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Public Company Accounting Oversight Board
Attention: Office of the Secretary
1666 K Street, N.W.
Washington, D.C. 20006-2803

**RE: Rulemaking Docket Matter No. 37
Concept Release on Auditor Independence and
Audit Firm Rotation**

Members of the Board,

I appreciate the opportunity to submit my comments to the Board with respect to the Concept Release on Auditor Independence and Audit Firm Rotation (the Release). I retired from public accounting in 2007 after 27 years at Deloitte & Touche LLP and am currently a full-time faculty member at the University of Notre Dame teaching undergraduate and graduate courses in accounting and auditing.

By way of further background, I was the Professional Practice Director of the Chicago Office at the time of the demise of Arthur Andersen. The Chicago Office absorbed many of Andersen's most significant Chicago clients. This large influx of clients is relevant to the discussion of auditor rotation because it is illustrative of the impact that would occur if an office were to have a very large, unplanned increase in its audit client portfolio.

The Chicago office did not have sufficient professional personnel to serve the many new clients acquired in 2002; this resulted in our having to hire nearly 200 former Andersen audit personnel. Taking on a new client is a time-consuming process not only for the engagement team, but for the office quality assurance function and various specialists (industry, valuation, actuarial, etc.) as well. While it may have been preferable that former Andersen personnel not serve the same clients they had served in the past, this was only insisted upon in situations where re-audits were required. Many of the new clients were in particular industries (e.g., public utilities, airlines, pharmaceuticals) where the Chicago office did not have existing expertise. Partners and senior managers with expertise in those industries were relocated to Chicago from other offices but at manager, senior and staff levels, former Andersen audit personnel had to be assigned to continue serving their former clients.

As the Board knows, auditors must review registrants' quarterly reports. In a normal situation, the new audit engagement team must commence its procedures at the new audit client during the first quarter of the "new year" and prior to the predecessor auditors' completion of their audit of the preceding year. A review of the first quarter cannot be done without a sufficient base of knowledge. This is a significant undertaking involving not only the "headquarters" auditors but those in participating offices in the US or around the world as well. The personnel serving the new client are reassigned from their existing clients, but disruption is minimized by the fact that not all of those people serving the new client come from the same existing client.

In 2002 the changes to new auditors occurred throughout the spring and summer and new teams got into those new clients during the 2nd and early 3rd quarters of 2002. Some 10-Qs were delayed pending auditor review but that was understood because of the uniqueness of the Andersen situation. Despite that, the stress on the personnel complement and other functions was significant as the persons assigned to those new audits wrapped up old engagements and while simultaneously taking on the new ones. Given the number of people involved, existing clients were severely impacted and the audit partner complement in particular was put under significant stress as many partners carried client loads that were significantly greater – in some cases nearly double – what had previously been considered reasonable client service loads. Had all the auditor changes been required to occur at the 1st quarter of the year, those quarterly reviews would not have been able to be completed and, accordingly, none of those clients would have been able to timely file their 10-Qs.

Recommendation:

I believe the Board's ultimate objective is to improve auditor objectivity. To that end, the Board should look not at firms but at individuals. In particular, the Board should consider the natural tendency of individual auditors to identify with their clients. Several published studies, such as Bamber & Iyer in 2007¹, suggest that auditors typically identify with their clients after a number of years. In my experience, while there is substantial turnover among audit professionals, many of those who remain with the firm eventually becoming partners, serve on some of the largest clients of the firm and do so for many years. Those individuals can spend the first decade or more of their careers on those large clients. While the partners come and go every five or seven years, managers and senior managers may have been serving those clients for a dozen years. Those are the individuals who gather and interpret the evidence used by the partners to formulate judgments about financial reporting and control issues; they and their younger staff members are more likely to be impacted by the tendency to identify with a client than is a partner who has only been serving that client for a year or two. Accordingly, I encourage the Board to explore the feasibility of instituting a tenure limit of seven years not only for "other partners" who serve registrants, but for all audit personnel.

My comments to the Board's specific questions are as follows:

1. If the Board determined to move forward with development of a rotation proposal, what would be an appropriate term length?

