Public Comment in Response to the SEC Concept Release on
Possible Revisions to Audit Committee Disclosures
SEC File Number S7-13-15

Submitted by Robert A. Conway, CPA
September 8, 2015

I am currently a Lecturer in Advanced Accounting at the University of California, Irvine. Prior to that, I was with the PCAOB for nine years where I led inspection teams in the field conducting PCAOB inspections of Big Four firm audits. As a Regional Associate Director at the PCAOB, I also had leadership responsibility for the PCAOB's Orange County and Los Angeles offices. Prior to the PCAOB, I spent 26 years at KPMG, including 17 years as an audit partner.

I am also the author of a 2007 recommendation to the Treasury Department's Advisory Committee on the Auditing Profession ("ACAP") that has been widely credited as the driving force behind ACAP's Final Report recommendation to the PCAOB to evaluate the feasibility and benefits that might result from providing greater transparency to audit firm operational metrics and output measures that may have a bearing on audit quality. The PCAOB's evaluation of that opportunity has given rise to the PCAOB's recent Concept Release on Audit Quality Indicators ("AQIs"). My response to that concept release (which also includes my original ACAP recommendation), can be viewed on the PCAOB's website.

The essence of my ACAP recommendation was to provide transparency to the attributes of the audit firm business model that threaten audit quality. Those attributes include heavy staff workloads, high staff turnover, low experience levels, high leverage ratios (as measured by audit staff to partners), and heavy partner workloads. At the engagement level, these operational metrics can provide audit committees with an important understanding of conditions that may have compromised the quality of their audit. I also anticipate that audit committees will be able to use AQIs to better inform their decisions about auditor selection and retention. Providing transparency to the audit firm business model at the firm-wide, office, and engagement levels also has the potential to unleash competitive forces that will drive improvements to the audit firm business model that will improve audit quality.

The views expressed herein are my own and do not reflect the views of UC-Irvine or any of its professional staff or employees.

Managing the Risks the Auditor Brings to the Audit

Audit committees are well versed in reviewing the auditor's assessment of the company's financial reporting risks and the manner in which the audit plan is tailored to address those risks. **However, audit committees do not systematically 1) assess the risks that the auditor brings to the audit and 2) plan steps to reduce and/or mitigate those risks.** Some of the more significant risks the auditor brings to the audit are listed below:

- **Risk # 1** – **The Lack of Auditor Independence** --The "independent auditor" is not truly independent as long as the auditor is retained and paid by the company under audit. The current auditor retention model undermines professional skepticism and objectivity – two elements that are critical to audit quality and protecting the interests of investors. The current auditor retention model divides the auditor's allegiance between management and the audit committee and can undermine the auditor's fortitude to "do the right thing" at the defining moment.

- **Risk # 2** – **The Big Four Audit Firm Business Model** --The Big Four audit firm business model is characterized by heavy workloads that cause high turnover that drive down experience levels and industry expertise. A significant percentage of the audit team members are not licensed CPAs. High ratios of staff to partners, coupled with heavy partner workloads, potentially undermine the partner's ability to adequately supervise the audit team. These factors pose a risk to audit quality.

- **Risk # 3** – **Tight Deadlines and Time Pressures** -- Earnings release dates are seemingly cast in stone. If the company is late getting critical analyses to the auditor, the time available to the auditor tends to shrink. Additionally, tighter deadlines for 10-Ks and 10-Qs mandated by the SEC have exacerbated the risk that time pressures might compromise auditor judgment. These factors pose a risk to audit quality.

- **Risk # 4** – **The Audit Partner in "Catch-up" Mode** – Heavy partner workloads and high leverage ratios (staff to partners) coupled with tight deadlines contribute to the risk that an audit partner may be operating in "catch-up" mode. In other words, the audit partner is behind where he or she should be in the review process and they are trying to catch up. We all know that if an accounting or auditing issue is identified early, the auditor can deal it with from a position of strength. On the other hand, if the issue surfaces just before the earnings release, the auditor has an unhappy client who states, "Your team has been out here for eight weeks. Why is this only coming up now?" The dynamics of resolving an issue "late in the game" can undermine the auditor's objectivity.

- **Risk # 5** – **Audit Quality Varies at Foreign Affiliates** -- Audits in foreign countries are conducted by audit firms who are only loosely affiliated with the US audit firm. Audit quality varies in foreign jurisdictions and there tends to be less familiarity with US GAAP and PCAOB Standards. These factors pose a risk to audit quality. In fairness, audit committees are paying some attention to this issue by virtue of communications from the PCOAB that have elevated attention to this risk.

