

September 10, 2018

Chairman William D. Duhnke III
Public Company Accounting Oversight Board

Dear Chairman Duhnke,

I was pleased to see the PCAOB solicit public feedback on the draft of its strategic plan. I see this as a very positive step. While much has been accomplished by the PCAOB, there is clearly more good work to be done. I hope you will find my feedback on the strategic plan to be informative, actionable, and useful in your quest to fulfill the PCAOB's important Mission.

My 360° Perspective on Issuers, Auditors, and the PCAOB

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 CPA firm in Southern California that focuses exclusively on technical accounting consultations and SOX 404 outsourcing. My responsibilities have me in regular contact with Big Four audit partners and public company CFO's, Chief Accounting Officers, 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). Ultimately, the PCAOB published a Concept Release on Audit Quality Indicators in June 2015.

The views expressed herein are my own and do not necessarily represent the views of CNM LLP or its partners.

My comments on the draft of the PCAOB's strategic plan are listed on the pages that follow.

Robert A. Conway

RetiredAuditPartnerACAP@Live.com

1. Clear Identification of the PCAOB's "Stakeholders" is Essential to Improving Audit Quality

Your draft strategic plan identifies your stakeholders as investors, audit committees, and other stakeholders. Public companies should be explicitly identified as one of your stakeholders for the following reasons:

The PCAOB's standard for audits of internal control over financial reporting is entirely principles based and brief in length. Yet, the expectations from the PCAOB communicated to auditors through the inspection process are very prescriptive. Public companies are in a tough spot because they only hear about the PCAOB's expectations second-hand from their auditors. In light of rising costs and some disbelief over the expectations of the PCAOB as communicated to companies by their auditors, companies have been hesitant to fully embrace what auditors say is required. The absence of suitable interpretive guidance to public companies and their auditors has contributed to the high rate of PCAOB deficiencies related to the auditor's testing of ICFR.

Public company management has front line responsibility for designing and executing internal controls. Public companies are directly affected by the PCAOB's actions. Public companies should hear directly from the PCAOB as to its expectations. Public company and auditor compliance with the ICFR requirements can be improved if the PCAOB and SEC provide practical interpretive guidance for public companies and auditors (similar to the interpretive guidance published by the FASB's Transition Resource Group to facilitate implementation of the new revenue recognition standard). To achieve the desired level of compliance and the allocation of effort in proportion to risk, public companies need to understand the PCAOB's expectations directly from the PCAOB. The PCAOB keeps saying that ICFR should follow a top-down risk based approach; however, until the PCAOB provides clear examples that public companies and auditors can rely on, there will be a tendency for auditors to fortify ICFR applications beyond that which is necessary due to the fear of being second guessed on inspection.

I expressed a similar view in an article published in Compliance Week on November 22, 2016 titled "The PCAOB Must Provide Better Guidance for ICFR." Many from the issuer community strongly agreed with my observations about the current state and the potential benefits of PCAOB interpretive guidance as a means to improve compliance and right-size the regulatory burden.

My best estimate from the information available to me is that audit fees for public company audits under the PCAOB's jurisdiction cost on the order of \$20 billion, of which ICFR audits are a material component. Given the far reaching consequences of the ICFR requirements on public

companies in terms of external cost and internal resources, public companies deserve more transparency as to what is necessary and what is not necessary.

In the process of preparing interpretive guidance, I am confident that the PCAOB and the SEC can identify plenty of opportunities to improve the cost-effectiveness of audits of ICFR, particularly in the low risk areas. I continue to be perplexed by the number of controls devoted to low risk areas such as basic payroll simply because payroll is a large number in the income statement. If you are interested, I've got plenty of ideas as to how the time and effort in low risk areas can be reduced without compromising control assurance.

Audit Professionals Should Also be Viewed as PCAOB Stakeholders for the Following Reasons:

An academic study and survey titled “Auditor Perception of the Audit Workplace, Audit Quality, and the Auditing Profession”¹ published in 2014 paints an unflattering view of public accounting as a career choice. I strongly encourage the Board to read this study before finalizing your strategic plan. It strikes me that a primary focus of the PCAOB should be to assure the audit professionals have the time, experience, and supervision needed to succeed on PCAOB inspections.

The US Treasury Department’s Advisory Committee on the Auditing Profession (ACAP) certainly thought the “Human Capital” component of audit quality was a priority. Human Capital was one of the three areas of focus for the ACAP proceedings (the other two being “Firm Structure and Finances” and “Concentration and Competition”). The ACAP Final Report noted, “To ensure its viability and resilience and its ability to meet the needs of investors, **the public company auditing profession needs to continue to attract and develop professionals at all levels who are prepared to perform high quality audits in this dynamic environment.**”²

In short, the nurturing of human capital was recognized as an important element to the long term sustainability of the auditing profession. The PCAOB should be equally focused on the human capital element.

