

Leon J. Level

December 7, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W., 9TH Floor
Washington, DC 20006-2803

Re: PCAOB Rulemaking Docket Matter No. 37, "Concept Release on Auditor Independence and Audit Firm Rotation"

FILED ELECTRONICALLY
(comments@pcaobus.org)

Dear Board Members and Staff:

Thank you for the opportunity to comment on the Public Company Accounting Oversight Board's (the "Board") "Concept Release on Auditor Independence and Audit Firm Rotation" Release No. 2011-006 (the "Concept Release"), which was issued August 16, 2011.

I have been involved with financial reporting and monitoring the performance of external audit firms for over a decade in my current roles as the Chairman of the Audit Committees for Levi Strauss & Co. and UTi Worldwide, Inc. and in my previous role as Chairman of the Audit Committee for Allied Waste Industries, Inc. Further, for 17 years, from 1989 to 2006, I served as Chief Financial Officer and Director of Computer Sciences Corporation. However, this letter reflects my opinions as an individual and my comments should not be taken to represent the views of any of these organizations.

It is worth noting that over time I have personally observed a significant improvement in the performance of Audit Committees. Audit Committee members have become more competent, focused, engaged and involved. Other board members look to Audit Committee members to discharge their financial reporting oversight responsibilities in a highly effective manner.

One of the primary responsibilities of the Audit Committee is the selection and performance evaluation of the external auditor. My experience has been that Audit Committees take this responsibility extremely seriously, diligently evaluate the quality of the work being performed by the auditor and initiate appropriate action when they perceive a lack of performance or independence up to and including initiating a change in auditor.

In my opinion, Audit Committees are already properly evaluating external auditor performance, including assessing whether the auditor is remaining appropriately independent, objective and adequately challenging management's accounting decisions

and processes. I do not think mandatory audit firm rotation will further improve audit quality or accomplish the PCAOB's goal of preventing audit failures, quite the contrary.

Improvements in Audit Quality

I think there have been many improvements in audit quality, as well as financial reporting, in the years since enactment of the Sarbanes-Oxley Act. The wide-ranging provisions of the Act and associated SEC regulations included:

- Provisions requiring Audit Committee members to be independent.
- Determination and disclosure of audit committee members deemed to be financial experts.
- Requirements prohibiting audit firms from providing non-audit services which could impair their independence.
- Provisions mandating rotation for the lead engagement partner and technical review partner (Engagement Quality Reviewer) after five years service.
- Empowering the audit committee to appoint and approve fees for the company's external audit firm.
- Requirements for management and the auditor to report on the effectiveness of internal controls over financial reporting
- Establishment of the PCAOB to oversee and regulate the public company auditors.

In addition to the forgoing requirements, the PCAOB has in recent years issued new audit standards (many of which have only recently taken effect) relating to a range of topics designed to improve audit quality (Audit Standards Nos. 7 through 15). I think that the benefit of these actions should be evaluated before considering measures which would involve disruptions of the magnitude mandatory firm rotation would entail.

In point of fact, audit firm rotation already takes place today on a voluntary basis (in the absence of a specific regulatory mandate) when audit committees elect to make an auditor change. Audit committees are not reluctant to change auditors when they determine a change is necessary based on their assessment of the firm's audit services. Audit committee decisions are based on all factors important to audit quality, including, but not limited to, independence, objectivity and professional skepticism.

Perhaps one of the best indications of improvements in the integrity of financial reporting and audit quality is the substantial decline in public company restatements in recent years. A study issued by Audit Analytics in May 2011 indicated that restatements have declined from a high of 1,795 in 2006 to 735 in 2010 and average impact on net income declined from \$25.5 million to \$5.0 million.

Risk of Audit Failure: Root Cause Analysis

One of the fundamental premises stated in the Concept Release supporting the need for mandatory audit firm rotation, is that audit failures derive from a lack of independence from management. On page 7 of the Concept Release, the Board cites excerpts from five inspection reports to support this premise. The first of these excerpts states “The audit partners . . . may have (emphasis added) a bias towards accepting managements’ perspective, rather than developing an independent view” and the four following excerpts provide somewhat similar comments. One issue is there are only five examples cited. Among other flaws, these are general inference statements and there is no root-cause analysis of any factual issue providing evidence lack of independence resulted in an audit failure.

