

**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.

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.”

My 360° Perspective on the Auditing Profession

I am a retired KPMG audit partner. I worked at KPMG for 26+ years, including 17 years as an audit partner. After retiring from KPMG, I joined the PCAOB where I worked from 2005 to 2014. During my last six years at the PCAOB, I was the Regional Associate Director with leadership responsibility for the PCAOB's Orange County and Los Angeles offices. Like virtually everyone else that joins the PCAOB, I was inspired by the PCAOB's important Mission to improve audit quality.

After leaving the PCAOB, I became the Professional Practice Director at CNM LLP, an 85-person regional CPA firm in Southern California that focuses exclusively on technical accounting consultations and SOX 404 outsourcing. My responsibilities put me in regular contact with Big Four audit partners, public company CFO's, Chief Accounting Officers, audit committees, and SOX Compliance Leaders.

My recommendation in 2007 to the US Treasury Department's Advisory Committee on the Auditing Profession (ACAP) was widely credited with providing the impetus for ACAP's final report recommendation that the PCAOB evaluate the feasibility and potential benefits of providing public transparency to audit firm input and output measures that may be indicators of audit quality (AQIs). The PCAOB ultimately published a Concept Release on Audit Quality Indicators in June 2015.

My specific responses to the questions posed by the PCAOB in the Concept Release are included in Appendix C beginning on page 26.

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SECTION 1

Audit Firm Mismanagement of Human Capital in a Technically Demanding and Complex Environment Poses a Great Risk to Audit Quality

The large audit firm staffing model is characterized by heavy workloads at the staff and manager levels that lead to a high turnover. The high turnover drives down experience levels and engagement continuity – two factors that undermine audit quality. Compounding matters, heavy partner workloads resulting from the high ratio of staff to partners can undermine the partner’s ability to provide adequate expertise and supervision to the less experienced members of the audit team.

What Can Go Wrong?

The fundamental risk is that audits conducted by inexperienced staff with minimal year-over-year continuity pose a heightened risk of undetected errors leading to an audit failure. This heightened risk is compounded by the concurrent risk that the audit is not adequately supervised due to heavy partner and manager workloads. Further compounding this risk is the perception that reporting deadlines are seemingly fixed, leaving some auditors wishing they had more time to conduct a better audit.

While the PCAOB clearly has the attention of the largest audit firms, the PCAOB’s inspection program and standard setting have failed to drive meaningful improvements to the Big Four audit firm staffing model. The staffing model that exists today is very similar to the staffing model when I first entered the profession over 40 years ago. Yes, there have been productivity improvements resulting from the use of technology and off-shore resources; however, these benefits have been more than offset by the increased complexity of the accounting and auditing standards, the increased complexity and global reach of commerce, and the demands of heightened regulatory scrutiny. **In summary, the audit firm business model is a mismatch for the complexity that auditors need to master in order to achieve a suitable level of audit quality.**

Several factors can stress the Big Four audit firm staffing model such as 1) higher than expected turnover, 2) unanticipated new work (perhaps due to an acquisition or an IPO), 3) higher than expected audit hours due to unforeseen audit or accounting issues, 4) lean manpower planning driven by the need to achieve profit objectives, as well as various other factors. Many of these factors are not readily predictable. This means that an audit practice is vulnerable to staffing shortages and inadequate supervision during the critical months of the so-called “busy season.”

Balancing manpower with the backlog of work is an ongoing challenge for every audit practice. While considerable effort is expended to manage manpower issues, much of this effort is reactive rather than proactive. Herein lies the opportunity for improved QC standards to make a difference.

The Interrelationship Between Quality Controls, Human Capital Management, and AQIs

In my 2007 ACAP recommendation, I identified the opportunity to monitor audit firm operational metrics as part of a quality control system as follows:

“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 [engagement] 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 [i.e., when excessive turnover occurs on an engagement team or in situations where engagement team member workloads becomes excessive]. Such safety 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.

Today, the large audit firms are in varying stages of using operational metrics as part of their quality control process to monitor audit engagements in process. Deloitte’s 2019 Transparency Report describes how its Audit Quality Monitoring and Measurement program provides for “continuous, consistent, and robust monitoring of completed and in-flight engagements” using AQIs and project management milestones. Similarly, KPMG describes in its 2019 Transparency Report that, “We use our Accelerated Audit Execution (AAE) framework to reinforce the importance of appropriate sequencing and timing of audit procedures. It is no secret that better quality outcomes will be achieved if interim and final audit procedures are completed in a timely manner allowing for suitable review and resolution of issues as opposed audits where the hours are back-end loaded close to the deadline for reporting.

The actions described above are all very positive; however, the issues associated with the mismanagement of human have not gone away. It is of paramount importance that the PCAOB take this opportunity deal with these issues head on. In the sections that follow, I will build the case for why the mismanagement of human capital should be a high priority issue. I will also explain how an improved QC standard can contribute to a meaningful long-term improvement to the management of human capital and audit quality.

Corroborating Evidence About the Realities of the Large Audit Firm Staffing Model

Academic Study / Survey

An academic study and survey titled “Auditor Perception of the Audit Workplace, Audit Quality, and the Auditing Profession”¹ sets off several alarms about the ill-effects on audit quality of the Big Four audit firm business model. The executive summary from that study is repeated below:

In this study, we use a survey instrument to obtain perspectives from over 700 auditors about present-day audit workloads and the relationship between audit workloads, audit quality, and job satisfaction. Our findings indicate that auditors are working, on average, five hours per week above the threshold at which they believe audit quality begins to deteriorate **and often 20 hours above this threshold at the peak of busy season**. Survey respondents perceive deadlines and staffing shortages as two of the primary reasons for high workloads and further believe **that high workloads result in decreased audit quality via compromised audit procedures (including taking shortcuts), impaired audit judgment (including reduced professional skepticism), and difficulty retaining staff with appropriate knowledge and skills. We also find that auditors’ job satisfaction and their excitement about auditing as a career are negatively impacted by high audit workload, particularly when the workload exceeds a threshold that is perceived to impair audit quality**. Overall, our findings provide support for the PCAOB’s recent concern that heavy workloads are

¹ See <https://pdfs.semanticscholar.org/a029/ecca4757286cf68b3548a03244907354f24c.pdf> for “Auditor Perceptions of Audit Workloads, Audit Quality, and the Auditing Profession” by Persellin, Schmidt, and Wilkens; December 2014

continuing to threaten audit quality and suggest that the primary drivers of workload (i.e., deadlines and staffing problems) might be the actual “root cause” of workload-related audit deficiencies.

While this study is admittedly five years old, recent anecdotal evidence tells me that these findings are just as relevant today as they were five years ago. Turnover statistics presented in the next section corroborate the anecdotal evidence.

Evidence Regarding Audit Firm Turnover from Big 4 US Transparency Reporting

Presented below is turnover data extracted from transparency reports recently published the US audit practices of the Big Four audit firms. Caution should be applied when using this data because there is no assurance that the data has been prepared on a comparable and consistent basis. Please also note that commentary provided by the audit firms indicates that the vibrancy of the job market after public accounting can significantly affect voluntary turnover rates.

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% ²
EY	Our Commitment to Audit Quality	FY19	22.5% ³	24.0
DT	US Audit Quality Report	2018	15.0% ⁴	n/a
KPMG	Transparency Report	n/a	n/a	n/a

n/a – Data is not available

It should be noted that the consequences of the resignation of one employee go beyond the loss of the one employee. The departure of a high performer often leads to one or more reassignments between engagements to fill the hole left by a departing high performer. As a result, engagement continuity may be diminished on other concurrent audits. Such reassignments are often driven by risk considerations and a desire to take better care of the biggest and best clients.

The common view over time has been that public accounting is an “up or out” model – and that is how the cream rises to the top. “Rising cream” might sound like a pleasant analogy, but the reality is that the existing model is based on high turnover at just about the time young professionals begin to achieve a suitable level of knowledge about auditing and accounting. This model is inherently detrimental to continuity, productivity, firm investments in formal training

² Represents the weighted average (based on headcount data) of rates reported separately for both seniors and senior associates.

³ Represents the weighted average (based on reported leverage data) of rates reported separately for 1) seniors and senior managers and 2) seniors and staff.

⁴ Excludes involuntary terminations.

and on-the-job training, and audit quality. What rises to the top is heavily geared to those 1) who can tolerate high levels of stress and 2) who can accept the sacrifice of work-life balance.