The old school view has always 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 inefficient in terms of productivity and audit quality. What rises to the

¹ See https://digitalcommons.trinity.edu/cgi/viewcontent.cgi?referer=https://www.google.com/&httpsredir=1&article=1040&context=busadmin_faculty by Persellin, Schmidt, and Wilkens; December 2014

² See <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf>, page VI:1

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.

The audit firm business model has changed very little since I entered the auditing profession over 40 years ago. The basic business model has always been based on heavy workloads, high turnover, low experience levels, and high leverage (which potentially jeopardizes the adequacy of supervision). While the basic business model has stayed the same, auditing has become increasingly more challenging as a result of the following developments:

- New and increasingly sophisticated technologies are dramatically increasing the complexity of commerce in many fields such as pharmaceuticals, medical devices, semiconductors, e-commerce, telecommunications, and entertainment to name a few.
- The internet has added new channels for product distribution and new mechanisms for the delivery of services to customers.
- The complexity of the accounting standards has grown exponentially over the last 40 years. It is worth noting that the Big Four interpretive guidance for the new revenue recognition standard ranges from 500 to 1,000 pages in length depending on the firm. One firm's guide on "Derivatives and Hedging" measures 650 pages in length.
- Fair value concepts increasingly permeate today's accounting standards.
- There has been a proliferation of the use of derivative instruments.
- PCAOB inspections of audits and new requirements for audits of internal controls over financial reporting came to pass with the passage of the Sarbanes-Oxley Act of 2002.
- Expanded global reach has more companies operating internationally than ever before.

My point is that today's audit professionals must be able to process an extraordinary breadth and depth of complexity in an increasingly demanding environment; yet the very little has changed about the Big Four business model. My concern is that the Big Four business model is a mismatch for the level of complexity faced by auditors today.

A suitable level of audit quality cannot be achieved without providing a quality work environment for public accounting professionals. In an unfortunate twist of irony, the PCAOB's inspection regime has created a high degree of hysteria among audit professionals. That hysteria has driven some of the best professionals out of public accounting. That hysteria also

appears to have driven certain audit professionals to rationalize the use of leaked PCAOB inspection selections to gain an advantage. These events should be a red flag for the PCAOB.

To be clear, I am not making excuses for those who broke the law. Nor am I suggesting that the PCAOB go soft on its inspections. Rather, the PCAOB needs to focus on opportunities that will drive the audit firms to enhance each professional's opportunity to succeed on every inspection. That means looking for opportunities that ensure that every public accounting professional will have the time, experience, and supervision they need to succeed on PCAOB inspections. The PCAOB's Audit Quality Indicator Initiative represents such an opportunity. This opportunity is discussed in my next recommendation.

The Bottom Line

Whether or not you define public companies and audit professionals as stakeholders, the bottom line is that the PCAOB needs to take a holistic approach to improving audit quality that considers the public company need for ICFR interpretive guidance and enhances the opportunity for individual auditors to succeed on PCAOB inspections. Otherwise, you risk winning the battle on individual inspections and losing the war to improve audit quality.

2. The Opportunity to Drive Audit Quality to the Next Level Using AQIs

In 2007, my submission to the US Treasury Department's Advisory Committee on the Auditing Profession ("ACAP") recommended that audit firms be required to publicly report certain operational metrics which I referred to as "Audit Quality Drivers" at the firm-wide, office level, and engagement level. Audit firms compete too heavily on price rather than attributes having a bearing on audit quality. As a consequence, audits have fallen victim of commodity pricing. The resulting business model is not conducive to audit quality. Today's audit firm business model is characterized by heavy workloads that drive high turnover that drives experience levels below where they need to be to achieve suitable levels of audit quality. The model is also characterized by high leverage (high staff to partner ratios) that undermine the supervision of inexperienced staff.

My thinking 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? What audit committee would desire to engage an audit firm with the least desirable blend of operational metrics? Lastly, what aspiring professional would favor employment with an audit firm having an unfavorable 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</u> | | <u>Metric 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 providing 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.^{3 4} While my recommendation focused on input indicators, the ACAP discussion expanded my recommendation, asking the PCAOB to consider both input and output indicators.

On July 1, 2015, the PCAOB issued a concept release on "Audit Quality Indicators." The Center for Audit Quality has conducted pilot testing on the use of AQIs with very favorable results. The CAQ website highlights that, "The CAQ has been at the forefront of the movement to develop quantitative and qualitative metrics regarding the audit -- commonly referred to as audit quality indicators (AQIs) -- that could be used to better inform audit committees about key matters that may contribute to the quality of an audit."

