

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 counter-balance this situation was that nearly everyone that started in public accounting 29 years ago had the ambition of becoming a partner. Today, that ambition is waning because the audit partners are overworked and under a lot of stress. Very few of the younger people these days desire to become an audit manager in public accounting, let alone an audit partner.

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

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

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

Measuring and Reporting Audit Quality Drivers

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

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

- **The average years of experience of audit professionals** – The experience level of the audit professionals is a key driver of audit quality. The complexity of accounting and high public expectations all point to the need for more

experienced professionals. By and large, corporate America is audited by young men and women just out of college – supervised by a limited number of experienced partners. My preference would be to measure this statistic only counting years of experience subsequent to the employee becoming licensed as a CPA. This will draw attention to the fact that much of the audit field work is conducted by employees who have not yet become CPAs. It will also drive the large Firms to encourage their employees to become licensed CPA's sooner and will reinforce the importance of technical excellence.

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

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

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

The airlines publish "On Time Departure Statistics" to help consumers make more informed choices about which airline to fly. Consumer Reports publishes a wealth of information to help consumers make informed buying decisions about cars, appliances and consumer electronics. Shouldn't audit committees be entitled to receive better information about the audit services they are procuring?

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

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

Defining the Safe Zone of Operation

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

To better manage the risks described above, I am recommending that the large firms use the metrics I have described herein to define **safe zones of operation** at the office and individual partner level. When the metrics indicate operation outside the safe zone,

I would expect the firm to implement safety measures to mitigate the risk associated with operating outside the safe zone. Such measures might include expanded second partner concurring reviews equivalent to the review expected of the engagement partner – to assure that audit quality has not been compromised.

The Audit Firm Quadropoly – Sustainability and Transparency

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

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

Much has also been said about requiring the audit firms to provide transparency about their financial results. It is already well known that the large CPA firms are very profitable. I do not foresee that the publication of the large firm financial results will accomplish a lot. On the other hand, providing transparency to the metrics impacting audit quality has the potential drive fundamental changes to the large audit firm business models which can significantly improve audit quality and long term sustainability.

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