

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

November 15, 2015

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 writing to supplement my initial response to the PCAOB's request for public comment. My initial response, dated July 6, 2015, is the second public comment listed under Docket # 41 on the PCAOB's website. I recently viewed the portions of the November 2015 webcast of the Standing Advisory Group meeting applicable to Audit Quality Indicators. I have also read the PCAOB's Briefing Paper on AQI's distributed in advance of the SAG meeting.

### Background

I am also the author (identified at the time only as the "Anonymous Retired Big 4 Audit Partner") of the recommendation<sup>1</sup> in 2007 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." 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 July 6, 2015 response to the PCAOB's request for public comment describes how my recommendation to ACAP was publicly identified as having provided the impetus for ACAP's recommendation that the PCAOB determine the feasibility of developing key indicators of audit quality and the potential benefits of requiring audit firms to publicly disclose these indicators.

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<sup>1</sup> Referred to in the ACAP Final Report in Chapter XIII, page 16, foot note #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>.

## **The PCAOB Has Defined the Objective of the AQI Project Too Narrowly**

In my July 6, 2015 public comment to the Audit Quality Indicator Concept Release, I noted the following under the caption “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.”

Prospective audit firm employees suffer from a void of information during the recruiting process that resembles the lack of information available to audit committees when assessing auditor selection and retention. Absent information about workloads, staffing leverage, turnover, and time spent on training, prospective employees are left to choose their employer based on intangible impressions created during the recruiting process that may bear little resemblance to life in the trenches after employment begins. **This point was an important part of my November 2007 public comment to ACAP that drove ACAP’s recommendation to the PCAOB to evaluate the feasibility and benefits of such disclosures.**

The ACAP Final Report recommendation did not prescriptively limit the potential audiences or beneficiaries of the transparent disclosure of audit firm operational metrics. To be clear, the ACAP recommendation reads as follows:

**“Recommendation 3. Recommend the PCAOB, in consultation with auditors, investors, public companies, audit committees, boards of directors, academics, and others, determine the feasibility of developing key indicators of audit quality and effectiveness and requiring auditing firms to publicly disclose these indicators. Assuming development and disclosure of indicators of audit quality are feasible, require the PCAOB to monitor these indicators.**

The SAG briefing paper made no mention about the opportunity to use market forces to improve retention of professionals by providing public transparency to audit firm operational metrics on a firm-wide or office-by-office basis, nor was there any discussion about this opportunity during the SAG meeting. This is disappointing in light of the considerable effort expended by the PCAOB to evaluate 28 potential metrics and the effort expended by public commenters to respond to the 73 questions posed by the PCAOB in its Concept Release. The SAG discussions were focused almost exclusively on providing engagement level metrics to audit committees with some benefit attached to firm-wide metrics. Firm-wide metrics are already published by at least one of the Big Four. The logical extension would be to publish operational metrics (workload, turnover, average experience levels, leverage, average partner hours managed, and average training hours) on an office-by-office or regional basis.

## **ACAP Final Report Perspectives on Human Capital Overlooked by the PCAOB**

Chapter V titled “Background” in ACAP’s Final Report dated October 6, 2008 opens with the following statement of ACAP’s objectives:

“The Department of the Treasury chartered the Advisory Committee on the Auditing Profession to develop recommendations to **ensure the “sustainability of a strong and vibrant public company auditing profession.”**

ACAP's efforts to **ensure the sustainability of a strong and vibrant public company auditing profession** were undertaken by three sub-committees:

Human Capital  
Firm Structure and Finances  
Concentration and Competition

The following quotes are from the chapter on "Human Capital" in ACAP's Final Report. They are very relevant to the PCAOB's ongoing deliberations on "Audit Quality Indicators":

"To ensure its viability and resilience and its ability to meet the needs of investors, the public company auditing profession **needs to continue to attract and develop professionals at all levels** who are prepared to perform high quality audits in this dynamic environment."

"The Committee recognizes the profession's commitment to human capital issues, and commends it for the varied initiatives undertaken in recent years **that encourage recruitment and retention, so that the "best people stay in the profession."** The Committee acknowledges the profession's progress in its ability to lower its attrition rate ... **Concurrent with its many human capital and workplace successes, however, is the acknowledgement by the profession and others that there "is still room for improvement."**

While my ACAP recommendation is credited with driving Recommendation 3 in the Chapter devoted to "Concentration and Competition," it has equal relevance to "Human Capital." I pointed this out in a letter to ACAP after reviewing a late stage draft of the ACAP report. That letter was not published as it was past the deadline for accepting public comments. However, the relevance of my finding to the Human Capital portion of the ACAP report was confirmed to me directly by one the ACAP Co-Chairmen and an Observer to the ACAP proceedings.

More than seven years have passed since ACAP published its final report. With the passage of so much time, I am concerned that some important aspects of the ACAP's thinking have fallen through the cracks at the PCAOB. If the PCAOB decides not to promote regional or office-by-office disclosure of operational metrics, I believe the PCAOB has a duty to explain publicly why this opportunity was not discussed and is not being pursued.