The CAQ's Paper on Audit Quality Indicators

In January 2016, the CAQ published a report titled, "Audit Quality Indicators – The Journey and Path Ahead." I am grateful for the work the CAQ has done with AQIs. Several useful observations have come out of their pilot testing and roundtables. However, I see some limitations to the CAQ's conclusions from its field testing that need to be considered when setting the future course for AQIs at the PCAOB.

As I read the CAQ publication, I found it interesting how many times the CAQ emphasized the need to "provide context" to engagement level AQIs. There were nine such references in the CAQ's report. Yet, there is a valuable source of context that the CAQ and the PCAOB seem hesitant to focus on – office level AQIs for the local office of the auditor of record and office level AQIs for the competing Big Four firms in the same geography as the auditor of record.

³ See Recommendation # 3 in the ACAP Final Report in Chapter XIII, page 14 at <https://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> and the footnote 56 reference to the Anonymous Retired Big 4 Audit Partner.

⁴ See webcast at http://pcaobus.org/News/Webcasts/Pages/10222008_SAGMeeting.aspx . Select Day 1 session at 2:02:45.

I believe this opportunity has been overlooked by the CAQ because it was not included in their pilot testing. Audit committees only looked at engagement level AQIs without any context from office level AQIs for the auditor of record or the office level AQIs in the same geography for the competing auditors. Not surprisingly, pilot participants came away yearning for context.

As an audit committee chair, if I take the audit out to bid, will I be content to receive projected engagement-level AQIs from the competing firms? Talk is cheap and often misleading. Personally, I'd like to see the history of AQIs at the office level for the competing firms. I think actual data would be a more reliable predictor of what I could expect from the competing firms because I can make apples-to-apples comparisons of the AQIs for the offices proposing to audit my company.

Even if I am not taking the audit out to bid, I'd like to keep an eye on how the local office or regional AQIs of my audit firm stack up against the local offices of my auditor's competitors. That provides very meaningful context to my engagement level AQIs.

The office managing partner has a critical role in managing the tension between audit quality and profitability. The office managing partner has a significant role in staffing and workload decisions that can have an enormous impact on office profitability, tone at the top, and audit quality. It would be naive to assume that Big Four firm offices have consistency across the country that rivals organizations like Hilton or McDonalds.

While the PCAOB has generated a good degree of fanfare and support for AQIs, I see the initiative stalling if office level AQIs are not an integral part of the solution.

Taking Audit Quality Indicators to the Next Level

To enable audit quality indicators to drive change in the market place, there must be **comparable metrics for competing firms in the same geography**. That will provide the necessary context that the CAQ expressed concern about. Comparable metrics in the same geography will also enable competitive forces to drive these metrics in more favorable directions. The critical questions are:

- a. What audit firm leader wants to be in last place when the metrics are published?
- b. What audit committee chairman will rationalize the appointment of an audit firm with least favorable blend of operational metrics?
- c. Lastly and perhaps, most importantly, what aspiring professional wants to work for the audit firm with the heaviest workloads, the highest turnover, and the poorest level of supervision (as evidenced by leverage or partner/manager workloads).

This is not about driving down partnership profits. To the contrary, I believe audit committees will pay more if they truly believe they will get a better audit from Brand X than Brand Y. The problem to date is that the audit firms have done a poor job differentiating themselves other

than price and industry expertise. The unfortunate result has been a race to the bottom, not the top. During the discussion of my recommendation during the ACAP proceedings, ACAP Co-Chairman and former SEC Chief Accountant Don Nicolaisen made the observation, “The accounting firms have competed on price from the beginning and the results have been disastrous.”

3. Improving the Quality Control Standards by Defining “Safe Zones of Operation”

The PCAOB’s existing standards on “Quality Control” (QC 20, QC 30, and QC 40) and “Integrity and Objectivity” (ET 102) are antiquated and unchanged from the corresponding AICPA standards as they existed when adopted by the PCAOB in 2003. The PCAOB’s existing “Quality Control” and “Integrity and Objectivity” standards pre-date the failure of Arthur Andersen and the audit failures of Enron, WorldCom, Tyco, HealthSouth, Adelphia, and Waste Management. It is surprising during the PCAOB’s 16 years of existence that no enhancements to these foundational standards have occurred.

In my original ACAP recommendation (submitted to ACAP in November 2007 – See Appendix A), I described the need for audit firms to define safe zones of operation. Virtually any machinery or plant (such as an airplane, a refinery, or a power plant) operates within defined tolerances that are largely driven by safety and quality control considerations. Audits should be no different. The existing standards require the firms to design, maintain, and monitor quality controls. The specifics are left to each audit firm. In some cases, firms have done very little in this regard.

