Mueller Water Products

December 13, 2011

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

Subject: PCAOB Rulemaking Docket No. 37

Gentlemen:

Mueller Water Products, Inc. is pleased to have this opportunity to comment on the PCAOB's proposal to impose independent auditor rotation requirements for the attestation function related to a public company's financial statements.

We recognize the importance of proper financial reporting and that it is our responsibility to prepare our financial statements in accordance with generally accepted accounting principles. We also recognize the role of the independent auditor to help ensure the investing public that they are getting proper financial information.

The premise that rotating auditors will improve auditor independence and thereby lead to fewer audit failures is dependent on the assertion that the current level of audit failures is unacceptably high and therefore in some need of remedial action. This assertion is unsubstantiated. The PCAOB Release cites numerous hypotheticals, but nothing to conclude that mandatory auditor rotation would improve current audit quality in any measurable way. Thousands of audits are performed every year and hundreds of thousands of audits have been performed over time. No set of controls should be expected to be perfect, but the number of audit failures for any reason has been relatively few. The number of audit failures due to a lack of independence would be a subset of total audit failures. In order for the PCAOB to promote mandatory auditor rotation as a means to improving audit quality, the PCAOB needs to establish (1) that auditors are not sufficiently independent and that this lack of independence results in poor audit quality and (2) that the higher costs associated with mandatory rotation of auditors are outweighed by the benefits of improved audit quality.

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Mandatory rotation of independent auditors will increase a company's audit costs substantially.

In the initial year or first several years of a new audit firm's engagement with a company, that firm devotes a significant amount of resources to learning and documenting financial reporting systems and transactional processes and systems, gathering historical documents and developing relationships with company personnel throughout the company. The PCAOB Release cited an estimate that initial year audit costs were more than 20% higher compared to a normal year. In a competitive bidding situation involving an incumbent audit firm, the new audit firm is at a huge disadvantage compared with the incumbent firm since the incumbent firm does not have to incur these additional costs. Removing the incumbent firm from the bidding process will remove an incentive for prospective auditors to submit a lower bid to compete with an incumbent. This will drive audit costs higher.

Even though an initial year audit might cost 20% more than a normal year audit, it cannot be assumed that these higher costs result in a better audit. These higher costs are required to get the audit team up to a baseline standard of performance. It would be easier to assume that the initial year of an audit engagement is the lowest in terms of audit quality simply because so much time is spent just understanding the basics of the company.

A company's time and other resources devoted to getting a new audit team up to speed are significant. Company personnel are involved with most of the procedures performed by the independent auditors. Company personnel generate auditor workpapers; identify, pull and replace supporting documentation; answer questions; coordinate timing and location of audit procedures; chaperone auditors around company facilities, etc. If the independent auditors are spending more time in the early years of an engagement, company personnel are spending more time with this process too. There is a very real cost associated with the level of company personnel assistance to the independent auditors. The more frequently this change occurs, the higher these costs will be.

The PCAOB Release questions whether audit firms should be required to devote more higher-level resources in the early years of an audit engagement to reduce audit risk. These higher-level resources will increase auditor costs since higher-level resources cost more than lower-level resources. It is illogical to assume more higher-level resources would replace a larger volume of lower-level resources such that overall audit costs would decline. It would be in the audit firms' best interest to already be doing this if this were true. Devoting more higher-level resources to the audit process will increase audit costs.

A public reporting company is required to file financial statements covered by auditor opinions generally over three years. The company is required to get the consent of its independent auditor to associate its opinion with a set of financial statements. After a change in auditors, such consents must be obtained from multiple auditors for at least two years until the same auditor has enough tenure to be responsible for all of the years covered by the current set of financial statements. Getting prior auditor consents is expensive. These consents are expensive because there is no competitive bidding process. Management time and other resources are also required to work with the predecessor auditor to get their consent to include their opinion with the financial statements. These management costs are also expensive.

The integrity of the financial reporting process will be compromised as the number of financial statement restatements will increase.

- Some accounting and financial reporting applications are very complex.
- Different people, different companies and different auditing firms will reach different conclusions regarding complex situations.
- As companies change independent auditors, prior decisions will be re-examined and the new auditor may disagree with prior conclusions.
- A different conclusion will result in a restatement since the prior financial statements, under current rules, will be deemed to contain an error that must be corrected.