First I do not agree with the concept of firm rotation. However, should the Board move forward, term length has to be long enough to minimize the number of registrants required to change in any one year. Even with a longer term limit and some method to phase-in the required rotation, the Board cannot assure that client turnover will be uniform across firms or across offices. At the extremes, one office may experience such a large net decrease in its portfolio of audit clients that it either must downsize and significantly reduce its headcount via layoffs or, for small offices, close; another office may experience such a large net influx of rotating clients that it experiences the chaos of the post-Andersen period resulting in major personnel relocations, decreases in overall quality of work and missed deadlines resulting in inability of registrants to timely file 10-Qs or other statements.

1 E. Michael Bamber & Venkataraman M. Iyer, "Auditors' Identification with Their Clients and Its Effect on Auditors' Objectivity", Auditing: A Journal of Practice & Theory, November 2007, Volume 26 Number 2, pgs. 1-24

2. Should different term lengths for different kinds of engagements be considered? If so, what characteristics, such as client size or industry, should this differentiation be based on?

I have no basis to judge term lengths by industry or size of company and am aware of no arguments advanced in favor of rotation referring to such characteristics as a basis for rotation. However, my post-Andersen experience would lead me to suggest that any industry that is served predominantly by two of the four large public accounting firms would be particularly damaged by forced rotation as any move to one of the other two auditors would require significant relocation and/or hiring of personnel. Similar to the Andersen experience, the new audit firm could end up hiring personnel from the predecessor firm to serve this new client negating any intended or perceived benefits of rotation.

3. Does audit effectiveness vary over an auditor's tenure on a particular engagement? For example, are auditors either more or less effective at the beginning of a new client relationship? If there is a "learning curve" before auditors can become effective, generally how long is it, and does it vary significantly by client type?

In my personal experience there is a learning curve of two or three years. The learning curve relates not only to the industry and workings of the new client, but of its people as well. While the predecessor auditors' working papers help one to understand the interrelationships among processes and financial statement elements, only time on-site helps one to learn about the people employed by that new client. Descriptions of client duties in auditor working papers don't include informal client relationships, customs, personalities and how they arrive at assumptions or make judgments. Observing client tendencies to be either aggressive or conservative takes time and multiple situations. How they handle an unusual item for example is not known until there is an unusual item to be handled.

4. Some have also suggested that, in addition to being less effective at the beginning of an engagement, an auditor may be less diligent toward the end of the allowable term. On the other hand, others have suggested that auditors would be more diligent towards the end of the allowable term out of concern about what the replacement auditor might find. Would auditors become more or less diligent towards the end of their term? Does the answer depend on the length of the term?

These conjectures are often based on the view of the audit firm as if it were an individual. An audit engagement team comprises many individuals, some in their first year serving the client some in their fourth or in some cases tenth year of service. Some partners may be perceived to be "more diligent" in their first year since they ask more questions because they don't know the client as well. Some partners may be perceived as more diligent in their fifth year because their questions are more penetrating as they have more knowledge on which to draw. The Board has the experience of half a dozen years of inspections on which to draw conclusions. How do audits of new clients compare with audits of those who have announced a change? The Board's inspection teams are certainly able to identify first year clients as well as those that have announced a change in auditors prior to year end; have inspectors found any patterns to suggest that auditors are either more or less effective in those situations? Have inspectors found any difference among partners who are in their first year of serving a client as compared to those in their fifth? My expectation is that there is not a difference in an individual's diligence related to upcoming rotation if for no other reason than the fact that so many other individuals are part of the audit process and those individuals are not necessarily rotating.

5. How much time should be required before a rotated firm could return to an engagement?

I believe the Board would be severely restricting the oversight of the registrant's audit committee if it were to specify anything other than a maximum term limit. Under Sarbanes-Oxley, the audit committee is the sole determinant of who the registrant retains as an auditor. Not only does forcing rotation undermine that oversight authority, but limiting the time period after which a predecessor can return further restricts the audit committee as to its ability to replace the newly engaged auditor.

6. Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers? Should the Board consider applying a rotation rule to some other subset of issuer audits? For example, are there reasons for applying a rotation requirement only to audits of companies in certain industries?