There is in fact no empirical evidence to prove lack of independence from management has resulted in significant numbers of audit failures. From my own experience, it seems more likely over reliance on management representations results from ever shortening reporting deadlines, or a lack of technical knowledge of what additional procedures to perform, or a combination of these and other causes.

Audit Quality

As pointed out in the Concept Release, and as has been noted in other studies, there are a number of potential negative consequences to mandatory auditor rotation. One drawback would be Audit Committees would be less inclined to initiate auditor changes in the event of poor performance, because it would be simpler and easier to wait until the mandatory rotation time. This would have the effect of encouraging Audit Committees to accept substandard performance by auditors, particularly in the final years of an audit engagement term.

My experience has been that the quality of an audit improves over time as the audit team gains more knowledge and experience with the client’s business, processes, systems and personnel. Mandatory audit firm rotation would increase the frequency with which public companies have to deal with a learning curve for its auditors. It seems an increase in the volume of changes in auditors across the breadth of all SEC registrants would drive a higher number of audit failures. It also would weaken investor’s confidence in the quality of the U.S. financial reporting process.

Another drawback to mandatory rotation is in the latter part of the audit engagement term, an audit firm may be less inclined to devote its best resources to a client it knows it will be losing. Firms may be more inclined to assign their best resources to winning and staffing new client engagements. This could have the effect of draining talented audit team members away from clients in the later years of audit engagements.

In fact, the entire audit team assigned to a client with an approaching rotation deadline would have a natural inclination to be concerned about future roles and assignments. This would result in time being spent by the assigned participants on efforts to find a new home, whether it be on another client of the firm or at another firm or business. This natural tendency on the part of the assigned team members would be a significant distraction to the performance of their duties at this client.

Costs of Mandatory Rotation

Without question one of the most significant consequences of mandatory audit firm rotation would be the substantial incremental cost. Finance professionals who are familiar with the audit process recognize there is a significant cost associated with the selection and start-up of a new external audit firm. There are costs borne by the audit firm in proposing and ramping up a service team. The GAO report on the potential impact of mandatory firm rotation (issued in November 2003) noted “first year audit-related costs could range from 43 percent to 128 percent higher than the likely recurring audit costs had there been no change in auditor.” There are also costs borne by the company in the selection process and knowledge transfer to the new audit firm. These more frequent audit start-up costs would be an additional layer of new costs we would be forcing upon SEC registrants other global competitors would not have to bear.

Market Constraints and Macroeconomic Impact

Another drawback to mandatory rotation cited by numerous observers is the limited number of audit firms with the capability to properly serve multi-national companies, which includes having the expertise in specific industries as well as regions of the world. Audit firms may not have adequate partner depth in cities where a particular multinational company is based or has significant operations. Most multi-national companies also utilize international audit firms for non-audit service needs, further limiting their options for rotation to another firm.

I do not think mandatory rotation is realistic in a market with limited service providers. A 2003 GAO study indicated that the four largest firms audit public companies comprising 99% of public company revenues. Moreover, even if mandatory rotation were realistic, I think any benefit gained in auditor independence, skepticism and objectivity would be dwarfed by reductions in audit quality.