Some accounting and financial reporting applications are very complex and may apply to a single event that affects several years of financial statements. Management and independent auditors work very hard to ensure a common understanding of facts and circumstances to ensure proper accounting and financial reporting. However, changing auditors exposes these facts and circumstances to different people who might draw a different conclusion that is simply an honest professional disagreement. It is highly unethical for a company to get an advance agreement (which might be deemed "opinion shopping") with a prospective independent auditor over the handling of a specific item. Similarly, there is a required disclosure of both the company and its prior auditor stating whether there has been any disagreement over an accounting matter that led to the dismissal of the auditor.

A publicly traded company may be subject to dire consequences, perhaps even prohibited, from filing financial statements with other than an unqualified opinion. Management and the two sets of auditors may not be able to agree on a common solution. Each of the major audit firms has its own set of precedents handling certain situations. If two firms differ, there will be no common ground since neither side will have the flexibility to change. The predecessor firm is even less incented to find an amicable solution since they were recently replaced. The new firm might then have to, and be incented to, re-audit prior year financial statements. Audit costs just got significantly higher. Whether prior financial statements or an auditor opinion gets changed, an explanation may be required that many readers will not understand. Presenting confusing disclosure cannot be in the best interest of good financial reporting.

The PCAOB Release suggests that the "fresh look" of new auditors will increase investor confidence in the integrity of a company's financial reporting. We believe the opposite is more likely to occur. Financial statement restatements agitate the investor community, which subjects the company and its independent auditor to a greater risk of a lawsuit for misleading stockholders. This is a relatively easy argument. Changing previously reported information indicates the previous information was inaccurate. Regardless of whether the change made the company look better or worse, some investor bought or sold the company's securities during the period between when the original information was released and when it was corrected. Some investor will have an argument that they were damaged by relying on information that turned out being inaccurate.

Litigation against a company and its independent auditors can be very expensive regardless of the merits or eventual outcome of such litigation. Any litigation risks against the public accounting profession are going to be built into its pricing model as higher audit fees.

A "fresh look" at a company's financial reporting practices already exists in the form of partner rotation for both the engagement partner and concurring partner positions of an audit team. These positions change every five years, but this has only been mandated since the passage of the Sarbanes-Oxley Act of 2002. It is too soon to determine the effectiveness of this rotation cycle in favor of the much more extreme alternative of rotating the entire firm.

Mandatory rotation of auditors will increase audit failures.

Publicly held companies tend to be large, complex organizations, and it is not reasonable to expect a brand new audit team to be as familiar with such a company as an experienced audit team with that company. This unfamiliarity breeds risk and there is very little time to get up to speed. A new auditor of a public company does not have a year between annual financial statements reporting cycles to learn the ropes of their new client. They have less than one fiscal quarter before they would have review responsibilities. This risk can be addressed with additional resources, but that adds costs (which have been addressed earlier in this letter).

The PCAOB Release contains commentary suggesting that the auditor about to be rotated off of an engagement will be especially diligent in their work because they do not want the new auditors to find fault with their work. This may or not be true, but there is no evidence to support either side of this position. We believe the opposite is also reasonably likely to be the case, that the exiting auditor may be less likely to perform their work at a high standard. Before such a big change as mandatory rotation of auditors would be implemented, we encourage the PCAOB the thoroughly study the impacts of a mandatory rotation of auditors on audit quality.

Mandatory rotation of auditors may not even solve the problem it is intended to address.

Audit failures can occur for various reasons. Most of the PCAOB Release seems to be addressing poor audit practices, but the only aspect of the audit process addressed by mandatory auditor rotation is independence. Whether poor audit practices are the acts of an individual auditor or systemic throughout a firm, this is not an independence problem and rotating audit firms will not fix this problem. Changing audit firms does not necessarily address auditor independence. It is reasonably possible that an audit team changes audit firms. This certainly happened with the demise of Arthur Andersen several years ago when large sections of their audit staff moved together to other firms. It would be naïve to believe that the new firm did not anticipate the former Arthur Andersen partners bringing as much of their client base with them as they could.