The larger the issuer relative to the size of the office(s) serving it, the more disruptive will be the rotation impact on the new auditor. Staffing large complex clients is not merely a matter of drawing from the auditors assigned to an office. In my experience with the former Andersen clients in Chicago, we were required to transfer partners and senior managers to Chicago from around the US to serve several of those clients not only because of a need for industry expertise but also because not all partners are sufficiently skilled to serve the very largest multi-national registrants. We had shortfalls in non-partner staff due to those same industry and experience factors, many of which we remedied by hiring former Andersen personnel. In a mandatory rotation environment with many clients changing every year, there is no means to predict which clients of what size and in which industry will come to an office so there is no way to plan headcount. While one can serve smaller clients adequately if one is slightly short-handed, unplanned rotation of major clients in significant numbers could cause the same post-Andersen disruptions on an annual rather than one-time basis.

I do not believe identifying specific industries for rotation is a viable option. Firms develop expertise in given industries over many years of serving clients in that industry and that expertise resides in the cities where those clients are located. Some industries are served primarily by two of the four largest firms – public utilities for example. That means auditors with the necessary training and expertise to audit those industries are not resident in all public accounting firms nor are they resident in all offices of a given firm. For example, if I were the audit committee chair of a registrant and my industry, say insurance, is only served by two firms in my city then my choice may be limited to only one other firm unless I am satisfied that one of the non-insurance expert firms in my city can timely relocate sufficient, appropriate personnel from elsewhere in the US to serve my company. However, if I were to be the only insurance company client for that new auditor in my city, I would be concerned about the quality of the audit my company would receive; a firm may transfer partners and senior managers but would likely not transfer the senior accountants and young managers trained in the insurance industry. My audit would be essentially an OJT program for the next two years.

7. To what extent would a rotation requirement limit a company's choice of an auditor? Are there specific industries or regions in which a rotation requirement would present particular difficulties in identifying an auditor with the necessary skills and expertise? Is it likely that some smaller audit firms might decide to leave the public company audit market due to the level of uncertainty regarding their ongoing client portfolios?

Numerous factors can impact a company's choice of auditor. Competitors don't often engage the same auditor. Office size and industry expertise in a given city are important as noted above. Audit committee chairs already deal with these concerns due to the five-year rotation requirement for lead partners; lack of depth of experience in the audit firm or the proposed engagement partner is often a factor in not choosing an audit firm to be one's independent auditor.

The Board recognizes that the very largest registrants in the world cannot be served by auditors other than the four largest firms not only because of the size of the firm or the number of employees it has, but because the smaller audit firm does not have sufficient capital to undertake the financial risk of auditing a very large registrant. Mandatory rotation limits the audit committee's choice to three firms; return limitations reduce the available pool to two firms should the audit committee determine that the engagement team for the new audit firm is not performing up to the committee's expectations. Middle-market or small registrants don't face this same constraint as they have scores of auditors from which to choose. The largest registrants do not have that luxury.

Industry limitations are as noted above.

8. If rotation would limit the choice of auditors, are there steps that could be taken to allow a company sufficient time to transition out of non-audit service arrangements with firms that could be engaged to perform the audit? Are there other steps that could be taken to address any limitation on auditor choice?

Non-audit arrangements are not the sole driver of limitations on choice of auditor and often not the primary driver. As noted above competitors' choices of auditors, auditor industry expertise and so on are important considerations. For multinational registrants, auditors' service capabilities in those areas of the world that are significant to the registrant are a primary concern; all firms do not have uniform service capabilities in all parts of the world.

As the Board knows, audit firms in the US do not control their international affiliates; they are not subsidiaries. Some of the non-audit arrangements that would be problematic from an independence standpoint are those that originate internationally and may not be known by the audit firm in the US or even the parent company registrant. Some auditor affiliates overseas practice under different names and some subsidiaries of US registrants do not use the name of their parent company. When we went through the client acceptance process for the former Andersen clients, we had to quickly take steps to identify and clear scope-of-service independence issues. Our overseas affiliates providing bookkeeping services to a small sales office in Southeast Asia, for example, would recognize the name of their local client but not the name of its parent. Large multinational registrants do not monitor expenditures at their subsidiaries at the extremely low levels that would constitute potential independence problems.