- **Risk # 6** – **Foreign Affiliates Place a Lower Priority on Referred Work** --The foreign affiliated audit firms naturally place a higher priority on clients headquartered in their country versus referred work from the United States. Service levels to clients headquartered in the foreign affiliates country are more important to near-term client retention by the foreign affiliated firm. As a consequence, work referred from the US may have a lower call on the affiliated firm's resources. This factor poses a risk to audit quality.

- **Risk # 7** – **Big Four Firm Initiatives to Move Audit Work Offshore** -- The Big Four firms are seeking to improve profitability by shifting audit procedures to offshore service centers in low cost jurisdictions. This poses a risk to audit quality. My conversations with audit committee chairmen have shown a low degree of awareness to this phenomenon.

More About the Auditor Independence Issue

It was an eye opening experience to go from “serving clients as an auditor” to “inspecting issuers as a PCAOB inspector.” As an inspector, I felt much more like an umpire at a baseball game “calling the balls and strikes as I saw them.” Of course, I listened carefully to the views expressed by the engagement team members and carefully considered the relevant evidence, but my conclusions were rooted strictly in the facts and the relevant guidance in the auditing and accounting literature. As an inspector at the PCAOB, my mind was not cluttered by whether I was going to lose the business. I did not need to worry about collecting fee overruns. I did not need to worry about being asked to rotate off the account prematurely. I did not need to worry about keeping the client happy. I did not need to entertain the client as part of my job description. Transitioning to the PCAOB was a radically different experience from the world of public accounting. Just about everyone making the transition from public accounting to the PCAOB has had the same realization.

The absence of true independence and objectivity at the audit firms has also been evident from many inspection findings where the mindset of the auditor was to advocate the company’s view rather than consider the implications of contradictory evidence and critically challenge the “client’s view.” Inspection reports have been critical of breakdowns in professional skepticism and objectivity; yet this continues to be an uphill struggle for the audit firms, despite their best efforts to create a culture dedicated to “getting it right” and encouraging professionals to “speak up” when they have a concern.

Advice I received early in my public accounting career bears repeating here. I was told, “Bob, it is important that you become a friend to your client because it is difficult for friends to fire a friend if something goes wrong.” This was good operational advice to help me meet my “client retention goals” while in public accounting, but it runs counter to the ideals of auditor independence and “calling the balls and strikes” as the auditor sees them.

Client entertainment also sends a mixed message that threatens independence. Some rapport with company personnel may be beneficial to getting the job done. On the other hand, some entertainment goes beyond building rapport. Audit committees should at least have visibility to “auditor paid” and “issuer paid” entertainment and should set some boundaries or consider prohibition altogether. I find it interesting that government contracts expressly forbid entertainment. Audit committees should know whether their auditor is entertaining company personnel at sporting events (or making tickets for such events available at no charge). At the extreme end, shouldn’t the audit committee know whether a key employee in the financial reporting chain of command went to the Super Bowl or The Masters courtesy of the so-called independent auditor?

The CPA is taught that independence is as much about "the appearance of independence as it is "independence in fact." Client entertainment and the focus on keeping the client happy sends a mixed message to the younger professionals who should be keenly focused on developing a strong sense of objectivity and professional skepticism.

An Insightful Question from the SEC in the Concept Release

The SEC posed a very insightful question in the caption at the top of page 38:

> *"Whether and How the Audit Committee Assesses, Promotes and Reinforces the Auditor's Objectivity and Professional Skepticism?"*

I hope I am wrong, but I fear that many audit committees might struggle with how to respond.

The unfortunate reality is that many audit committees are undermining certain of the controls put in place by Sarbanes-Oxley that were intended to improve auditor independence, objectivity, and professional skepticism. When the Sarbanes-Oxley Act (SOX) was passed in 2002, there were two provisions of SOX that, in tandem, held great promise to improve auditor objectivity:

1. SOX strengthened corporate governance by shifting responsibility for the external auditor relationship away from corporate management to the independent audit committee.

2. SOX also required that each audit committee have at least one audit committee financial expert ("ACFE").

There was widespread recognition at the time that true auditor independence was undermined by the fact that the auditor was retained and compensated by the management of the very company the auditor was engaged to audit. The hope and expectation at the time was that the new framework required by SOX would enhance auditor independence from management.

While audit committees now formally appoint the external auditor, the reality is that audit committees rely heavily on recommendations from management for auditor retention and the auditors know that. Fees are regularly discussed and cleared with management prior to going to the audit committee. Discussions about the collection of audit overages also start with management, not the audit committee. Audit committee dependence on management stems from the fact that few audit committee chairpersons are knowledgeable enough about the complexities of financial reporting and the conduct of the audit to be able to take full charge of the auditor relationship.

