

January 24, 2020

Supplement to Public Comment Originally Submitted on January 15, 2020 by Robert A. Conway, CPA

Note to the Reader: My original response to the PCAOB's response for public comment was submitted on January 15, 2020. Since that time, there have been two developments that are noteworthy:

1. I have identified a potentially superior alternative to reporting certain audit firm operational metrics in the "critical audit matters" section of the auditor's report. I have modified the "Synopsis" in the first two pages of my January 15, 2020 submission (presented below) to reflect the potentially superior alternative in **red typeset** (to report such information in the public company's proxy statement).
2. I have also modified the table on page 6 summarizing the turnover statistics by firm to include the results from KPMG published on January 21, 2020. Those results are also highlighted in **red typeset** at the bottom of the last page.

The Synopsis Section is repeated below with changes in red typeset:

**Response to the PCAOB's Request for Public Comment on its Concept Release Titled
"Potential Approach to Revision to PCAOB Quality Control Standards"**

**By Robert A. Conway, CPA
January 15, 2020**

The Mismanagement of Human Capital by Large Audit Firms is a Serious Threat to Audit Quality

Safe Zones of Operation Can Deter/Mitigate the Mismanagement of Human Capital by Large Audit Firms

Amend Critical Audit Matters to Include Analysis of Specific Engagement Level Metrics

Synopsis

The mismanagement of human capital by the large audit firms must cease in order to achieve much needed improvements in audit quality. Commodity pricing for audits and the profit motive have driven the largest audit firms to a staffing model characterized by heavy workloads, high turnover, low year-over-year continuity, low experience levels, and low staff supervision caused by the high leverage ratio of staff to partners. **This staffing model is a complete mismatch with the complexity that auditors must master in order to achieve a suitable level of audit quality.** My assertions about the staffing model are validated by evidence presented in Section 1 of this paper.

The single greatest opportunity to improve the audit firm staffing model begins with the use of audit firm operational metrics to define "safe zones" of operation (defined by the audit firm). The metrics should be monitored on a real-time basis to identify audits operating outside of defined safe zones. Appropriate action should be undertaken to restore the audit to the safe zone of operation. In some situations, it may be appropriate to subject specific audits to greater scrutiny by the engagement quality reviewer to assure that audit quality has not been compromised. In all cases, audit committees and the

engagement quality reviewer should have visibility to the operational metrics and a clear understanding of any staffing challenges encountered during the conduct of the audit. The metrics I have in mind include continuity measures, turnover measures, experience level metrics, leverage ratios, and the achievement of targeted levels of involvement by specialists. These are metrics that can be monitored at the engagement level on a real-time basis. Information about relevant industry expertise should also be discussed when relevant. This opportunity is described in Section 2 of this paper.

I support the notion that the new QC standard should be risk-based and principles-based with one notable exception. The PCAOB should be prescriptive (as it relates to the largest audit firms) in setting forth the QC requirements related to human capital management. Such requirements largely fall under the captions in the Concept Release titled Engagement Performance; Resources; Information and Communication; and Monitoring and Remediation. The opportunity here is too great and too critical to allow for misinterpretation and under-delivery by the largest audit firms.

My comments that follow should be considered in the context of the SEC's recently proposed amendments to the Regulation S-K Disclosure Rules to "include, as a disclosure topic, **human capital resources, including any human capital measures or objectives** that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business, such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the **attraction, development, and retention of personnel.**" I see no reason why the large audit firms should not be subject to similar requirements both firmwide and at the engagement level to describe "human capital measures that [audit] management focuses on in managing" the human capital deployed on each audit.

The PCAOB has acknowledged that academic research supports the linkage between various operational metrics and audit quality. It follows that the scope of **Critical Audit Matters** should be amended to include disclosure of certain engagement level operational metrics alongside the comparable firmwide goals for audits of public companies. If applicable, this would provide the opportunity for the auditor to describe whether the auditor encountered any particular challenges and, if applicable, what counter measures were undertaken to mitigate any risk that audit quality may have been compromised. These are matters that the auditor should regularly discuss with the audit committee. I am simply suggesting that the auditor go one step further, to summarize such discussion in the auditor's report as part of Critical Audit Matters.

Alternatively, timing considerations might lead to the conclusion that the auditor's disclosure of engagement level metrics and compliance with the auditor's defined safe zones of operation **should be discussed in each public company's proxy statement**. This is a logical alternative since, in most cases, the proposed ratification of the appointment of auditors for the succeeding year is part of the proxy statement. This alternative would require the PCAOB to collaborate with the SEC on changes to SEC rules governing disclosure requirements in proxy statements.

The PCAOB has expressed an interest in conforming operational metrics across large audit firms to enhance the comparability of large firm transparency reporting. That goal should be vigorously pursued. Once accomplished, **the stage would be set for a company like Audit Analytics to extract the metrics from individual audit opinions and tabulate comparable operational metrics by geography by firm. This information would then provide audit committees with the necessary context to make more informed decisions about auditor selection and retention.** This would address the primary concern coming out of pilot testing by the Center for Audit Quality regarding the use of engagement level metrics. Pilot test participants found engagement levels metrics to be of great interest, with the only drawback being the absence of "context." The amalgamation of metrics appearing in Critical Audit

Matters by Audit Analytics will yield office level metrics for competing firms in the same geography; thereby fulfilling the expressed need for context.

The Opportunity for a Giant Leap Forward in Audit Quality – Fueled by Competitive Forces

The transparency of audit firm operational metrics for all audit firms in the same geography creates a real opportunity for those metrics to improve as a result of competition. After all, what audit committee can rationalize selection or retention of the audit firm in its geography with the poorest array of metrics? Motivated by self-interest, audit committees will be willing to pay more for audits if they know that a specific audit firm will deliver more (according to the relevant human capital metrics).

Additionally, this information would provide job seekers (both entry level and with experience) with information to make more informed decisions about which audit firm job offer to accept. After all, what prospective employee wants to go to work for the audit firm with the heaviest workloads, highest turnover, and lowest levels of supervision (as evidenced by the highest leverage ratios)?

This information would also free the audit committee from relying excessively on recommendations from management about auditor selection and retention, thereby enhancing auditor independence from management.

The transparency of audit firm operational metrics in the manner set forth above can drive real change in how the big audit firms manage their human capital. Transparency will enable competition on factors other than price, thereby relieving the audit firms from the disastrous effects of commodity pricing. As former SEC Chief Accountant Don Nicolaisen noted during the Advisory Committee on the Auditing Profession proceedings, “The firms have competed on price since the beginning and the results have been disastrous.”

Changes to page 6 are reflected below (in red typeset) to incorporate recently reported turnover statistics for KPMG (distributed on January 21, 2020) that were previously shown as “not available”:

Big 4 Turnover Statistics

<u>Firm</u>	<u>Transparency Report Title</u>	<u>Most Recent Period Data is Available</u>	<u>Audit Professional Turnover Rate</u>	<u>Sr. Associate and Associate Turnover Rate</u>
PwC	Our Focus on Audit Quality	FY19	20.0%	22.0% ¹
EY	Our Commitment to Audit Quality	FY19	22.5% ²	24.0%
DT	US Audit Quality Report	2018	15.0% ³	n/a
KPMG	Audit Quality Report	2019	17.2%⁴	21.0%

¹ Represents the weighted average (based on headcount data) of rates reported separately for both seniors and senior associates.

² Represents the weighted average (based on reported leverage data) of rates reported separately for 1) seniors and senior managers and 2) seniors and staff.

³ Excludes involuntary terminations.

⁴ Represents the weighted average of rates reported separately for managers and associates.