However, there are other independence issues besides non-audit services that impact auditor choice; for example, close relatives in positions of authority or ownership. To continue the earlier example, if I were an audit committee chair, and the CFO of my company is a sibling of one of the partners in one of the audit firms I am considering for appointment due to rotation, my ability to switch firms is further complicated by the independence requirements related to "close relatives" of audit partners. We faced this situation specifically with the Andersen personnel as one of the Andersen partners was the sibling of the CFO of an existing client. The prospective partner was not in a position to relocate for family reasons and thus could not be admitted to the firm. Had that client been contemplating a change to Andersen back in 2000 for example, it would not have been able to select Andersen as its auditor absent the termination of its CFO or Andersen's termination of the partner. In my personal experience, if an audit firm could not relocate a partner to cure a potential independence issue, it would decline the opportunity to be appointed as auditor.

An audit firm may also have other business arrangements that would preclude its appointment as auditor without significant cost. For example, a large mutual fund complex may be the investment vehicle for an audit firm's employee and partner benefit plans. The audit firm would not be able to accept appointment as auditor without moving all those investments to another fund complex. Audit firm personnel and their families also invest in non-audit clients and understand that an investment must be divested in the event it becomes an audit client; rotation would of course exacerbate this turnover in personal and family portfolios.

9. If rotation were required, would audit firms have the capacity to assign appropriately qualified personnel to new engagements? If they do not currently have that capacity, could firms develop it in order to be able to compete for new clients, and would they do so?

The assignment complexities related to the Andersen experience in the summer and fall of 2002 leads me to believe the audit firms will accomplish this painfully in the first year; however, it will become increasingly difficult as years go by due to the inability to predict how many net new clients one will have for any given year – or what the net loss of clients will be for those who experience such a net loss. The stress in the post Andersen period was significant, but mitigated by the fact that we knew it would be a one-time event.

The premise of this question is that rotations are uniform; however that will not be the case. For example, a firm might propose on ten possible audits hoping to get three to replace rotating clients. It might win none of those; it might win seven. There is no way for a firm to predict that it would be the winner of an audit engagement in a

particular office or a particular industry so there's no way to plan personnel complements to staff potential engagements. It would almost require firms to have a "stable" of auditors at all levels who could be relocated on very short notice to any city in the US. The impact on morale would be significant; the impact on employee retention would also be significant.

Additionally, I believe this would have an impact on the level of industry specialization among auditors. A net reduction in audit clients in a given industry would require some number of the professionals who specialize in that industry to re-tool themselves to serve in other industries or seek employment with another audit firm. Similarly, net increases in clients in a given industry beyond the availability of professionals trained in that industry would require assignments of non-specialists to those registrants. I found myself in that latter position as a partner when I was required to serve public utilities and later broker-dealers because of the lack of availability of specialists in our office and the inability to transfer into the office the necessary specialist partners. Not only does one experience the new client learning curve, but the industry learning curve as well.

As noted above, there is no way for the Board to predict how the changes due to rotation will fall in any office of any firm in any year. Firms will develop different models to deal with this. Some may go to regional mega-offices. Some may choose to have excess staffing to handle possible influx; others may choose to hire only in response to immediate staffing needs retaining a core group of "career" auditors. Some individual auditors might switch firms following their clients to the new audit firm after rotation. Again, because there's no model to predict how an audit firm's client portfolio will change office by office, there's no obvious model for how to manage personnel complements either by office or by industry.

10. Would rotation create unique challenges for audits of multinational companies? For voluntary rotations that have taken place, what have been the implementation and cost issues and how have they been managed?

As noted above, all audit firms do not have same service capacity in all parts of the world. An audit committee selecting an auditor today requires potential audit firms to demonstrate their ability to serve in various parts of the world. Those who have weak spots in critical areas don't get the work. A mandatory rotation process puts those firms into the mix forcing registrants to choose firms whose service delivery capabilities don't match the registrant's structure. This could result in the same staffing chaos overseas meaning wholesale changes in personnel complements or even whole offices changing from one international affiliation to another. It could also result in registrants retaining the incumbent auditor in certain international markets at key subsidiaries; this compounds the normal risk of miscommunication among international affiliates by adding the risk associated with multi-firm audits.

