

**Response to CMA's Invitation to Comment
Actionable Recommendations Provided by Robert Conway, CPA
November 11, 2018**

Please accept my response to CMA's Invitation to Comment on the "Statutory Audit Market", albeit shortly after the stated deadline of October 31 deadline. I am proposing actionable suggestions that are responsive to CMA's specific concerns.

My 360° Perspective on Public Companies, Auditors, and the Regulatory Framework

I am a retired KPMG audit partner in the United States. I worked at KPMG for 26+ years, including 17 years as an audit partner. After retiring from KPMG, I joined the Public Company Accounting Oversight Board (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.

I am currently the Senior Professional Practice Director at CNM LLP, a 90-person CPA firm in Southern California focused exclusively on technical accounting consultations and assisting public companies with Sarbanes-Oxley compliance. My responsibilities have me in regular contact with Big Four audit partners, public company CFO's, Chief Accounting Officers, Sarbanes-Oxley Compliance Leaders, and Audit Committee members.

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.

My ACAP recommendation and more about me can be found on my LinkedIn profile at <https://www.linkedin.com/in/bob-conway-68b35644/> .

While my experience is largely limited to the US environment, I believe the structure of the auditing profession and the issues we both face bear considerable similarity. My response to CMA's invitation to comment is in the pages that follow.

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

Sincerely,

Robert A. Conway, CPA

Robert Conway's Response to the CMA Invitation for Public Comment

Below are specific statements in the CMA Invitation to Comment that motivated me to write to you:

- 1.3 We are carrying out a market study to consider whether the market for the provision of statutory audit is working as well as it should. ...
- 2.23 Widespread public concerns indicate that the audit sector is not meeting expectations. A well-functioning market should deliver good outcomes for both businesses and their shareholders, and also other stakeholders with an interest in audits.
- 2.24 Most of the concerns focus on audit quality rather than price. ...
- 2.25 Unlike in some markets where there are concerns over whether the market is working well, there seem to be few complaints here that prices are too high. Indeed, quite the opposite: we have heard views that there might be merit in prices being higher in order to secure higher quality. ...
- 3.8 ... shareholders are likely to find it **difficult to judge audit quality**, because quality may take the form of intangibles such as auditor skepticism and challenge of management's opinions.
- 3.10 Market outcomes are driven by the interplay of competition and regulation. Strong **competition** between audit firms (through periodic tender for audit contracts) can play an important role in driving good outcomes by giving customers choice and enabling new entry, expansion, and innovation.

Enabling Free Enterprise and Competition to Work its Magic

Informed consumers play an important role in the free enterprise system. Informed consumers thoughtfully evaluate the attributes of competing products and purchase the product that, in their eyes, provides them the best value for the need they are seeking to fulfill. This keeps competitors on their toes to innovate, develop quality products, manage costs, and meet consumer needs. Free enterprise and competition rewards the providers who deliver the best products and services at a good value. Highly differentiated products that are responsive to consumer needs can command higher prices and/or gain market share.

Herein lies the problem with respect to procuring audit services. Other than the industry expertise of engagement team members, **audits are relatively undifferentiated products that have fallen victim to commodity pricing**. Audit committees know very little about the underlying quality of the services they are procuring. In those circumstances, price is likely to be a leading differentiator.

The Adverse Effects of Commodity Pricing

The complexity of today's financial and accounting world requires that highly skilled professionals have suitable time to conduct and supervise high quality audits. These highly skilled professionals deserve to be appropriately compensated. However, even with the existing Big Four "quadropoly," downward pricing pressure continues to be intense. Audit firms are challenged to appropriately compensate their partners in a commodity pricing environment. This has resulted in intense pressure for the Big Four firms to reduce costs. Cost reduction efforts have focused predominantly on increasing individual productivity at all levels in the audit firm supplemented by the off-shoring of audit services to low cost jurisdictions. This has resulted in an audit firm business model characterized by:

- Heavy staff workloads that lead to high turnover that drive down experience levels, staff continuity, and efficiency.
- Heavy partner workloads and high staff to partner leverage ratios that undermine the partners' ability to adequately supervise the professional staff

Inadequate partner supervision of inexperienced staff poses a serious threat to audit quality. Given the complexity of today's commerce and the technical accounting standards, this is hardly the model one would strive for if audit quality was our highest priority. Rather, we would be looking for reasonable workloads, high experience levels, high staff continuity, and partners with sufficient time to provide appropriate attention to the complexities of the audit.

