PwC has set forth a good blue print that should be followed by others.

**Question 65.** What are the best methods for measuring magnitude of restatements for errors? Is one method superior to the others? Why?

Some judgment will need to be applied here because the nature of restatements varies. I think it would be difficult to craft rules or procedures for identifying the most significant restatements. I think I would couch the requirement in terms of requiring the audit firm to be able to defend its basis for identifying its five most significant restatements. The nature of the restatements described should help the reader understand the degree to which the auditor bears responsibility; however, this may be difficult in certain situations if the restatements have triggered lawsuits.

**Question 66.** Would one or more AQIs related to fraud and other financial reporting misconduct be helpful to discussions of audit quality? If so, what AQIs would best inform those discussions? How could the challenges listed above be overcome?

Financial reporting fraud is an important issue and should continue to get a high level of scrutiny outside the scope of the AQI project. However, I do not see a direct way to create a relevant AQI on this subject. Indirectly, restatements and enforcement proceedings (AQIs # 21 and # 27) will provide useful information to audit committees about whether the auditor is appropriately alert to fraud (albeit on a lagging indicator basis).

**Question 67.** Comment is requested on each of the issues raised about this indicator. Would it be preferable to identify specific indicators related to financial reporting quality or to focus on audit firms' measures of reporting quality to measure risk? How would the latter approach control for differences among firms?

I would exclude AQI # 23, "Inferring Audit Quality from Measures of Financial Reporting Quality." I see such measures as a tool to inform a risk assessment. I do not believe such information can be used to compare the audits of one firm to the audits of another, nor do I believe such information can be used to validly assert that one audit firm's client portfolio is riskier than another audit firm's client portfolio.

**Question 68.** How should factors such as difficulties in foreseeing business difficulties, or the risk of providing an incentive for unnecessary going concern warnings be reflected in an indicator of this kind?

I think the indicator is fine the way it is. I would leave it up to the audit firm's MD&A to provide any insights that might be relevant to understanding the results (such as unforeseen business difficulties). I think the typical pushback from clients in "marginal going concern situations" is sufficiently strong to mitigate what might otherwise be viewed as "an incentive to issue unnecessary going concern warnings."

**Question 69.** Who should administer the survey described in this indicator? What steps would be necessary to assure that the results of anonymous surveys were comparable? Would the same set of questions be necessary? Would the same individual or organization have to administer each of the surveys?

I do not support the use of AQI # 26, "Results of Surveys of Audit Committee Members." The survey is not something that already exists and may be costly to administer in a uniform independent manner. Furthermore, the survey by its nature involves subjective assessments. Communication is a two-way process and, in some instances, the audit committee may bear some responsibility in failing to set expectations if communications are perceived as deficient. If there are perceived problems pertaining to the audit, the root cause issue may be something other than communication (for instance – a late surfacing issue that might be more a function of the partner operating in "catch-up" mode than truly a communication issue). However, the audit committee, presented with the survey on communications, might label the issue as pertaining to communications when communication was not the core issue. For these reasons, I do not support the survey of Audit Committee members solely for the purpose of gauging communications between the auditor and the audit committee.

**Question 70.** How often would a survey of this type have to be administered to retain its validity?

NA as I do not support the survey for reasons articulated in # 69 above.

**Question 71.** What other logistical issues might arise from a survey of this sort?

NA as I do not support the survey for reasons articulated in # 69 above.

**Question 72.** Should tabulation of cases for purposes of this indicator include all cases filed or only cases that result in findings against an accountant or accounting firm? What about settlements entered into without an admission of wrongdoing?

I see obstacles to expecting any kind of discussion at a detailed level about such matters. I think the best alternative is to report recorded "audit practice protection costs" as a percentage of audit revenues. I understand "practice protection costs" to include insurance premiums, settlements, and third party legal expenditures." It may be more palatable to the audit firms to report this as a three-year moving average.

**Question 73.** Should tabulation of cases for purposes of this indicator include all cases filed or only cases that result in findings against an accountant or accounting firm? What about settlements? NA – See response to Question 72 above.