11. Would increased frequency of auditor changes disrupt audit firms' operations or interfere with their ability to focus on performing high quality audits? How would any such disruption vary by firm size? For example, would a rotation requirement pose fewer or more implementation issues for small firms than for large ones?

The comments above related to my experience with the post-Andersen client turnover situation are illustrative of the disruption I would envision were the Board to require mandatory rotation. As impacts will be felt at the office level, I believe they will be felt equally by large and small firms alike. However, large firms may have the means to address that impact in the short term through relocation of personnel. That is, an office that loses 100,000 audit hours due to rotation may get 50,000 back in new audits leading to layoffs or transfers. The very next year, that same office may experience a net increase of 100,000 new hours. Relocating staff from office to office around the country to meet annual fluctuations such as this would place significant strain on a large firm. For a small firm that does not have the same depth of personnel, an impact such as this would be so highly disruptive that I suspect small firms would be forced into mergers with other small firms or would depend on CPA staffing services to fill short-term gaps. For both large and small firms I believe this would significantly reduce audit quality.

12. Would audit firms respond to a rotation requirement by devoting fewer resources to improving the quality of their audits? Would firms focus more on non-audit services than on audit services?

The ever-present risk of litigation and PCAOB inspections would help ensure that firms do not devote fewer resources to maintaining audit quality. If the Board adopts mandatory rotation, firms will do what they need to do just as with the Andersen situation. However that was a one-time event that people recognized would not be repeated. If the possibility for a major influx of work exists every year, the stress exists every year. Similarly, if the possibility for a major net loss of clients exists every year, the possibility for layoffs and office downsizing or closing exists every year. Accordingly, the ability of firms to retain top talent in their audit functions will be strained.

13. Would rotation have any effect on the market for non-audit services? Would any such effect be harmful or beneficial to investors?

The consulting practices in public accounting firms are somewhat autonomous. The people in those practices are not part of the audit practice; they work independently and sell services usually without the knowledge of their auditor colleagues. I believe the consultants would continue to sell to non-audit clients and take their chances that they would have to give up their consulting client in the event it became an audit client. It would likely not impact overseas locations where services are sold by the affiliates of US public accounting firms; overseas consultants are even less likely to be concerned by possible future US independence issues.

14. Some have expressed concern that rotation would lead to "opinion shopping," or that in competing for new engagements firms would offer favorable treatment. Others have suggested that rotation could be an antidote to opinion shopping because companies would know that they could not stick with a firm promising favorable treatment forever. Would opinion shopping be more or less likely if rotation were required? If rotation limits auditor choice, could it at the same time increase opinion shopping?

I have no basis to know whether opinion shopping would be tried by registrants but I believe auditors would detect that in the proposal process and consider it a negative trait in management leading to concerns about management integrity. A registrant that does attempt to opinion shop likely would have fewer firms willing to serve as its auditor compared to a non-opinion shopping firm, all else equal.

15. What effect would a rotation requirement have on competition for audit engagements? If competition would be increased, how might that affect audit quality?

The Board should understand that despite the relative low level of rotation, auditors currently operate in an environment that is highly competitive. Auditors currently compete for re-appointment by the audit committees of their clients every year. Auditors on even the very largest audit client in the world fear that there is at least one other firm that would be more than willing to serve their client for the upcoming year. And while the number of firms the largest registrant could look to as potential new auditors is limited to "the other three" because they are the only firms with sufficient capital to accept the risk associated with that audit, the possibility that the audit committee could make that change makes the audit landscape highly competitive. Auditors in small audit firms also know that the audit committees of their registrant clients have dozens of firms that could take their place. That tension of potentially being replaced is ever present. To the extent audit committees truly fulfill their role of auditor oversight; the threat of replacement each and every year should serve to keep the auditors committed to performing high-quality audits. Rotation would not increase competition; it would merely make client turnover certain and remove an ace-in-the-hole from the audit committee's hand.

16. Are there any requirements the Board should consider to mitigate any risks posed by rotation? For example, are there enhancements to firms' quality control systems that might address such risks?