To address this concern, I submitted a recommendation to the US Treasury Department's Advisory Committee on the Auditing Profession (ACAP) in 2007. The thinking behind my 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 CPA firm 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

During ACAP’s deliberation over my recommendation, former SEC Chief Accountant and PwC senior partner Don Nicolaisen stated:

“...the firms compete primarily on the basis of cost ... and it has been disastrous for investors and for the firms. I think it is in the best interest of everyone to identify some of those things that that would ... provide audit committees and investors an opportunity to better understand how firms compare amongst themselves – and what are some of those things that would lead you to engage an audit firm, other than price.”¹

Going Beyond Audit Firm Transparency Reports

What I am advocating goes well beyond firm-wide transparency reporting. To achieve the full benefit of providing transparency to audit firm operational metrics, it is essential that the audit regulator require the audit firms to disclose operational metrics in varying levels of detail for the respective constituents as follows:

<u>Metric Level</u>	<u>Audience</u>
Engagement Level	The Company’s Audit Committee
Office-wide	The Public
Firm-wide	The Public

This array of information will provide important context to the audit committee members who can compare the operational metrics for their individual engagement to the office-wide metrics for the primary office serving their account as well as the metrics for the other competing offices in the same geography. One will not need to put the audit out for tender to understand how the service delivery model for their auditor in the immediate geography compares to the service delivery model for competing offices in the same geography.

It is obviously imperative that the metrics be prepared on a standardized method so that comparability among competing firms would not be a problem. Much of this information is already used by the audit firms to manage each engagement, each office, and the firm. I believe these would be very reasonable and common sense information requests. To stave off any concerns about unintended consequences, I would invite the audit firms to provide their own version of “Management’s Discussion and Analysis.”

An Overview of Audit Quality Indicators in the United States

If you have not already done so, I encourage the Competition and Markets Authority to take a close look at the work done in the United States pertaining to Audit Quality Indicators. I believe the following documents will be particularly useful:

¹ From the April 1, 2008 deliberations of the US Treasury Department’s Advisory Committee on the Auditing Profession.

- The PCAOB's Concept Release on Audit Quality Indicators dated July 1, 2015 at https://pcaobus.org/Rulemaking/Docket%20041/Release_2015_005.pdf
- My responses to the PCAOB Concept release that can be found at https://pcaobus.org/Rulemaking/Docket%20041/002_Conway.pdf and https://pcaobus.org/Rulemaking/Docket%20041/050_Conway.pdf
- The Center for Audit Quality publication titled "Audit Quality Indicators – The Journey and Path Ahead" dated January 2016 at https://www.thecaq.org/sites/default/files/auditqualityindicators_journeyandpath2016-2.pdf

I have long believed that audit committees would be willing to pay more if they had good reason to believe they were going to get more in return. Audit quality indicators create the opportunity for that to happen **at the engagement level, at the office level, and firm-wide**. All things being equal, audit committees will reward the audit firm that can deliver a better mix of specialists, partners, managers, and experienced senior time relative to less experienced professionals. A better mix means better supervision and review by the most experienced professionals. As the PCAOB notes, this can facilitate a discussion at the audit committee level that will lead to more informed decisions about auditor selection and retention.

You may find it useful to contrast for a moment the wealth of information available to buyers of products and services such as automobiles, consumer electronics, and air travel to the relative void of information available to audit committees when selecting among competing audit firms.

Defining Safe Zones of Operation

The operational metrics listed on the prior page can be used to define "safe zones of operation" at the office and individual engagement level. When the metrics indicate operation outside the safe zone, I would expect the firm to implement safety measure 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. In the US, the quality control standards are sorely in need of upgrade to build in requirements for the definition and monitoring of audit operations within safe zones. Perhaps similar needs and opportunities exist in the UK?