### **New Factors Affecting Audit Staff Turnover That Did Not Exist When ACAP Met in 2008**

Before the PCAOB passes on doing something constructive about the turnover issue, I strongly encourage the PCAOB to take a close look at voluntary staff turnover during 2015 compared to earlier years. There are at least three conditions that exist today that did not exist when ACAP reported in 2008:

1. We have an improving economy today compared to the Great Recession in 2008.
2. The millennial generation is now pouring into the public accounting ranks with different attitudes about sacrificing work-life balance.
3. The auditing profession is now feeling the full brunt of the pressures brought about by the PCAOB's inspection regime (with a high proportion of findings now pertaining to internal controls over financial reporting). While audit professionals have historically been squeezed for productivity, more recently, there is intense pressure on audit professionals for audit quality. While the focus on audit quality is very welcomed, the audit staff can manage only so much pressure. I suspect that there is an uptick in recent turnover statistics relative to historical levels.

Today, fewer audit staff aspire to be a manager or a partner. The absence of work-life balance at the partner and senior manager level undermines retention of the best and brightest professionals.

The operational metrics in the hands of both audit committees and prospective employees create a real opportunity for market forces to seek a better equilibrium point than the commodity-based equilibrium point that exists today.

### **Consequences to Objectivity and Professional Skepticism**

An observation was made during the SAG that the AQI were not going to have any impact on objectivity and professional skepticism. True, solid operational metrics do not assure objectivity and professional skepticism. However, it is difficult to achieve a high level of objectivity and professional skepticism in an environment where workloads are high, turnover is high, experience levels are low, and supervision is low.

It is unrealistic to expect high levels of objectivity and professional skepticism from relatively inexperienced professionals. Objectivity and professional skepticism grow with experience. The audit firm business model drives down the experience levels of the staff and instead, relies heavily on the objectivity and professional skepticism of its more experienced managers and partners. However, the ability of experienced professionals to bring objectivity and professional skepticism to bear is often undermined by their own excessive workloads. The audit partner or manager in “catch mode” is an accident waiting to happen.

### **Comments by Former SEC Chair Richard Breeden**

Richard Breeden was one of the few, but forceful, objectors to audit quality indicators. Richard Breeden expressed concern about unintended consequences and analogized to the failure of “risk adjusted capital ratios” during the recent credit crisis, noting an inverse relationship between favorable “risk adjusted capital ratios” and financial institution survival. I think the analogy is unfair. I think the concept underlying risk adjusted capital ratios is a good one; however, it relies heavily on assessments of the risk of individual investments. The credit crisis stemmed from the belief that collateralized mortgage obligations were a safe bet in an environment with steadily increasing real estate values. Financial institution managers, regulators, and auditors failed to draw timely attention to lax credit granting practices that fueled a frenzy of purchases of real estate that created an unsupportable bubble in real estate valuations that eventually came crashing down.

By comparison, audit firm operational metrics are those metrics that define the audit firm business model. These metrics are the same metrics used largely by the Big Four to manage their business. I do not see risk in providing transparency to metrics that simply provide transparency to the management of the audit firms’ human resources. The greater risk lies in doing nothing.

Don Nicolaisen, ACAP Co-Chair, remarked during the ACAP proceedings that the audit firms have competed since the beginning on price – and the results have been disastrous.

## The Consensus I Heard from the SAG

The consensus I heard from the SAG, with which I agree, was as follows:

- Do not mandate AQIs at this time; instead, use thought leadership papers and speeches by the PCAOB to inform audit committees on the nature of information that audit committees should seek from the audit firms to better inform their discussions about auditor selection and retention.
- Monitor progress and the usage of such information over time. Further experience may clarify whether the PCAOB needs to mandate or the dissemination of such information.
- I sensed an interest in metrics that are objectively verifiable versus those that attempt to measure the more subjective elements of audit quality. Audit quality cannot be readily measured; however, there is perceived benefit to providing transparency to fundamental operational metrics and engagement team experience.
- The operational metrics and hours spent by specialists can be used to compare “what was promised” to “what was delivered.”
- I sensed that the SAG is not looking for the PCAOB to be the aggregator of all relevant measures or the producer of a balanced scorecard. Said differently, the PCAOB is not JD Powers nor should it pretend to be JD Powers.
- An audit quality framework may provide further context as to what the AQIs are and what they are not. My public comment to IOSCO on Audit Quality Indicators in 2010 included a framework I prepared on my own titled the “Audit Quality Pyramid.” I created that graphic to help various parties understand the role of Audit Quality Indicators (i.e., What they are and what they are not). My Audit Quality Pyramid is attached for your reference.