Based on my experience watching the Andersen debacle the Board cannot do anything to mitigate the risk that will come with personnel staffing issues. You will cause those issues, exacerbate any that already exist and

generally throw human resource planning into a state of confusion. Firms will not be able to plan hiring; will likely be faced with increasing needs for layoffs on a city by city basis; and dramatically alter their recruiting on college campuses. Hiring from those laid off by other firms will increase the number of people in the office who must be trained in new audit methodologies and learn to work not only with new clients but new colleagues. This will reduce audit quality and make it more difficult to hire people and give them any assurance of the possibility for a career. I suspect some auditors will become “carpet baggers”, taking their skills from audit firm to audit firm as clients rotate.

17. If the early years of an auditor-client relationship pose higher audit risks than later years, should the Board require firms to provide additional audit supervision and oversight in the first year or two of a new engagement? Should the Board impose such a requirement for auditor changes even if it does not further consider requiring audit firm rotation? If firms are accepting new clients but are unable to perform quality audits for them until several years have passed, should the Board require enhanced client acceptance procedures? What impact would additional requirements of this type have on audit costs?

This will further exacerbate the staffing problem. A potentially large influx of new audit work to a given office would not only have to be staffed for engagement startup but also for PCAOB-mandated additional startup. As noted above, a big part of the learning curve in the initial years of an audit relate to the auditors’ learning about the client personnel and their behavior patterns. I do not believe this sort of knowledge is gained through additional “procedures”.

That being noted, what has the Board learned from its inspection program? Have inspectors looked at a sample of first year engagements and then come back to those same engagements two or three years later for comparison? Have the inspectors noted “best practices” by any of the firms related to first year audits? If so, I believe the Board should share those best practices with the registered firms either formally or informally, however those best practices should not become standards; they should be allowed to evolve and improve over time.

18. If mandatory rotation were required, are existing standards relating to communications between predecessor and successor auditors sufficient? Should additional communications be required? For example, should the outgoing auditor provide the incoming auditor with a written report outlining audit risks and other important information about the company?

In my experience, information provided by predecessor auditors is adequate to understand the basics at a new audit client, though some firms do provide more information than others. One learns a great deal in particular from the listings of both corrected and uncorrected misstatements. However, that information is also provided to the registrants’ audit committee annually so it is also in a position of knowledge with respect to the technical strengths and weaknesses of management. Firms tend not to give access to proprietary working papers, much of which relates to risk and risk assessment. Successor auditors do have access to the written communications given to the audit committee; however audit committees aren’t necessarily forthcoming with respect to the non-written communications from their auditors. Information provided is not uniform across firms or even across partners. Standardization of this communication process would be appropriate whether or not the Board adopts mandatory rotation.

19. Are there other audit procedures that should be required to mitigate any risks posed by rotation?

I do not believe the risks attendant on rotation are a function of audit procedures; the risks are a function of execution with the appropriate complement of people. Given that the Board can’t control the number of clients switching to a given firm in any year, or event that a given firm or office gets any client in any year, the management of that compliment of people is the primary factor in those risks. The Board cannot develop procedures that mitigate the chaos in an office that suddenly must double in size or one that must radically downsize.

20. If the Board moved forward with development of a rotation proposal, should consideration be given to the recommendation for a cause restriction on the company's ability to remove an auditor before the end of a fixed term? Would such a provision be useful? Would there be unintended consequences of such a requirement? Should the Board work with the SEC on implementation of this recommendation? Are there other matters on which the Board should coordinate with the SEC?

If the Board moves in this direction it would be directly usurping the power of the audit committee to exercise oversight of the independent auditor. If you take from that committee the authority to hire and fire the outside auditor, you effectively make them powerless.

21. What other transition issues might arise in the first year of a rotation requirement? How should the Board address these issues?

While I have tried to think of issues that would arise should the Board move to mandatory rotation, I have no doubt there are many issues that neither I nor anyone else will be able to anticipate. Just as the Justice Department likely underestimated the impact of its indictment on Andersen, I suspect the Board would underestimate the impact of mandatory rotation. Like the ancient Greek fable about Pandora, once the box is opened, the damage done would be very difficult to reverse.

I appreciate the opportunity to offer my comments.

Sincerely,

s/ James L. Fuehrmeyer, Jr.

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