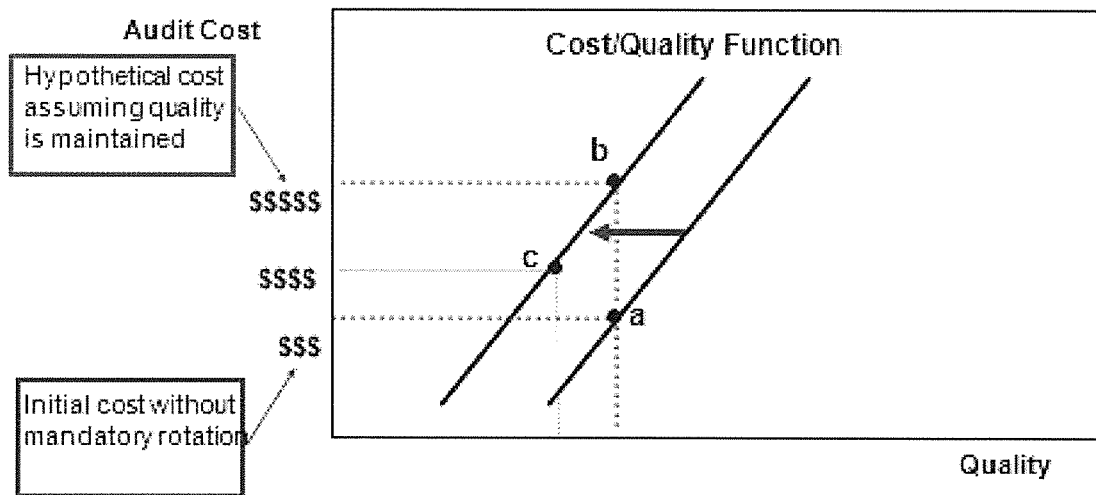
In addition to the macroeconomic constraints, which would likely render mandatory audit firm rotation unrealistic, the disruption this would cause to the business and operations of the audit firms could lead to serious negative impacts to the firms and instability in the market as a whole. Rotation may also result in other adverse impacts on the profession and market. Instability caused by mandatory rotation, exacerbated by limited number of firms, could erode firms’ ability to effectively plan and manage growth or contraction.

This would threaten their ability to make investments in methodology and tools, training, industry specialization and innovation critical to audit quality. Market disruption could also threaten career development and further lessen the overall attractiveness of the profession, which could lead to declines in qualified resources.

As a consequence, I think mandatory audit firm rotation could very well not only increase audit costs but at the same time lower audit quality. The following graphic representation illustrates my view.

Impact on Cost/Quality Function of Mandatory Rotation

Costs increase from "a" to "b" assuming quality is maintained. If however mandatory rotation erodes audit quality due to the negative impact on other factors critical to audit quality, cost could actually increase while quality declines "c".

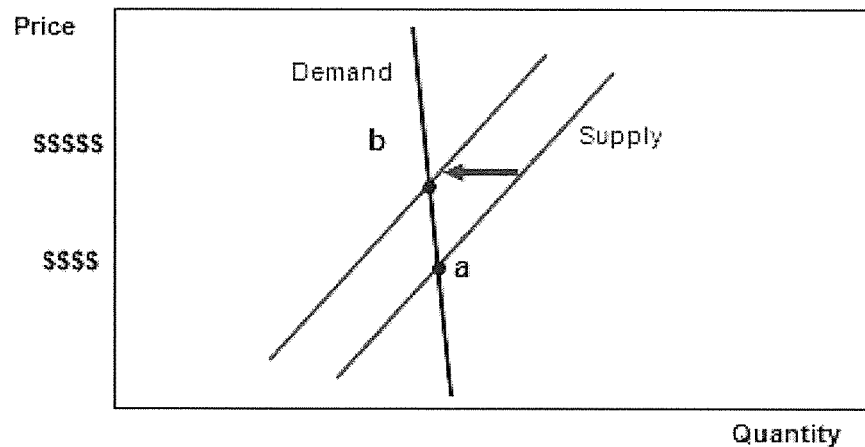


The shift in the cost/quality function results from cost increases arising from the direct and indirect consequences of mandatory firm rotation (first year learning curve start-up costs, personnel relocation costs, increased training and development to address industry specialization, decreased utilization rates due to client turnover, etc.). As a consequence, audit costs will be higher to deliver audit services while maintaining a constant level of quality.

More generally, my view of the macroeconomic impact of mandatory firm rotation on the market for public accounting services is represented in the following chart.

Macroeconomic Representation: Impact on the Market for Audit Services

Mandatory firm rotation shifts supply for audit services so that for any given quantity of services the price would be higher. The demand function for audit services is nearly vertical reflecting the inelastic character of demand as a result of regulatory requirement.