My personal view is that audit committees can obtain the information they desire to ascertain industry relevant experience and the involvement of specialists. The additional metrics that audit committees and prospective employees should be seeking are:

<u>AQI Number</u>	<u>Attribute</u>
# 1	Staffing Leverage
# 2	Partner Workload (as measured by hours managed)
# 3	Manager and Staff Workload (using chargeable hours or utilization)
# 5	Average years of experience subsequent to CPA certification
# 8	Staff Turnover
# 9	Audit hours outsourced to offshore service centers
# 10	Training hours per professional

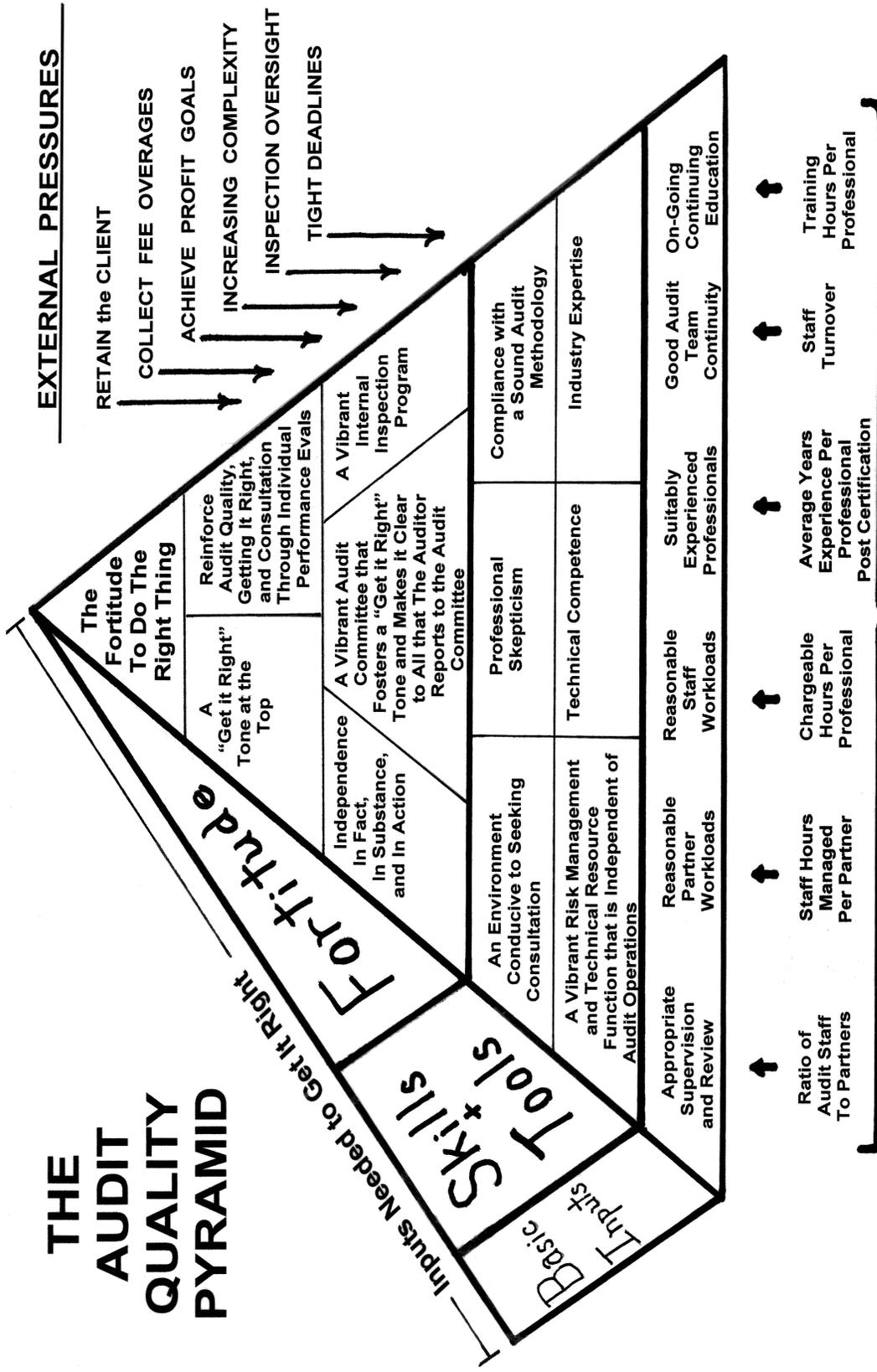
I sincerely hope you find my observations constructive and helpful.

Sincerely,



Robert A. Conway, CPA

# THE AUDIT QUALITY PYRAMID



## EXTERNAL PRESSURES

- RETAIN the CLIENT
- COLLECT FEE OVERAGES
- ACHIEVE PROFIT GOALS
- INCREASING COMPLEXITY
- INSPECTION OVERSIGHT
- TIGHT DEADLINES

### The Fortitude To Do The Right Thing

Reinforce Audit Quality, Getting it Right, and Consultation Through Individual Performance Evals

A Vibrant Audit Committee that Fosters a "Get it Right" Tone and Makes it Clear to All that The Auditor Reports to the Audit Committee

A Vibrant Internal Inspection Program

Fortitude

Fortitude

Fortitude

## AUDIT FIRM BASIC OPERATIONAL INPUT METRICS

- Ratio of Audit Staff To Partners
- Staff Hours Managed Per Partner
- Chargeable Hours Per Professional
- Average Years Experience Per Professional Post Certification
- Staff Turnover
- Training Hours Per Professional