Think for a moment about situations in everyday life where we find ourselves at the mercy of a specialist in a field in which we do not have deep knowledge. I am thinking about when we are seeking assistance from an auto mechanic, a doctor, or a lawyer for example. If we are not experts in those fields, we are highly reliant on the judgments of the mechanic, the doctor, or the lawyer and it is difficult to question the scope and cost of their services. Our best and perhaps only control point is a second opinion (or a competitive quote). It stands to reason that if we are looking for someone to provide oversight to the company's finance function, the external auditor, and the internal auditor -- at least one person on the audit committee should understand the complexities of financial reporting, the inner workings of a Big Four audit firm, the details of conducting an audit, and Risks # 1 through # 7 described earlier herein. Otherwise, it is difficult for the ACFE to take full control over the audit relationship (including the audit fees) and the auditor is back to where the auditor has always been – beholding to management.

Conflicting Goals for Recruiting Board Members

Companies frequently seek board members in high profile positions who can provide strategic thinking and facilitate strategic partnerships. However, at least one member of the company's board of directors should be devoted to someone who truly is an audit committee financial expert in the fullest sense and is familiar with the inner workings of the regulatory framework for public reporting and auditor oversight. I am concerned that the current framework for audit committee experts may not be delivering the necessary skillsets to many audit committees. As a consequence, the auditor may feel more beholding to management than the audit committee.

My concern is much less with the adequacy of audit committee reporting. Micro-managing audit committee reporting will not improve audit quality. The bigger focus should be on the qualifications of the ACFE to carry out his or her responsibilities. More clarity in the proxy about the ACFE's qualifications to be an ACFE might help; **but I think the real issue goes back to SEC rules for qualifying as an ACFE**.

It may be helpful to recall that the SEC's proposed rules to implement the SOX requirements for ACFEs were originally issued in October 2002 and set a high bar for ACFE qualification. The ACFE requirements drew criticism from the public as being too stringent. Concern was expressed that it might be difficult to find enough ACFE's. That led the SEC to lower the requirements in January 2003. Perhaps the SEC should have never lowered the ACFE requirement. My recommendation is that the SEC should revisit the qualifications to be an ACFE in light of the reality that audit committees have generally been unsuccessful at creating an environment where auditors clearly feel more beholding to the audit committee than management.

I will close this section with an anecdote that you should find troubling. At the time the Sarbanes-Oxley Act was being crafted, a prominent securities attorney from a high pedigree law firm told me, "Bob, the Sarbanes-Oxley Act requirements are going to make it difficult to find friendly audit committee members." Need I say more?

More About Audit Quality Indicators

The PCAOB Audit Quality Indicator initiative (including the recently issued PCAOB Concept Release) offers a great opportunity for audit committees to become more informed and more discriminating consumers of audit services. The AQI initiative also gives the audit committee (and the audit firm) new tools to monitor AQI's at the engagement level as the engagement progresses. Audit committees should understand that they do not need to wait for the PCAOB to determine a final set of AQIs to be published and reported by the audit firms. Since the audit committee is empowered to retain the auditor, I am optimistic that the Big Four firms and next tier firms will be glad to respond to reasonable requests for AQI data at the engagement level.

The Center for Audit Quality has been supportive of the AQI initiative and has already conducted some pilot testing of its own on AQIs. At least one Big Four firm that I am aware of is already publishing firm-wide operational metrics on a three year comparative basis. So the opportunity is there for audit committees to take charge using Audit Quality Indicators. This could be the beginning of prying responsibility for the audit relationship away from the management and redirecting primary conduct on the audit to the audit committee financial expert.

Other Observations

I wholehearted agree with Denny Beresford's reminder to us all that the audit committee bears oversight for the accounting function and both the external <u>and</u> internal auditor. The investors should receive a well articulated explanation as to the operation and structure of the issuer's accounting function, including information on the Chief Accounting Officer's qualifications, the size of the accounting department, the number of credentialed professionals in the department, the sufficiency of personnel and systems for the scope of the company's operations, turnover, unfilled positions, anticipated and recently completed system conversions, etc.

Investors would similarly be interested in the qualifications of the internal audit director, the size of the department, skills sets of internal audit team members, department turnover, and unfilled positions in the department. A brief statement about the internal auditor's reporting responsibilities to the ACFE and others would also be pertinent.

Lastly, a good articulation of the considerations factoring into auditor retention should be included. In the future, some reference to AQI's may help to inform the Company's discussion about the auditor retention decision. The discussion should also incorporate consideration of the length of the auditor's tenure and the audit committee's evaluation of the relative risks, if any, for lengthy auditor tenures.

Thank you for seeking public comment. I hope you find my thoughts useful. Please feel free to contact me directly if I can be of further assistance.

Sincerely,

Robert A. Conway

Robert A. Conway
[redacted]
Cell phone: [redacted]