Similar to the cost/quality function, the shift in the macroeconomic supply function for audit services results from cost increases arising from the direct and indirect consequences of mandatory firm rotation (first year learning curve start-up costs, personnel relocation costs, increased training and development to address industry specialization, decreased utilization rates due to client turnover, etc.). As a consequence, audit costs will be higher for any given volume (or quantity) of services.

Although market supply is represented to be linear, supply would more nearly be more inelastic in the short term due to market scalability constraints. This might be better represented by a geometric function where the slope increases continuously as quantity increases becoming nearly vertical as supply approaches practical market capacity. This is particularly critical to the market for audit services due to the limited participants which constrains market responsiveness.

In a microeconomic context, the price/quantity (or supply) function for an individual firm is somewhat more inelastic (steeper slope of the line – price increases more rapidly for any given increase in volume, or quantity, of audit services) than for the market as a whole. This is due to scalability constraints for a single firm over the relevant time horizon. Mandatory firm rotation will result in significantly greater volatility in demand and increase the difficulty associated with planning and managing growth and contraction for each firm, similar to the overall effect on the market as a whole.

I am concerned that since supply is concentrated in the four largest firms, the potential market disruption as a result of this proposed regulation would effectively further constrain supply of audit services available to any given company. Thus mandatory rotation would produce the exact opposite of the intended outcome and result in not only an increase in cost but decline in audit quality. As a consequence, I would recommend a detailed economic study be performed, including development of econometric models, in order to fully evaluate the potential impact on both audit quality and costs. I think this would be necessary in any event to fulfill the statutory requirement to evaluate the cost associated with such regulations.

Alternative Recommendations

While I think further analysis is needed to determine whether lack of auditor independence is truly a driver in audit failures, if this were determined to be a root cause, there are a variety of alternative solutions which should be considered.

I think the following example alternative measures would more likely improve audit quality without the substantial disruption and cost associated with mandatory firm rotation.

- The best means of improving audit quality is to leverage the audit committee's role for oversight of the company's financial reporting, including the responsibility for appointment and compensation of the company's independent auditors mandated under Sarbanes-Oxley. I recommend strengthening the criteria for designation as a "financial expert". The refined criteria might include requiring a more in depth understanding of financial reporting matters which might be gained either as a chief financial executive or in the public accounting profession.
- Another possible means of leveraging the audit committee's governance responsibility might be for the PCAOB to share its findings or the results of its inspections with the companies inspected. Audit committees could then take steps to ensure any deficiencies identified are appropriately addressed in the auditor's examinations of financial statements and internal control over financial reporting.
- An alternative means of directly addressing independence, objectivity and professional skepticism might be to broaden the rotation requirements relating to senior audit firm engagement personnel. Broader rotation requirements for individual engagement partners and senior managers serving significant business units may strengthen independence, objectivity and professional skepticism. Rotation requirements might also be established to address the collective period of service including services provided by an individual at all levels – staff accountant, senior, manager, senior manager and partner. This same principal could apply to individuals moving from firm to firm. I believe this approach

would be more effective than mandating audit firm rotation because independence, objectivity and professional skepticism are more nearly a function of individual engagement team relationships, than the corporate relationship between the registrant and the audit firm.

In summary, I think Audit Committees are adequately monitoring auditor performance and independence, that there is no empirical evidence proving lack of auditor independence is a significant or frequent cause of audit failures, partner rotation and auditor rotation does already occur, and there are significant drawbacks and costs associated with mandatory audit firm rotation.

Thank you for the opportunity to comment on this Concept Release. I appreciate your consideration of my comments.

Sincerely,

A handwritten signature in black ink, appearing to read "L. Level", written in a cursive style.

Leon J. Level

cc: Mr. James R. Doty, Chairman
Mr. Lewis H Ferguson, Board Member of the PCAOB
Mr. Daniel L. Goelzer, Board Member of the PCAOB
Mr. Jay D. Hanson, Board Member of the PCAOB
Mr. Steven B. Harris, Board Member of the PCAOB