Evidence About the Weighted Average Years of Audit Team Experience Post-CPA Certification

I estimated the weighted average years of experience of a typical audit team at 3.2 years of experience subsequent to CPA licensing. The tenure statistics in the second column below are from Deloitte’s 2018 “US Audit Quality Report,” reduced by an estimated 2-year time lag between joining the firm and becoming licensed as a CPA. The third column is my estimate of the typical distribution of chargeable time by level. My estimated distribution is consistent with the Firm’s reported “headcount-based” leverage ratios with slight adjustments reflecting higher chargeability levels typically achieved by less senior personnel.

Estimated Weighted Average Years of Audit Firm Experience After CPA Certification

<u>Job Title</u>	<u>Average Tenure at Deloitte after CPA Licensing (in years)</u>		<u>Engagement Level Data</u>	
			<u>Author’s Estimated Percentage Distribution of Chargeable Hours by Level</u>	<u>Tenure After CPA Licensing Weighted by Percentage of Chargeable Hrs</u>
Partners and managing directors	20.0 yrs.	x	10% ⁵	= 2.0
Senior managers	9.2	x	5%	= 0.5
Managers	4.3	x	10%	= 0.4
Seniors	1.4	x	25%	= 0.3
Staff	0.0 ⁶	x	<u>50%</u>	= <u>0.0</u>
			<u>100%</u>	

Estimated Audit Team Weighted Ave. Years of Experience After CPA Licensing **3.2 years**

There are a couple of key takeaways from this data. First, you can see the “high leverage” I have been talking about. The true experts at the top of the organization account for only a small percentage of the hours expended on each audit. Second, a near majority of the audit hours come from professionals who are not yet licensed as CPAs. This distribution of audit hours accounts for common criticisms of from corporate controllers and CFOs about 1) being a training ground for young auditors, 2) being asked the same questions over and over, and 3) not seeing enough of the partner and manager assigned to the audit.

⁵ Deloitte reports a 1 to 8.0 headcount ratio of partners and managing directors to all other audit personnel. The result of 12.5% was adjusted downward slightly since lower level staff have higher total chargeable hours.

⁶ This data point from the 2018 Deloitte Audit Quality Report was 1.3 years of average experience before I subtracted the typical two-year time lag to become a licensed CPA. In other words, it would be rare to find anyone at the staff level with an active CPA license.

Example of an Audit Failure Attributed in Part to Mismanagement of Human Capital

A January 2018 article published by Reuters⁷ about the FDIC's claim against PwC in the Colonial Bank matter highlighted a quality control failure with respect to PwC's human capital management as follows:

Among PwC's shortcomings, according to Judge Rothstein: The auditor relied on the chief architect of the fraud, Taylor Bean chair Lee Farkas, to verify key information about the collateral underlying a Colonial credit facility for Taylor Bean. PwC also signed off on Colonial's audit without ever understanding the third and most complex iteration of the fraud, which involved a credit facility based on phantom mortgage securitizations. **After an auditor who was supposed to make sense of the transactions gave up, saying they were "above his pay grade," PwC assigned a college-aged intern to evaluate the nearly \$600 million asset.**

Judge Rothstein was distinctly harsh about PwC's failings. Basing Colonial's certification on Farkas' account of Taylor Bean's collateral was "quintessentially the same as asking the fox to report on the condition of the hen house," she wrote. **And charging an intern to decipher a loan facility beyond the expertise of a senior auditor was a "truly astonishing" departure from PwC's mandate, the judge wrote.**

Evidence from the Advisory Committee on the Auditing Profession

During the discussion of my recommendation at the ACAP proceedings in 2008, ACAP Co-Chairman and former SEC Chief Accountant Don Nicolaisen observed, "The accounting firms have competed on price from the beginning and the results have been disastrous." Nicolaisen was acknowledging the foundational premise of my ACAP recommendation which was as follows: The audit firms compete too heavily on price rather than attributes having a bearing on audit quality.⁸ Consequently, audits have fallen victim to commodity pricing. To compensate for commodity pricing, the Big Four have found it necessary to squeeze audit professionals for productivity to achieve a suitable degree of profitability. The result is an audit firm staffing model characterized by heavy workloads that gives rise to high turnover that drive down experience levels and engagement continuity – a result that undermines audit quality. While the audit partners are high in knowledge and experience, they are also saddled with heavy workloads (due to the highly leverage business model). **The risk is that audits are conducted by inexperienced audit staff that are not adequately supervised due to heavy partner workloads.** The Big Four audit firm business model is a complete mismatch for the enormous complexity of today's accounting standards, the intricacies of the ICFR standards, and the growing complexity of domestic and international commerce.

The perspective described above was also echoed at the PCAOB's October 22, 2008 meeting of the Standing Advisory Group (SAG) to discuss the merits of ACAP's recommendation about providing transparency for audit quality indicators.⁹

⁷ See <https://www.reuters.com/article/us-otc-fdic-idUSKBN1ER1U1> authored by Allison Frankel.

⁸ This is generally true with the possible exception of instances where industry specific experience is important.

⁹ Listen to audio transcript at https://pcaobus.org/News/Webcasts/Pages/10222008_SAGMeeting.aspx at 1:59:23 (Windows Media Player), SAG Meeting on October 22, 2008.

Don't Be Deceived by the Inclusion of the Big Four in Fortune Magazine's 100 Best Places to Work

Yes, the Big Four are all in the top 50 of Fortune Magazine's Best Places to Work. How could that be? Fortune Magazine explains that the "Best Places to Work" list is compiled by its research partner, a company called Great Places to Work. Survey data is compiled from five broad categories: 1) perks, 2) diversity, 3) paid time off, 4) compensation, and 5) applicants per opening. As best I can tell, work-life balance does not factor into the Fortune list.

Vault.com conducts an annual survey of accounting firms using criteria identified as important to job seekers. Those criteria followed by their weighting in the survey results are as follows: prestige (35%), firm culture (20%), job satisfaction (10%), compensation (10%), work-life balance (10%), business outlook (5%), formal training (5%), and informal training (5%). The Big Four do well in this survey [generally in the top four] because of the heavy weighting given to prestige. However, commentary from the 2016 survey reveals that, **"The Big Four ... regularly score much lower (usually in 20th place or below) along the dimensions that are most indicative of their desirability as places to work, most notably firm culture, work-life balance, and job satisfaction.** ... It suggests that the Big Four may be more desirable as resume-building stopovers in a career path pointed elsewhere than as long-term destinations."¹⁰

Don't Be Deceived by the Decline in Restatements – Here is Why More Must Be Done

The decline in restatements among US issuers has coincided with a prolonged period of economic prosperity. Whether auditors do good audits or not, the risk of an audit failure is reduced during improving economic periods characterized by growing revenues and profits. Auditing is riskiest during turbulent economic periods that inevitably stress impairment analyses, fair value estimates, other judgments and estimates, and going concern considerations. Turbulent economic times frequently lead aggressive CEOs and CFO to push the edge of the envelop of reasonable judgements and regulatory compliance.

Over the eight years subsequent to the financial crisis, the returns in the S&P 500 have outpaced the returns in the FTSE 100 by 2.5 to 1.¹¹ It is not surprising to me that big audit firms in the UK have been plagued by a series of audit failures and restatements while the experience in the US has been far better. Of course, there are many variables that have led to this disparity. Nonetheless, I believe the better economic climate in the US has tested US auditors far less than auditors have been tested in the United Kingdom.

The bottom line is that more needs to be done to improve audit quality in advance of future downturns. Don't be deceived by the decline in restatements.

Why Don't the Big Four Migrate to a Better Staffing Model?

One might think that less turnover and higher experience levels would yield engagement efficiencies and reduced training costs that might pay for the incremental costs associated with more experienced personnel and reduced workloads. There would also be the prospect of reduced costs of litigation and

¹⁰ See <https://www.thebalancecareers.com/best-accounting-firms-to-work-for-1286650>

¹¹ See <https://topforeignstocks.com/2017/08/26/sp-500-vs-ftse-100-returns-since-global-financial-crisis-chart/>

settlements resulting from better audit quality over the long run. So why haven't the audit firms changed to a better business model?

The answer is simple. It is all about short-term profitability and the ill-effects of commodity pricing described earlier. Absent the ability to increase rate per hour, a more experienced service delivery model will reduce near-term partner profits. Yes, there are some potentially very attractive future upsides: improved productivity, higher client satisfaction, a reduction in training costs per professional, and a reduction in the costs of poor audit quality (legal fees, settlements, an insurance premiums). The inertia to achieving these upsides comes from the reality that partner compensation is strictly based on the amount of cash in the audit firm's bank account that is available for distribution at the end of each fiscal year. This model does not reward the long-term investments necessary to make meaningful improvements in the audit firm staffing model. The end-result is that the big audit firms are stuck in an unhealthy equilibrium point that is the result of the inability of the audit firms to differentiate themselves, resulting in commodity pricing and the inherent pitfalls described earlier.