The Progress of Audit Quality Indicators in the US

While there has been great enthusiasm over the promise for audit quality indicators, the initiative has unfortunately morphed into an effort to definitely measure audit quality using the optimal blend of audit quality indicators. Naysayers have also expressed concern about unintended consequences. **The real question is whether audit committees would be better off with the information I am suggesting than without it?** From what I have read about the situation in the UK, my sense is that the capital markets would be better served if audit committees had the benefit of the incremental information I am advocating.

If you delve into the Center for Audit Quality (CAQ) information I referenced on page 5, you will see very positive results from pilot testing conducted by the CAQ. You will also seem some concerns expressed about the lack of context that stemmed from the fact that the CAQ pilot test did not include any information about the operational metrics for competing firms in the same geography. That concern would be quickly remedied with the varying levels of operational metrics (engagement level, local office, and firm-wide) that are described on page 4.

What About Professional Skepticism and Independence?

The benefits of providing transparency to audit firm operational metrics is an important part of the solution to improve audit quality. However, there are other important elements that contribute to audit quality. The operational metrics need to work in concert with robust inspection programs conducted by the regulator and the audit firm. Those inspection programs are your best weapon to enforce and institutionalize the ongoing importance of professional skepticism and independence.

That said, I would maintain that a healthy audit firm business model provides a much better platform for the exercise of professional skepticism than the model that exists today. A lean audit firm business model poses the risk that issues are either missed or identified late in the audit cycle because the audit partner is consumed with other matters. When issues are identified early by the audit team and the audit partner is involved in a timely manner, the audit firm is in a position of strength to get appropriate resolution. If issues are identified late, the client will typically say, "Why I am only hearing about this now. Your team has been out here for 3 months and our earnings release is this Thursday!" Such pressure can diminish partner judgement.

The Important Role of the Audit Committee

I am admittedly unfamiliar with the requirements for audit committee membership in the UK. If you haven't recently done so, I would encourage a close examination of whether the requirements to participate on an audit committee are sufficiently high to achieve the level of engagement I have described in the paragraphs that follow. I would also evaluate whether your rules provide sufficient separation of personal relationships between the Audit Committee and the CEO.

The responsibility of the audit committee to hire the auditor is great in concept. However, if the audit committee is not sufficiently engaged with the auditor and the audit committee relies heavily on management for a recommendation on auditor retention, you are likely no better off than you were before.

A high level of audit committee engagement in the auditor retention process will enhance the auditor's allegiance to the audit committee over management. This includes the audit committee's understanding of the auditors' business model, monitoring the achievement of the operational metric expectations set forth at the beginning of the engagement, and the resolution of instances where the audit firm over-promised and under-delivered. If the auditor has under-delivered, the audit committee need to understand the implications to the level of audit quality achieved.

The auditor needs to understand that they are first and foremost beholding to the audit committee and investors. The auditor will understand this if the audit committee is able to suitably challenge management and auditor conclusions that may be questionable. To do so, the audit committee needs visibility to the roll-forward of reserve balances for all judgmental accounts such as the allowance for bad debts, reserves for excess and obsolete inventories, sales return reserves, warranty reserves, the valuation allowance against deferred tax assets, reserves for uncertain tax positions, fair value estimates, impairment estimates, and the like. Penetrating questions will inform the audit committee as to the audit partner's level of engagement and the appropriateness of the audit partner's conclusions.

The audit committee also needs to keep a close eye on whether auditor sign-off dates for the earnings release are reasonable. Particularly troublesome are situations where important new information is made available to the audit firm late in the audit cycle and the auditors are placed under undue pressure to reach quick conclusions. Challenging judgments are difficult enough without excessive time pressure. History has shown that excessive time pressures can undermine good judgment. The audit committee needs to be alert to such situation and should intervene to avoid undue pressure on auditor decision-making.

Improving Independence and Skepticism by Prohibiting Entertainment

As an auditor, 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 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 beholding to -- management or the investors (via the audit committee)? 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 Wimbledon or other lavish entertainment venues. The US government contracts apply strict prohibitions on the entertainment of government workers by government contractors. Why should the auditing profession be any different?