Any mandatory rotation will need to address the longer term issue of who the audit firm can be in subsequent rotations. Any pattern of switching back and forth between the same two auditors over relatively short periods of time will be subject to the same independence arguments as this current discussion.

There is an insufficient pool of acceptable audit firms to make mandatory auditor rotations practical.

There are four major audit firms in the United States (PWC, E&Y, KMPG and D&T) and these firms audit the vast majority of publicly traded companies in the United States currently. These audit firms have achieved their status at the top of the audit profession because of, among other factors, their reputations, their technical expertise and their geographic reach to serve such large and complex customers. These public companies can generally only engage their auditor for audit related services and they often engage other of these major audit firms for other services for the same reasons. These other services may pose a conflict of interest that precludes these firms from rotating into the role as the company's independent auditor. Therefore, the pool of these Big Four audit firms eligible to rotate onto a company is at most three and possibly none. Mandatory auditor rotations could result in a vast game of musical chairs as the audit firms swap audit and other services among themselves.

The PCAOB Release suggests that mandatory auditor rotations would prompt more second tier audit firms to compete with the Big Four firms for audit work at the major public companies. History does not support this suggestion. Over the past several decades, what was the Big Eight became the Big Four. Six of the Big Eight paired up into three of the firms, KPMG remains and Arthur Andersen is gone. None of these firms merged with a smaller player and none of the smaller firms has risen in stature to get anywhere close to the stature of the Big Four firms. Many of these smaller firms have a focus that makes them ill-prepared to audit publicly held companies.

The PCOAB Release requested comment on whether a company paying for audit services distorts the independence relationship between the company and the auditor.

The company paying the independent auditor for audit services does not impair the independence of the auditor with respect to the company. A company paying a third party for independent analysis also occurs with financial ratings agencies, which are also relied upon by investors in a company's debt securities. The Big Four audit firms are responsible for the audits of numerous companies, none of which is individually critical to the overall financial success of the audit firm. An audit firm's reputation is among its most valuable assets. It will not risk that reputation on behalf of any client company. To do so would put that firm out of business.

If a company paying its audit firm impairs that audit firm's independence, then it would be logical for a company to increase its audit fees to further impair that independence such that the company would have free rein to prepare its financial statements regardless of the applicable rules. This obviously is not true.

The primary party responsible for the accuracy of a company's financial statements is the company's management.

The headlining financial statement failures were not necessarily audit failures. They were certainly the result of corrupt management. If management intentionally misstates its financial statements, legal recourse under the Sarbanes-Oxley Act of 2002 currently only extends to the Chief Executive Officer and the Chief Financial Officer. The list of responsible parties should be much broader, but that is beyond the scope of this discussion.

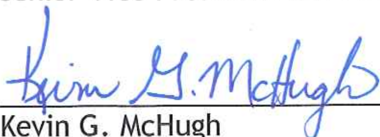
If mandatory auditor rotation can be tested to assess its effectiveness, the following are some suggestions that may mitigate the adverse effects discussed above.

- The rotation period should be longer than 5 years, such as at least 10 years. A much longer rotation period, such as 20 years, would make little sense since there would likely be complete turnover of both company and audit firm personnel over such a long period. Once rotated off of a company, that audit firm could not be re-engaged by the company for 10 years. Audit personnel changing firms cannot perform audit work at the same company for each firm.
- If the financial statements audited by a predecessor auditor do not change, consent from that auditor to include its opinion related to those financial statements is not required. Some changes are also relatively simple reclassifications or other minor items. Such changes should also be exempt from requiring the consent of the predecessor auditor.
- A change in accounting which results in a disagreement between the current auditor and the predecessor auditor will not require a restatement of the financial statements audited by the predecessor auditor. Any changes would get reflected solely in the financial statements examined by the current auditor.
- If mandatory auditor rotation is going to be tested as a pilot program, start with small companies instead of big companies. This would have the added benefit of making the pilot companies more appealing to smaller audit firms.

We again appreciate the opportunity to express our views on this matter and thank you for your time to consider our views and those of other respondents.

Sincerely,

Evan L. Hart
Senior Vice President and Chief Financial Officer



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