An Ironic Twist: As Turnover Increases – Profits Increase!

In the near term, an audit firm's revenues tend to be relatively fixed. So when turnover occurs, particularly during the busy season, payroll costs go down and audit firm profits tend to increase. This is because less expensive labor is typically substituted for the more expensive labor that has departed. Yes, the audit staff will likely work harder during the busy season to make up for the professionals who resigned. But without any overtime compensation for those putting in the extra hours – firm profits also increase. Yes, audit quality likely diminishes, but the effects of lower audit quality (i.e., audit failures) typically are not realized in the bottom line until years later. So in the near term, just surviving the busy season (with heavy workloads and high turnover) isn't such a bad thing for the partners in terms on profits per partner – even though audit quality may have suffered.

SECTION 2

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

Upgrading the QC standard provides a tremendous opportunity for the PCAOB to mitigate audit quality issues caused by audit firm mismanagement of human capital. To my knowledge, this would be the first time for the PCAOB to deal directly with the human capital challenge in its standard setting process.

While I endorse the risk-based and principles-based approach articulated in the PCAOB's Concept Release, such an approach will not drive the change needed with respect to human capital management.

Instead, the PCAOB should follow a very prescriptive approach as it relates human capital management and engagement performance. Absent a prescriptive approach, I fear that the risk assessment process will not lead the big audit firms to progress to where they need to be. As I have articulated herein, human capital mismanagement is simply too big and too pressing of a problem to enable a soft touch. The existing audit firm staffing model has been resistant to change for decades; therefore, a prescriptive approach to human capital management issues is essential for the largest audit firms (perhaps defined as the Big Four, the top six, or audit firms annually conducting audits of more than 100 issuers).

As you will read later herein, a prescriptive approach will set a foundation for providing transparency at the engagement level for key human capital management metrics. This transparency will enable the compilation of key human capital metrics for offices of audit firms competing in the same geography (i.e., a city or region). This information will enable audit committees to make more meaningful decisions about auditor selection and retention and will stimulate competition among audit firms on attributes having a bearing on audit quality.

What QC Controls and Processes Are Envisioned with Respect to Human Capital Management?

The QC process should begin in advance of the firmwide hiring cycle and should be incorporated into the audit firm's strategic planning process. After considering all relevant input, the firm (in concert with representatives from the quality control side of the firm) should set goals using audit firm operational metrics that define the targeted audit staffing model (leverage, workload size / chargeability, average experience levels, hours devoted to training, and estimated turnover). These goals should also be congruent with anticipated promotions, compensation increases, and the firm's retention strategies.

Another way of framing this is, "What kind of an audit firm do we want to be?" The answers can range from "high experience and continuity, low leverage, and high audit quality" at one end of the spectrum to "low experience and continuity, high leverage, and low audit quality" at the other end of the spectrum (with various combinations in between).

The definition of the audit staffing model from this process should enable firm leaders to define staffing goals and safe zones of operations using the audit firm operational metrics. Monitoring mechanisms should be put in place to identify audits (on a real time basis) that may be operating outside safe zones of operation. Such audits should receive additional attention to remediate the situation and / or require additional levels of scrutiny for technical compliance with the auditing and accounting standards.

The PCAOB standards governing the Engagement Quality Review (“EQR”) should be amended to ensure that the EQR reviewer is advised in a timely manner of audits subject to his or her review that are operating outside the safe zone of operation. The EQR reviewer should be made aware of remedial activities undertaken to compensate for the effects of operations outside of the safe zone of operation and should consider the sufficiency of such activities as part of the engagement quality review. The EQR reviewer should also understand whether specialists have been involved to the extent as originally planned. Audit reports should not be signed until the EQR reviewer is satisfied that audit quality has not been compromised due to human capital mismanagement.

The audit committee should be similarly informed as to staffing plans and any changes to those plans that have caused the audit to operate outside the safe zones of operation. The audit committee should similarly be advised as to remedial activities undertaken to assure that audit quality has not been compromised. There should also be a clear dialog with the audit committee as to whether additional time might be required beyond originally planned dates for completion of the audit.

What I have described above aligns nicely with the following description on page 24 of the Concept Release under the heading “Engagement Performance”:

Finally, we are considering whether a future PCAOB QC standard should require firms to develop and implement engagement monitoring activities to prompt them to proactively prevent or detect engagement deficiencies, such that appropriate actions can be taken before engagement reports are issued. We understand from our oversight activities that some firms already monitor engagement performance using a variety of techniques, including through establishing and tracking of performance measures, using engagement tracking tools, and performing reviews of in-process engagements. We are considering whether requiring engagement monitoring activities would lead to improvement in engagement performance across all firms. To be scalable, such requirements would need to provide for less formal engagement monitoring activities by smaller, less complex firms, but would also **mandate** more robust and formal activities for larger, more complex firms.

SECTION 3

Moving Forward on Transparency Reporting

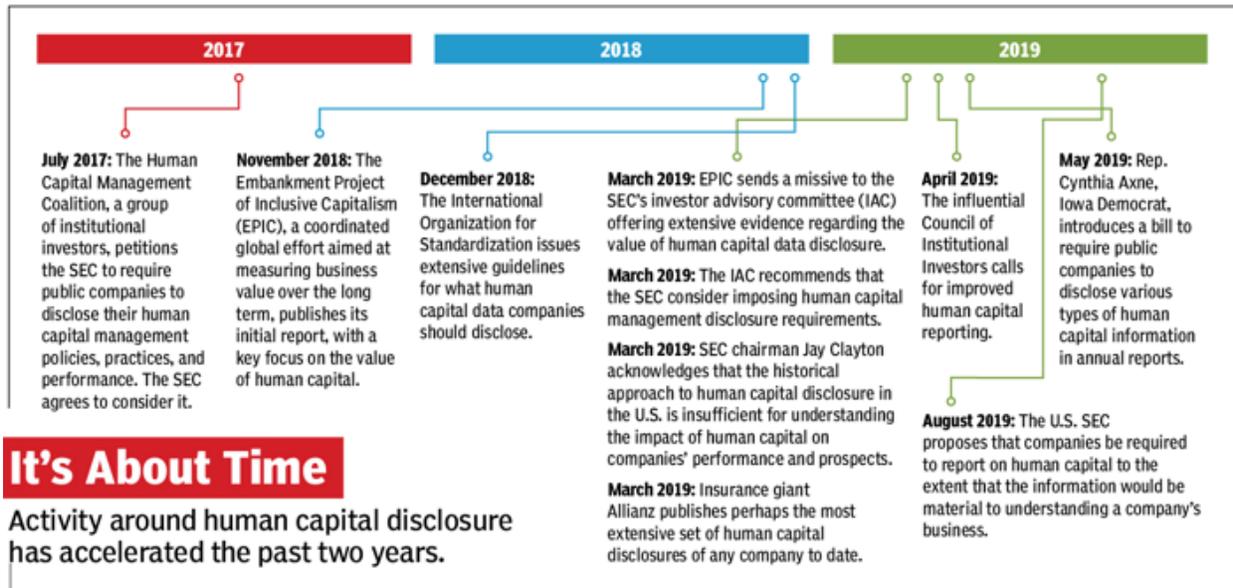
Amending Critical Audit Matters to Include Analysis of Engagement Level Metrics

Stamping Out the Disastrous Effects of Commodity Pricing for Audit Services

The Global Trend – More Informative Disclosures About Human Capital Management

As the PCAOB deliberates on the future direction of the QC standard, the PCAOB should be mindful of domestic and global trends favoring more information about the management of human capital.

The table below¹² summarizes a series of recent events culminating in the SEC’s August 2019 proposal that public companies be required to make expanded disclosures on human capital to the extent that such information would be material to understanding a company’s business. In a similar vein, the International Standards Organization (ISO) issued ISO 30414 in January 2019 titled, “Human Resource Management – Guidelines for Internal and External Human Capital Reporting.” ISO noted that “It is well known that effective human resources (HR) strategies can have a positive impact on organizational performance” and that this is “the first International Standard that allows an organization to get a clear view of the actual contribution of its human capital.”¹³



The SEC’s August 8, 2019 press release announced 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

¹² This table is from an article titled “Human Capital’s Big Reveal” by David McCann which was published in the September 2019 issue of CFO Magazine.