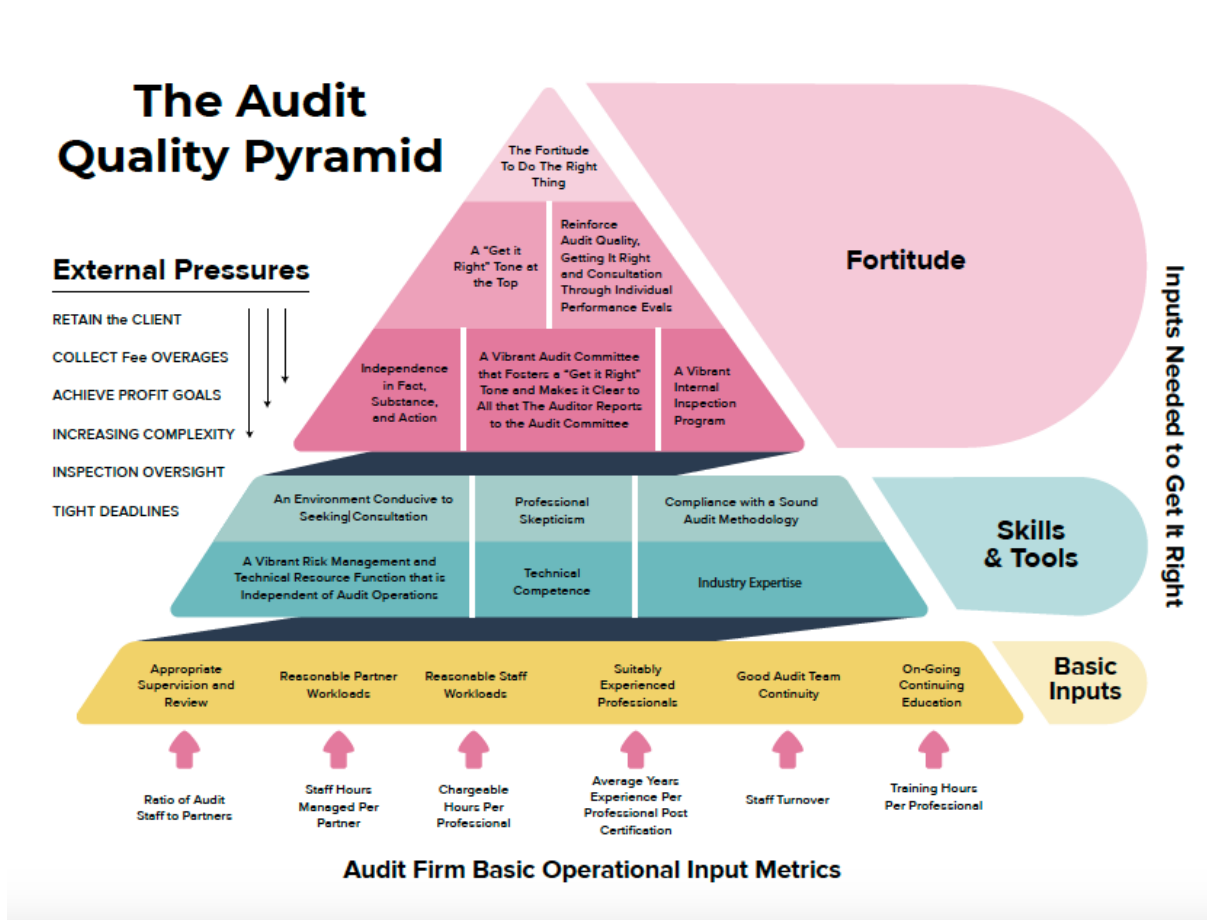
Closing Thoughts

I hope the information I have shared will stimulate a healthy discussion about the options available to the CMA to improve competition among audit firms leading to improved audit quality. I would be pleased to be of further assistance if you are interested.

Sincerely,

Robert Conway, CPA

The Audit Quality Pyramid



Author's Note: I prepared the above proprietary graphic to demonstrate the role of the operational metrics (at the foundation of the pyramid). The operational metrics do not guarantee that a high level of audit quality will be achieved; rather, the operational metrics are foundational to achieving audit quality. In other words, it is very difficult to achieve a suitable level of audit quality without a good operational foundation (time, technical knowledge, continuity, and supervision) for the delivery of high quality audits.