There is a heightened risk that pressure to meet deadlines can undermine audit quality. Most audit models operating today do not monitor the audit process in sufficient detail to flag situations where audit quality is in jeopardy due to excessive workloads (at the individual partner, manager, and staff levels), engagement team turnover, insufficient staff continuity, insufficient experience levels, insufficient partner or manager involvement, or excessive leverage. The reality is that audit reports tend to move down the assembly line and out the door according to schedule without expanded quality reviews or other compensating measures when conditions indicate that audit quality may have been compromised.

Jeanette Franzel mentioned in her 2017 remarks at Baruch College that some audit firms are integrating audit quality indicators into their monitoring and quality control processes. I’d like to see the PCAOB take a more proactive role in this regard via the quality control standards. The PCAOB should be leading, not following. Yet here we are in 2018 with PCAOB using quality control standards that were written by the AICPA in 1997.

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.”

The AICPA’s Integrity and Objectivity standard 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. 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.

4. **Assess Whether the Inspection Report Process and Format are Meeting Investors’ Expectations**

Does the Financial Press Reporting of So-called “Deficiency Rates” Improve Audit Quality?

I am a big fan of transparency and competition. Those elements are foundational to my ACAP recommendation. However, I am deeply concerned about the level of hysteria that exists over PCAOB inspections and the so-called “deficiency rate.” Not all deficiencies reported are of equal severity.

The solution begins with a laser focus on what really matters to investors. What really matters is:

- a. Whether errors in reported results or the application of GAAP were identified from the inspection,
- b. Could material errors in reported results have existed and gone undetected by the auditor as a result of deficiencies in substantive auditing (analogous to the “could factor” in assessing material weaknesses in ICFR), or
- c. Were there control deficiencies that rise to the level of a material weakness that the auditor failed to identify?

The “deficiency rate” reported by the press can be horribly misleading and results in excessive pressure on auditors to achieve near perfection in ICFR when investors are much more concerned about the items “a”, “b”, and “c” enumerated above. These are the things that really matter to investors. I think the Board should take a hard look at the existing inspection reporting model and evaluate whether there is an alternative model that better serves the interests of investors and, at the same time, reduces the hysteria that exists within the audit firms as a result of the PCAOB’s inspection process.

5. Improving Independence and Professional Skepticism – Prohibitions on Auditor/Client Entertainment

The PCAOB's Staff Audit Practice Alert issued in December 2012 on "Maintaining and Applying Professional Skepticism in Audits" is a good document. It addressed an important issue that is evident from many PCAOB inspection reports – that professional skepticism needs to improve.

As a young auditor, I experienced conflicting signals about keeping the client happy versus doing quality work. As my career progressed, I was encouraged to develop close personal relationships with my clients. The rationale was that it was difficult for friends to fire friends. Client entertainment was an important vehicle for developing those close personal relationships.

While I can appreciate that some rapport is important to getting the job done, the mere existence of client entertainment sends a mixed signal about who the auditor is behold to -- the company or the investors (via the audit committee)? My view is that client entertainment should either be strictly limited or prohibited altogether. At an absolute minimum, audit committees should set policies on entertainment and should have visibility to the nature and extent of the auditor's entertainment of the audit client as well as visibility to the public company's entertainment of the auditor. The audit committee should know if the auditor is taking the CFO to the Super Bowl, the Masters, or other lavish entertainment venues. The US government applies strict limits on the entertainment of government workers by government contractors. Why should the auditing profession be any different?

6. Attention to Earnings Management

An academic survey of 375 CFOs⁵ points to a belief that earnings are being distorted as often as 20% of the time by a magnitude of about 10%, even though the companies are adhering to GAAP. Examples of such distortion include the intentional delay of customer shipments at period end to defer revenue and profits into the next period or the insertion non-substantive extended payments term on software arrangements that delay revenue recognition based on an engineered technicality. Such behavior likely stems from pressure to meet earnings goals and/or efforts to maximize performance bonuses. The study reports that the understatement of earnings (so called "lowballing") represents approximately one-third of the instances where results are manipulated within the confines of GAAP. This strikes me as a serious matter that warrants the joint attention of the PCAOB, the SEC, and the FASB. If such activities are occurring (even if they are somehow in accordance with GAAP), audit committees and investors have a keen interest in knowing about these situations. The PCAOB's Auditing Standard AS 2401, *Considerations of Fraud in a Financial Statement Audit*, addresses financial reporting fraud that violates GAAP. However, AS 2401 does not address manipulations of earnings that public companies would assert are allowable within GAAP. Investors expect that these types of

5 See https://www.thecorporatecounsel.net/nonmember/docs/06_15_Dichev.pdf.

manipulations should not occur because they obscure a company's true quality of earnings. When these manipulations occur, at a minimum, the effect on revenues and earnings should be disclosed. Further attention in this area is clearly warranted.