¹³ See <https://www.iso.org/news/ref2357.html> dated January 15, 2019.

on the nature of the registrant’s business and workforce, measures or objectives that address the **attraction, development, and retention of personnel.**”

Transparency Reporting Implications

Robust disclosures by public companies of measures applicable to the “attraction, development, and retention” of human capital harmonizes with the emergence of “transparency reporting” by the Big Four. The PCAOB has signaled an interest in developing a standardized approach to transparency reporting for large audit firms so that audit committees can better differentiate between audit firms on quality.¹⁴ I wholeheartedly agree that the PCAOB should pursue standardization.

One audit firm was willing to move forward rapidly with the transparent disclosure of audit firm operational metrics over a decade ago. In testimony before the Advisory Committee on the Auditing Profession (ACAP) in December 2007, Dennis Nally, Chairman and Senior Partner of PwC LLP, stated, “We also 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.”^{15 16}

During the ACAP deliberations, my original recommendation was modified to include output measures of audit quality. ACAP’s final report recommendation read as follows:

“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.”¹⁷

Delays in the Progression of Transparency Reporting, Relevant History, and Lessons Learned

After ACAP published its final report recommendations in October 2008, many audit firms signaled a willingness to move forward on the transparency opportunity. The only pacing item was word from the PCAOB as to which blend of metrics should be disclosed. Unfortunately, a series of operational issues at the PCAOB stalled progress on the transparency initiative, including 1) the Madoff scandal and the need to launch a broker-dealer inspection program, 2) an external challenge to the constitutionality of the PCAOB, and 3) vacancies on the PCAOB Board that were prolonged by the constitutionality challenge.

The PCAOB renewed its focus on the transparency opportunity when its Audit Quality Indicator (AQI) project was identified as a strategic priority beginning in 2013. Meanwhile, PwC gave up waiting for a decree from the PCAOB as to the desired blend of operational metrics for disclosure. In 2014, PwC

¹⁴ See <https://pcaobus.org/News/Speech/Pages/DesParte-Improving-Audit-Quality-through-a-Renewed-Focus-on-Quality-Control.aspx> for speech by PCAOB board member Duane DesParte dated Sept. 12, 2019.

¹⁵ See <https://www.treasury.gov/about/organizational-structure/offices/Documents/Nally%20Testimony%2012-03-07.pdf> for the complete text of Dennis Nally’s testimony before ACAP on December 3, 2007.

¹⁶ I learned a few years later that Nally’s remarks were inspired by my November 11, 2007 ACAP recommendation.

¹⁷ See <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> for ACAP Final Report dated October 2008 (page VIII:14).

published its first transparency report titled “Our Focus on Audit Quality.” That publication incorporated substantially all of the metrics I proposed and several more.

In 2015, the PCAOB published its concept release on Audit Quality Indicators offering up a menu of 28 possible audit quality indicators. The underlying concept was that the menu of potential indicators would be narrowed down to something that might look like a balanced score card. My general impression was that what ensued was a search for the definitive measures of audit quality. Predictably, many said that audit quality defies measurement and the initiative lost momentum.

I never suggested that audit quality could or should be definitively measured. My original approach was simple. Nearly every job requires suitable time, experience, and supervision to complete a task well. Audits are no different; therefore, the disclosure of input measures has value by itself.

As it stands now, PwC, Ernst & Young, and Deloitte have produced annual transparency reports with disclosures of operational metrics (although Deloitte may have scaled back its disclosure of metrics in its most recent transparency report).

Firmwide Transparency and Engagement Level Metrics Are Not Enough

The Center for Audit Quality published “Audit Quality Indicators – The Journey and Path Ahead” in January 2016 to describe the results of the CAQ’s pilot testing on AQIs at the engagement level. While most participants in the pilot testing found AQIs very useful, many expressed concerns about the lack of context for the AQIs. The availability of operational metrics for all competing large firms in the same geography would provide much needed context, thereby increasing the utility of engagement level metrics.

If I am seeking bids from competing audit firms, it is not sufficient to simply have in hand the engagement level metrics for the incumbent auditor and the firmwide transparency reports for all competing firms. There is simply too much variability in audit quality from office to office. Here’s why:

Local office leadership is typically under considerable pressure to produce favorable bottom-line results. Local office leadership is also typically responsible for hiring and workload decisions that can have an enormous impact on the trade-off between office profitability and audit quality. If favorable results are achieved, local office leadership is handsomely rewarded. The tone at the top may also vary from office to office as will turnover statistics. It would be naive to assume that the large audit firms deliver consistency across the country that rivals organizations like McDonalds, Hertz, or Hilton Hotels.

There is also another factor to consider beyond the variability in quality across offices. Assume I know the engagement metrics for the incumbent firm. A competing firm can and will promise the moon. For instance, a common assertion in large firm audit proposals is that, “Our team brings 125 years of experience relevant to your business.” The reality is that the partners with the years of experience are rarely seen except during the proposal process. Additionally, those who are directly involved in the audit contribute only a small fraction of the total hours. Wouldn’t I rather have concrete historical information about the operational metrics of the competing firms in my geography rather than simply a handful of promises?

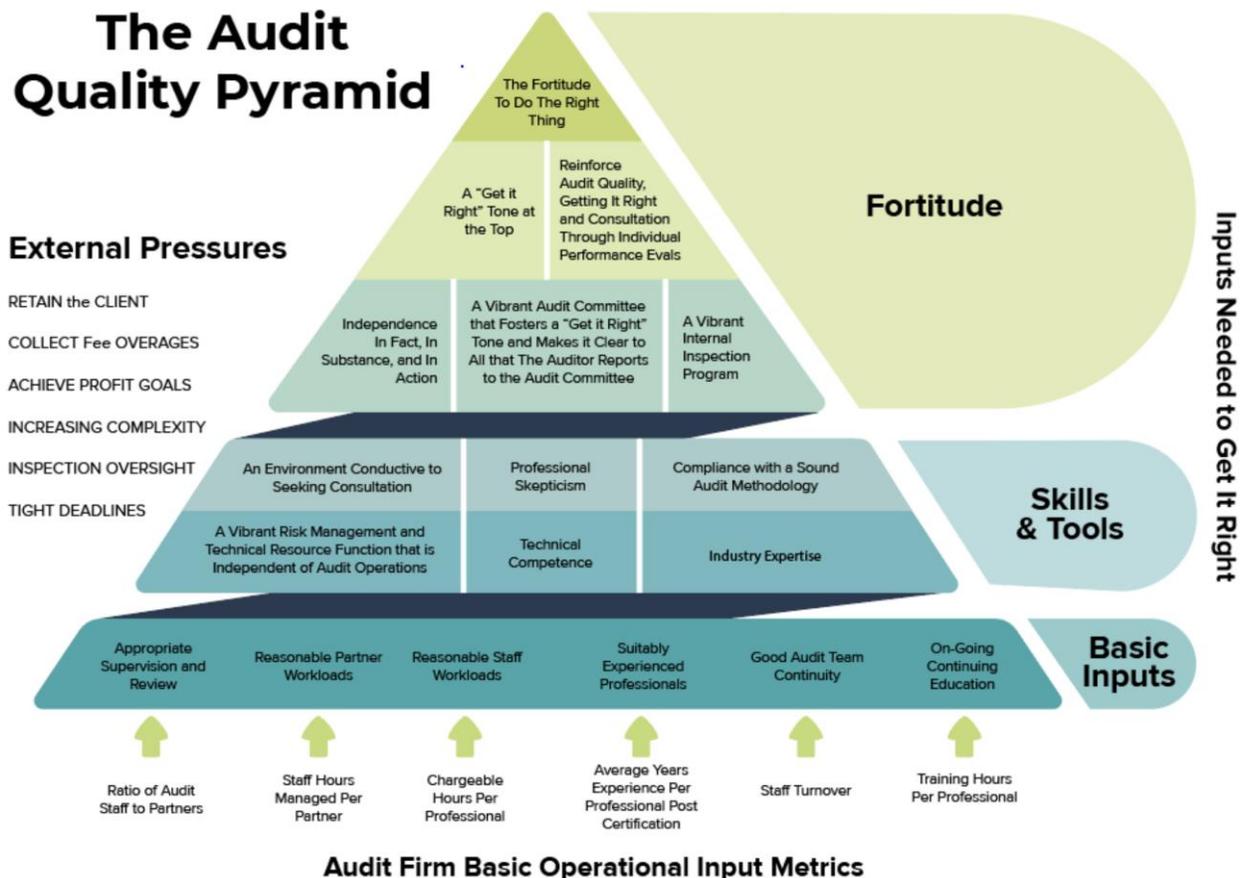
The only way I can truly stimulate competition on factors other than price and promises is to have concrete information about my incumbent auditor and the competing auditors in my same geography.

This information is essential to empowering competition and stamping out the ill-effects of commodity pricing that have undermined audit quality for decades.

Human Capital Metrics at the Engagement and Local Geography Level Will Improve Audit Quality

Having the right mix of basic inputs (workloads, expertise, supervision, turnover) does not guarantee audit quality. **However, the wrong mix of basic inputs (heavy workloads, high turnover, low experience levels and low supervision) can make it very difficult to achieve a suitable level of quality.** An audit team with heavy workloads, low experience levels, and poor supervision will be poorly equipped to identify issues. These factors are intuitive, but they have also been validated by academia.¹⁸ The absence of suitable experience and supervision will undermine professional skepticism and the ability to identify red flags and issues. Furthermore, if issues are identified late in the audit cycle (possibly because the partner is behind in his or her review due to workload issues), time pressures can undermine the fortitude to do the right thing.

Many factors contribute to audit quality. Below is a graphic I prepared to facilitate a discussion about the various factors that contribute to audit quality. As you can see, the operational metrics are positioned at the bottom of the pyramid because they are foundational to achieving audit quality. They do not guarantee audit quality, but audit quality is hard to come by without them.



¹⁸ See <https://pcaobus.org/News/Speech/Pages/Brown-Audit-Committees-Audit-Quality-Investor-Protection.aspx> for speech by PCAOB board member J. Brown titled "Audit Committees, Audit Quality, and Investor Protection."

Human capital is in the “Basic Input” row at the bottom of the pyramid. As you can see, I have identified metrics that provide useful insight into these basic inputs such as 1) the ratio of audit staff to partners, 2) staff hours managed per partner, 3) chargeable hours per professional, 4) average years of experience post-certification, 5) staff turnover, and 6) training hours per professional. These are the foundational inputs.

There are also “Skills and Tools” that encompass the audit methodology, technical resources, industry expertise, consultation programs, etc.

Further up the pyramid are the more qualitative elements that ideally support “The Fortitude to Do the Right Thing.” These elements include independence, tone at the top, and a vibrant inspection program.

Not only is human capital a foundational driver of audit quality, it is also the input with the highest degree of variability from audit to audit and office to office. So, it follows that better controls over human capital represent one of the richest opportunities to drive improvements in audit quality.

So how do we get office level metrics on human capital management? Herein lies an enormous win-win opportunity described below.

A Major Step Forward for Audit Quality: The Discussion and Analysis of Selected Human Capital Management Metrics at the Engagement Level in Critical Audit Matters

The PCAOB’s auditing standard on “Critical Audit Matters” requires the auditor to communicate in the auditor’s report any critical audit matters arising from the current period audit of the financial statements that involved especially challenging, subjective, or complex auditor judgment. From my perspective, it is logical to include a discussion about the auditors’ management of human capital during the course of the audit – because the management of human capital is challenging and the mismanagement of human capital can have a direct bearing on the auditor’s ability to identify and deal with issues that are complex or involve considerable judgment.

The PCAOB has acknowledged that academic research supports the linkage between various human capital operational metrics and audit quality.¹⁹ Given the significance of human capital to audit quality and the degree of variability that may exist from audit to audit, it follows that the scope of Critical Audit Matters should be amended to include the auditors’ discussion about human capital management at the engagement level, including commentary and analysis as to how certain engagement level operational metrics compare with the audit firm’s firmwide goals for audits of public companies. If there are any outliers in the engagement level metrics, the auditor should describe the steps it took to assure that audit quality was not compromised. This information is important for audit committees to understand and should be part of the auditor’s required communications to audit committees – similar to the manner in which critical audit matters are discussed with the audit committee. It follows then, that the auditor, as part of critical audit matters, should provide information to those relying on the audit opinion about whether the audit firm delivered suitable amounts of experience, expertise, and supervision to the audit.

¹⁹ See <https://pcaobus.org/News/Speech/Pages/Brown-Audit-Committees-Audit-Quality-Investor-Protection.aspx> for speech by PCAOB board member Jay Brown titled “Audit Committees, Audit Quality, and Investor Protection.”

The case I made in Section 1 about the large firm history of human capital mismanagement supports this action.

For sake of discussion, I'll advance my recommendation for the four attributes and the metrics that should be reported and discussed in Critical Audit Matters:

<u>Attribute</u>	<u>Relevant Metrics</u>
General Experience	Years of Experience Subsequent to CPA Licensing
Knowledge of Client	Year-over-year Continuity (personnel retained from last year for the current year audit; losses would include voluntary resignations and reassignments to other audits or transfers to other offices)
Workload	Percentage of hours incurred over 40 hours per week as a percentage of total hours incurred
Supervision / Leverage / Expertise	Ratio of staff time to partner time

Additionally, there should be a qualitative discussion devoted to industry expertise and the use of specialists.

If the operational metrics are prepared on a comparable basis across firms (which the PCAOB has expressed an interest in doing to advance large firm transparency reporting²⁰), **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 (referred to earlier) to make more informed decisions about auditor selection and retention.** After all, what audit committee can rationalize the 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.

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)?

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 also 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."

²⁰ See <https://pcaobus.org/News/Speech/Pages/DesParte-Improving-Audit-Quality-through-a-Renewed-Focus-on-Quality-Control.aspx> for speech by PCAOB board member Duane DesParte dated Sept. 12, 2019.

The Opportunity to Favorably Impact the Future of the Auditing Profession

The 2019 Main Street Investor Survey tells us that only 78% of US investors express confidence in audited financial statements. That strikes me as an abysmally low number. We should all strive to drive that statistic into the 90th percentile. I can't say this for a fact, but I would venture that the large audit firm mismanagement of human capital contributes to the low 78% confidence measure because 1) the mismanagement of human capital directly contributes to poor audit quality and 2) investors realize that the audit firm staffing model is a mismatch for the complexity auditors need to master to produce reliable audited financial statements.

The future of the auditing profession is something that we should all be concerned about. Given the complexity of auditing and accounting, the complexity of commerce, and the global reach of most companies today, it is important that the profession attract and retain the best and brightest. The human capital management issues I have described herein are not only driving talented professionals out of the profession, they are driving college graduates away from even considering the auditing profession as a career in the first place. With the advent of social media, there are no misconceptions on campus about the work-life imbalance associated with a career in public accounting.

Year after year, many express concerns about the profession's ability to attract and retain high quality professionals. Yes, there have been a series of initiatives to nibble around the edges of this problem; but no one has really taken the bull by the horns to directly deal with the work-life imbalance that exists in public accounting.

It is important to fix the human capital management issues that exist today, not only to improve audit quality in the near term, but to secure our profession's longer-term ability to thrive and produce reliable audited financial statements.

**Synopsis of Robert Conway’s November 2007 Recommendation to the
US Treasury Department’s Advisory Committee on the Auditing Profession**

Enabling Competition to Achieve a Better Equilibrium Point Between Profitability and Audit Quality

I have often pondered why our free enterprise system of competition has not yielded a better equilibrium point between the profitability of audits and the quality of audits. My thinking in this regard drove my 2007 public comment to the Treasury Department’s Advisory Committee on the Auditing Profession. The fundamental premise of my recommendation was that poor audit quality was the adverse result of commodity pricing for audit services. The audit firms had failed to differentiate themselves based on attributes related to quality. As a result, competition among auditors to win or retain audit clients has been too heavily based on the lowest bid.

I concluded (and ACAP agreed) that audit committees had limited information upon which to make the “auditor procurement” decision. My recommendation was that audit firms be required to publicly report certain operational metrics which I referred to as “Audit Quality Drivers.” That recommendation is attached in Appendix B 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 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 of 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 was 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. 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.

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 conveyer 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.

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

**Improving the
Transparency and Sustainability
Of the Audit Profession**

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 counterbalance 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.

Responses to the PCAOB's Questions Posed in its Quality Control Concept Release

Introduction

1. Should PCAOB QC standards be revised to address developments in audit practices and provide more definitive direction regarding firm QC systems? Are there other reasons for changes to the QC standards that we should take into account?

Absolutely yes. As described in my accompanying paper, if the right changes are made (specifically with respect to defining safe zones of operation and providing transparency to large firm audit practice operational metrics), an improved QC standard can deter and mitigate the effects of human capital mismanagement by the large audit firms.

2. Is it appropriate to use ISQM 1 as the basis for a future PCAOB QC standard? Are there alternative approaches we should consider?

ISQM 1 is a reasonable starting point. However, if you merely replicate ISQM 1, you will miss opportunities to drive significant improvements in how the large audit firms manage their human capital.

3. Are the reasons provided for differences between ISQM 1 and a future PCAOB QC standard appropriate? Are there other potential reasons for differences that we should consider?

The differences referred to in the Concept Release are reasonable. However, as noted above, there are important opportunities for the PCAOB to take a leadership position as it relates to improving how the large audit firms manage their human capital.

Background and Considerations for Potential Revisions to QC Standards

4. Are there other developments affecting audit practices we should consider addressing in a future PCAOB QC standard?

There are two elephants in the room: 1) the auditor is not independent so long as the auditor's fee is paid by the company under audit and 2) the large audit firms have mismanaged human capital for decades – to the detriment of audit quality. The PCAOB has accomplished very little in the standard setting process to directly address either of these elephants. A re-write of the QC standard provides an opportunity to deal with the second elephant in the room provided the PCAOB does not simply copy ISQM 1.

5. To the extent that audit firms are already updating or making enhancements to their QC systems to align with international developments, can you characterize the nature and extent of those changes and related efforts? What benefits do you anticipate from updates to QC systems?

I have described in Section 1 of my submission how audit firms are already using milestones and certain metrics internally. Some of what the PCAOB is doing is merely catching up. However, there

are considerable opportunities for the PCAOB to drive critical improvements to how the audit firms manage their human capital (as described in the body of my submission).

6. Please provide references to any academic studies or data we should consider, including academic studies or data that might address costs and benefits relevant to an economic analysis of potential revisions to PCAOB QC standards.

The body of my submission provides considerable evidence supporting my assertion that the large audit firms have been mismanaging their human capital. All such references have been carefully footnoted.

Potential Standard-Setting Approach Based on Proposed ISQM 1

7. Would the approach to quality control standards described in this concept release be preferable to the current PCAOB quality control standards?

The PCAOB's existing quality control standards are abysmally weak. More prescriptive standards are necessary to hold audit firms (and individuals within the audit firms) accountable. Leadership in the larger audit firms are rarely held accountable for decisions that undermine the ability of the audit teams to achieve a suitable level of audit quality – mainly because the ill effects of poor audit quality may not rear its ugly head until years later when there is a restatement and/or litigation.

I like the risk-based scalable approach (tracking with the COSO Framework). However, for a critical matter such as human capital management, I favor a much more prescriptive approach. The audit firms have mismanaged human capital for decades. A more prescriptive approach with respect to human capital is warranted and essential to driving future improvements in audit quality.

8. Would the objective of a quality management system provided in Proposed ISQM 1 be an appropriate objective for a QC system under PCAOB standards? Are there additional objectives that a quality control system should achieve?

The objectives expressed on page 11 of the Concept Release appear reasonable and sufficiently complete.

9. Would the potential revisions to PCAOB QC standards described in this concept release improve QC systems and audit quality?

The changes discussed will largely catch the standards up to where the more sophisticated audit firms are today. Improvements to the QC standards will 1) define the policies and procedures the rapidly growing / less sophisticated audit firms will need build out as they grow and 2) will create greater accountability for the larger firms (and individual leaders) to adhere to the better practices. To drive real improvement across a major portion of the market capitalization under audit, it will be important for the QC standards to incorporate safe zones of operation, transparency reporting, and the discussion of key audit team human capital metrics in Critical Audit Matters (as described in my submission).

10. Would the potential revisions to PCAOB QC standards described in this concept release enhance firms' ability to prevent audit deficiencies? Are there additional revisions to PCAOB QC standards that we should consider as supporting a preventive approach to managing quality?

Yes. A good new standard will create greater accountability that will in turn drive greater consistency in compliance. This should help to reduce deficiencies.

The key additional revisions I favor are about improving the management of human, particularly by the large audit firms.

11. Should a future PCAOB QC standard have additional or alternative requirements for firms that audit brokers and dealers? If so, what?

No basis for comment.

Specific Aspects of a QC System and Potential Changes to PCAOB Standards

12. What would be the costs and benefits of implementing and maintaining an integrated QC system as described in this concept release? Are there particular costs and benefits associated with specific components that we should consider? What, if any, unintended consequences would there be?

There will be up-front costs associated with documenting the risk assessment and building out controls, information and communication, and monitoring processes. I suspect that the larger firms have some of this in place already.

Firm Governance and Leadership

13. Is the approach to firm governance and leadership appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

After the PCAOB adopted the AICPA standards as they existed in 2003, the AICPA made some useful amendments to their QC standards that were never adopted by the PCAOB. Specifically, the AICPA modified its Quality Control Standard in 2007 to "strongly emphasize the responsibility of audit firm leadership to set the proper "tone at the top." ... Each audit firm is required to design and implement quality control procedures that support that message and promote a quality-oriented culture." The AICPA policy requires that the audit firm "assign management responsibilities so that commercial considerations do not override the quality of the work performed." ... Perhaps most importantly, QC leaders should possess the necessary authority to implement [QC] policies and procedures and to ensure that others within the firm will not override those policies to meet short-term financial goals."²¹

²¹ Comments are from "Audit Watch" dated July 28, 2008. The PCAOB's Staff Audit Practice Alert issued in December 2012 on "Maintaining and Applying Professional Skepticism in Audits" discusses certain of these concepts; however, the alert caveats that it does not establish rules of the Board nor does it reflect any Board determination or judgment.

14. Would more clarity in the assignment of firm supervisory responsibilities enhance supervision and positively affect QC systems and audit quality?

Yes, individual responsibility and accountability are essential to driving improvements via the quality control standards (via both management action and via the PCAOB inspection and enforcement process).

15. Should a future PCAOB QC standard address quality considerations in the appointment of a firm's senior leadership? If so, how?

An important element of a firm's commitment to quality is to include quality as the first and most important element of any performance evaluation and considerations for compensation adjustments and/or promotions. This applies to all professionals – and most especially to a firm's senior leadership.

16. Allocation of financial resources is one aspect of firm governance and leadership under Proposed ISQM 1. Should this be given greater emphasis in a future PCAOB QC standard than it is given in Proposed ISQM 1? For example, should a future PCAOB QC standard emphasize the importance of counterbalancing commercial interests that may lead to underinvestment in the audit and assurance practice, particularly in firms that also provide non-audit services?

Yes. I discussed this specifically in my answer to question #13 above.

17. Should a future PCAOB QC standard incorporate mechanisms for independent oversight over firms' QC systems (e.g., boards with independent directors or equivalent)? If so, what criteria should be used to determine whether and which firms should have such independent oversight (e.g., firm size or structure)? What requirements should we consider regarding the qualifications and duties of those providing independent oversight?

I'd favor a phased approach that gives the audit firms the opportunity to first implement a system of controls, information and communication, and monitoring. Logically, those processes would eventually be subject to PCAOB inspection and review as part of an expanded and more focused part of the PCAOB's evaluation of the sufficiency of a firm's quality control policies and procedures.

The Firm's Risk Assessment Process

18. Is the approach to the firm's risk assessment process appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

I like the risk assessment approach. However, I think it is important for the PCAOB to be very prescriptive about the expectations for the management of human capital given 1) the poor past performance of large firms managing human capital and 2) the potential benefits to audit quality that can be achieved from improved management of human capital.

19. Are principles-based requirements sufficient to prompt firms to appropriately identify, assess, and respond to risks, or is supplemental direction needed? If supplemental direction is needed, what requirements would assist firms in identifying, assessing, and responding to risks?

As noted earlier, it is very important that the requirements for the human capital be very prescriptive in order to realize the potential benefits (along the line of those strategies described in the body of

my public comments in Sections 1, 2, and 3 – such as defining safe zones of operation and mitigation requirements for operations outside of the safe zone).

20. Should a future PCAOB QC standard specify certain quality risks that must be assessed and responded to by all firms? If so, what should those risks be?

It is essential that the following risks associated with human capital be addressed in the risk assessment: 1) excessive workloads, 2) high turnover, 3) low continuity, 4) low experience levels, 5) low supervision as evidence by high ratios of staff to partner hours.

21. Should firms be required to establish quantifiable performance measures for the achievement of quality objectives? If so, how should such measures be determined and quantified (see also Question 46)?

Yes, please refer to the metrics identified in the body of this submission.

Relevant Ethical Requirements

22. Is the approach to relevant ethical requirements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

The AICPA's Integrity and Objectivity standards have always forbidden the subordination of judgment when differing views arise over a material issue. In other words, a subordinate with a differing view is obligated to speak up on material matters. This construct is critical to audit quality. The AICPA, recognizing that it is not easy for subordinates to challenge overbearing supervisors, added provisions prohibiting supervisors (including audit partners) from exercising undue influence over subordinates. In other words, a partner should not apply undue influence to override a subordinate and bypass appropriate dispute resolution protocols. These enhancements to the AICPA standards were made by the AICPA after the PCAOB adopted the AICPA standards in 2003. It is important that the PCAOB at least catch up to the AICPA in this regard so that subordinates know that their PCAOB professional standards fully support their responsibility to voice their concerns, even in the face of an over-bearing supervisor.

I did not see the concept of an "ethics hotline" as a mechanism to encourage people to come forward if they have awareness of ethical issues pertaining to themselves or others (in addition to options to speak with the immediate supervisor or above).

23. Should a future PCAOB QC standard extend detailed requirements for independence quality controls (formerly SECPS member requirements) to all firms? How would this affect the costs and benefits of a QC system?

No comment.

Acceptance and Continuance of Clients and Engagements

24. Is the approach to acceptance and continuance of clients and engagements appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

I favor linkage of actionable risks identified in the acceptance and continuance process to audit planning. In some instances, important risks identified in client continuance process are not adequately factored into the assessment of audit risk that drives the specific audit procedures to be performed. This is particularly important with respect to fraud risks.

Engagement Performance

25. Is the approach to engagement performance appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

Prescriptive requirements applicable to human capital management (described in Sections 1, 2, and 3 of this document) are essential.

26. Should a future PCAOB QC standard expressly address firm responsibilities and actions to support and monitor the appropriate application of professional skepticism and significant judgments made by engagement teams? If so, how?

I believe existing PCAOB standards are sufficiently robust with respect to the assessment of risks, including those involving significant judgments and estimates, which contemplate the exercise of professional skepticism. That said, issues may arise in these areas if the team is not suitably experienced, does not have relevant industry expertise, suffers from excessive workloads, or suffers from poor supervision (which bring me back to the importance of appropriate controls related to the management of human capital).

27. Should a future PCAOB QC standard expressly address the use of other audit participants? If so, should the scope of the requirements include affiliated and non-affiliated entities and individuals, including specialists and service delivery centers? Should we consider any changes to the scope of the potential requirements described? If so, what changes would be necessary?

Yes, quality controls pertaining to the use of other audit participants should be incorporated into the QC standards. It is important for the primary auditor to assess the quality of an affiliate's work. Most firms have a mechanism for grading network affiliates. Any potential red flags applicable to participating auditors should be made known to the primary auditor so that relevant risks and the need for any mitigating procedures can be considered.

28. Should the Appendix K requirements be retained? Should the scope or application of the Appendix K requirements be changed, for example to extend the requirements to all audits in which a non-U.S. firm issues an audit report on the financial statements of an issuer, or to exempt certain audits from one or more requirements? Should the individual requirements in Appendix K for filing reviews, inspection procedures, or disagreements be revised or updated? If so, how? Is it clear how the responsibilities of an Appendix K reviewer differ from the role of the engagement quality reviewer?

The Appendix K requirements fulfil a useful purpose and should be retained. Expansion of those requirements should be considered, bearing in mind the cost-benefit relationship. A good case could be made for expanding the filing review requirement to be comparable to an engagement quality review. Filings from outside of the United States naturally pose a higher risk of non-compliance with US GAAP, PCAOB Standards, and SEC Rules and Regulations. That risk would be mitigated to some degree by an expanded review requirement (comparable to an Engagement Quality Review) by a seasoned technical partner in the affiliated US audit firm.

29. Should a future PCAOB QC standard require firms to adopt engagement monitoring activities (e.g., performance measures, engagement tracking tools, or reviews of in-process engagements) that would prompt them to proactively prevent or detect engagement deficiencies? What are examples of less formal, but effective, engagement monitoring activities that could be adopted by smaller firms?

Yes, monitoring activities should be adopted. This is where the real opportunity to improve audit quality resides. My submission describes opportunities to monitor both operational metrics and milestones as tools to improve audit quality. The engagement level metrics that come to mind include workload metrics (for instance hours worked in excess of 40 hours per week), engagement continuity metrics that encompass both transfers to other assignments and voluntary resignations, weighted average years of experience on the engagement team subsequent to CPA licensing, and a leverage ratio [such as 1) staff and manager hours to partners or 2) total staff hours (including manager hours) to partner hours].

30. How should a future PCAOB QC standard expressly address firms' actions to support the fulfillment of the auditor's responsibilities under Section 10A of the Exchange Act, including:

- a. With respect to fraud?
- b. With respect to other illegal acts?
- c. With respect to going concern considerations?

The QC standards should be clear about procedures for the audit team to report knowledge or suspicions of fraud and other illegal acts up the chain of command. Hotlines should also be available to staff to report concerns about ethics issues at the firm and at the audit client.

There is a separate auditing standard to deal with going concern considerations. I do not see a need to make any modifications to the QC standards beyond possibly a policy that identifies and communicates those situations requiring consultation (which might include challenging going concern situations).

Resources

31. Is the approach to resources appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

The ISQM starting point is reasonable. Protection of client data and workpapers stored in hard copy form or electronically should also be considered given the relevant risks. Similar to engagement performance, resources should also be monitored to identify bottlenecks and flag/elevate identified resource shortages.

32. Should a future PCAOB QC standard continue to expressly address technical training on professional standards and SEC requirements? Are there other subjects for which training should be expressly required? Which firm personnel should be covered by the training requirements? Should the standards set minimum requirements for the extent of training? If so, what should those requirements be based on?

The firm should monitor compliance of individuals (for all professional staff) with technical training requirements set forth by the audit firm, state CPA licensing requirements, and requirements set forth by other licensing organizations. It is equally or more important that professionals have ready access to a library of accounting and auditing standards and interpretive guidance that will enable staff to research and understand the relevant technical requirements applicable to each assignment. It is also important to understand situations where consultations with technical resources are mandatory.

In cases where unique industry experience is relevant, consideration should be given to as to whether specific individuals have suitable industry experience (based on prior audit assignments, specific training or experience in private industry) to operate at specific levels of responsibility. The industries that come to mind where this would be relevant include insurance, oil and gas, broker-dealers, real estate, and financial services. In cases where insufficient experience is assigned to an audit in a specialized industry, measures to compensate for elevated risk should be undertaken. The engagement partner and quality reviewer should have visibility as to the sufficiency of industry relevant experience when the need for such experience is relevant.

33. Should a future PCAOB QC standard continue to expressly address required competencies of engagement partners? Are the competencies discussed in this concept release appropriate? Are there other competencies that should be added?

The required competencies vary with the nature of the responsibilities and should be articulated for all levels of responsibility (partners and QC reviewers included). This articulation may also help professionals understand the competencies needed to progress to next level.

34. Should the competencies of individuals in engagement or QC roles, in addition to the engagement partner and engagement quality reviewer, be addressed in a future PCAOB QC standard?

Yes. See above.

35. Should a future PCAOB QC standard expressly address the use of emerging technology in QC systems or engagements? Should a future PCAOB QC standard expressly require firms to design and implement controls to prevent unauthorized access to technology and data? Are there any other requirements we should consider related to the use of technology on engagements?

At this time, I would focus only on matters pertaining to the confidentiality and safeguarding of client information and the auditor's workpapers.

36. Ensuring that firm personnel in QC and engagement roles have sufficient time to properly carry out their responsibilities is one aspect of firm resources under Proposed ISQM 1. Should a future PCAOB QC standard place greater emphasis on this requirement than Proposed ISQM 1 does? If so, how?

My submission describes how the annual large firm planning process (which includes consideration of the risk assessment applicable to audit operations) should be used to identify the criteria that define the firm's staffing model for the upcoming year. This contemplates hiring, compensation, retention, targeted workloads (perhaps defined as hours in excess of 40 hours per week), expected turnover, targeted experience levels (i.e., FTEs at each level), and the ratio of partners to managers to staff. From the goal setting process, the firm should be able to define safe zones of operation around the targeted metrics that define "safe operation." As long as audit operations at the engagement level are within the safe zone, engagement work should continue to be carried out as planned. However, if monitoring activities identify engagements operating outside the safe zone, consideration should be given to whether audit quality may have been compromised and whether specific activities should be undertaken to compensate for the elevated risk of an audit quality failure.

37. Should a future PCAOB QC standard expressly address how the firm's incentive system, including compensation, incorporates quality considerations? If so, how?

It is very important that the firm's processes for performance evaluation, compensation, and promotion prioritize technical skills and audit quality as the first and most important consideration in any performance management program. This is an important element of setting the proper tone at the top.

Information and Communication

38. Is the approach to information and communication appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

The information and communication processes need to enable robust monitoring at the office and individual engagement level to be able to identify audits being conducted outside of the pre-defined safe zones of operation.

39. Should a future PCAOB QC standard require public disclosure by firms about their QC systems? If so, what should be the nature and timing of such disclosures (e.g., information about the firm's governance structure)? (see also Question 46)

As it stands currently, the audit firms need to comply with certain information requirements embedded in the various stock exchange listing standards. Those requirements are generally qualitative and descriptive in nature. Some of the firms, such as PwC, include a wide array of metrics that are useful to better understand PwC's audit staffing model. Other firms have followed suit to varying degrees. The PCAOB should work with the largest firms (based on a measure determined by the PCAOB – perhaps based on firms auditing more than 100 issuers annually) to identify metrics that the firms can report on at a national level on a consistent and comparable basis. This information will better inform audit committees in the exercise of their duties to select and retain auditors.

My submission describes a unique opportunity to capture and report certain engagement level metrics for inclusion in Critical Audit Matters with commentary from the auditor about actions required to mitigate measures that may have registered outside of the pre-defined safe zones of operation during the conduct of the audit. If this reporting is required, a firm like Audit Analytics can compile operational metrics for competing firms within the same geography that will provide much needed context for engagement level metrics. This information will empower competition for audit services on something more than simply the lowest bid. Healthy competition on operational metrics that intuitively have a bearing on audit quality should stimulate competition to improve those metrics (as opposed to sinking to commodity pricing which has undermined audit quality for decades).

The Monitoring and Remediation Process

40. Is the approach to the monitoring and remediation process appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

The critical incremental element that will drive future improvements in audit quality is the ability to monitor the operational metrics applicable to individual audits so that operations outside of defined safe zones of operation can be identified, addressed, and remediated in a timely manner (while the audit is in process). In addition to metrics, certain milestones may be useful such as the completion or interim fieldwork according to a predetermined schedule (that includes partner review of interim fieldwork in a timely manner).

41. Would the requirements related to monitoring and remediation discussed in this concept release prompt firms to develop an appropriate mix of ongoing and periodic monitoring activities? Would the requirements create an appropriate feedback loop to prevent future engagement deficiencies?

My response to both questions is yes.

42. Should a future PCAOB QC standard provide additional direction regarding determining appropriate monitoring procedures, appropriate root cause analysis, and remediation of QC and engagement deficiencies? If so, what type of direction is needed?

There are practical limits to how prescriptive these requirements should be. The audit firms should develop their own strategies; but whatever those strategies may be, they should be disclosed so 1) the public understands the approach used by the audit firm and 2) so that the PCAOB can then hold each audit firm accountable to their stated strategies.

43. Should all firms, as part of their monitoring procedures, be required to have internal inspections of their completed engagements? If not, which firms should not be required to have inspections of their completed engagements, and what alternative measures should be required for those firms?

Internal inspections provide valuable feedback to the firm and individual engagement teams. Internal inspections should be required for the largest audit firms. Internal inspections also discourage anyone from slacking off on the basis that selection of one of their engagements for inspection by the PCAOB in the coming year is unlikely.

44. Should a future PCAOB QC standard establish requirements for internal inspection selection criteria? Should a future PCAOB QC standard specify minimum or cyclical thresholds for inspections of completed engagements by the firm? If so, what should the threshold(s) be (e.g., one engagement for each engagement partner, and/or the audit of each issuer, broker, and dealer on a specified basis)? Should we require selection of engagements for internal inspection to include either random selection or an element of unpredictability?

I would leave the quantity and selection criteria to the discretion of each audit firm. However, the number of engagements selected for internal inspection should be disclosed. A minimum threshold for inspection should be established (i.e., each audit partner is inspected at least once every three years).

45. Should firms be required to perform an annual evaluation of their QC system's effectiveness? If so, should the required evaluation be as of a specified date or for a specified period? How should the date or period be determined?

I would favor an evaluation throughout the year.

46. Should firms be required to report to the Board on their annual evaluations of QC system effectiveness? If so, what should be included in the report? Should firms be required to disclose any performance measures that were important to their conclusion about their QC system's effectiveness? Should firm reports be publicly available (see also Question 39)?

It follows that, if all of the elements following a "COSO Framework" model are in place, the audit firms should test the design of the controls and the operating effectiveness of controls. It is in the audit firm's best interest to do so. I do not believe that public reporting of the results of such testing should be required to be made public (at least not until the audit firms have had a suitable period to remediate and continuously improve). Perhaps at some point, an audit firm will feel so good about its control system that it might be willing to subject it to third party testing and reporting.

47. Should we require the firm's top leadership to certify as to their QC system's effectiveness, either as part of or in addition to the firm's report on their QC system's effectiveness?

This is a reasonable idea (much like the officer Section 302 certifications accompanying 10-Ks and 10-Qs).

Documentation

48. Is the approach to documentation appropriate (i.e., use of ISQM 1 requirements as a starting point, with incremental or alternative requirements)? Are changes to the approach necessary for this component?

The ISQM starting point is good, as are the incremental changes described by the PCAOB in the Concept Release.

49. Are the potential sufficiency and retention period requirements described in this concept release appropriate for a QC system? Why or why not? If not, what alternatives should we consider?

The requirements described in the Concept Release appear reasonable to me.

50. Should we require firms to document their understanding of network or third party provided methodology and tools, including how such methodology and tools are responsive to the requirements of the professional standards and applicable legal and regulatory requirements?

The large firms using tools provided by third parties or networks should document their acceptance of such tools as if they were their own

Roles and Responsibilities of Individuals

51. Should a future PCAOB QC standard specify roles and responsibilities of firm personnel in relation to the firm's QC system?

Individual responsibility and accountability are important to achieving the benefits of upgrades QC standards. A managing partner cannot strive to maximize the bottom line without also being held personally responsible for compliance with critical controls and processes over quality control.

52. Are the roles and responsibilities described in this concept release appropriate? Are there other roles that should be added (e.g., chief ethics officer, chief technology officer)? Are there further responsibilities that should be added?

Every place where there is a control point, there should be an individual responsible for the effective operation of that control, including the analysis and remediation of any deficiencies that are identified.

Related Potential Changes to Other PCAOB Standards

53. Are the potential amendments to AS 2901 appropriate? Are there other approaches we should consider to prompt firms to appropriately respond when there are indications calling into question the sufficiency of audit procedures performed and/or audit evidence obtained?

The Concept Release implies some inconsistency in the application of AS 2901 due to the lack of clarity in how the existing standard is written. Clarification of AS 2901 should be undertaken.

54. Does AS 1110 provide helpful direction to auditors, or should it be rescinded? Please provide explanation for your answer.

There is some value to AS 1110, but it sounds like some clarification is warranted.

55. Are there other PCAOB standards for which substantive changes might be needed to align with a future PCAOB QC standard?

Please refer to the recommendation in the Section 3 of my submission regarding the incorporation of certain engagement level human capital metrics into Critical Audit Matters. In Section 1 of my submission, I made a strong case that the mismanagement of audit firm human capital presents a significant risk to audit quality. As an investor, I'd like some feedback from the auditor about how human capital was managed on the audit -- just as much as I would like to know what critical audit matters the audit team dealt with and discussed with the audit committee.

Scalability

56. We intend that a future PCAOB QC standard developed using this approach would be applicable to all firms and scalable based on their size and complexity and the nature of their engagements. What factors should we consider when developing a future PCAOB QC standard to ensure that its requirements are appropriately scalable?

Scalability is admittedly important, but it should not undermine the achievement of robust requirements applicable to the largest audit firms that are responsible for auditing 90+% of the market capitalization at risk. I favor more prescriptive requirements for the largest firms, in part, because circumstances warrant greater attention. In the most critical areas, such as the management of human capital, I am concerned that a risk assessment can be manipulated to result in a "soft touch" when a high level of scrutiny is actually warranted.

57. Are there aspects of the approach described in this concept release that would disproportionately affect smaller firms? If so, which areas, and what steps could the PCAOB consider to mitigate those effects?

Without adequate attention to scalability for small firms, the requirements could be burdensome. For the smaller firms, there may be third party audit practice management software and checklists that can provide the necessary guidance supporting the conduct of audits of suitable quality.

58. Should we have additional, more specific requirements regarding certain components or areas (e.g., governance and leadership) for larger, more complex firms or based on the nature of engagements performed by the firm (e.g., broker and dealer engagements or engagements for issuers in specialized industries)? If so, what should those be?

Again, requirements pertaining to human capital managements at the largest firms should be prescriptive. The need for attention in this area (and the upside for improvement) is simply too great to leave to misinterpretation or the underapplication of suitable effort.