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Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, DC 2006-2803

PCAOB Rulemaking Docket No. 37

Dear Board Members:

I appreciate the opportunity to comment on the PCAOB's Concept Release No. 2011-006 on "Auditor Independence and Audit Firm Rotation." The views expressed in this letter are my own. In evaluating mandatory auditor rotation, which is an alternative proposed to solve or address a problem, it is important to consider what the fundamental problem is. The first sentence in the concept release states the purpose, which is to "solicit public comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced." While these characteristics are essential to the profession, I believe the more fundamental problem facing the PCOAB is how to enhance and improve audit quality. Objectivity, independence, and professional skepticism are certainly necessary, but they are not sufficient characteristics to achieve audit quality. By defining the problem as "how to boost independence" there is a risk that well-meaning decision makers could actually solve the wrong problem, increase audit fees charged to preparers (and investors), and at the same time decrease overall audit quality. In other words, even if independence did increase as a result of this or other proposals, if the proposal simultaneously leads to decrease in audit quality and an increase in cost, the public interest is not served.

One of the specific questions in the proposal asks for comment on the potential costs and benefits of the mandatory firm rotation proposal. This semester I had the privilege of teaching about 100 bright and engaged graduate business students and the question on the potential costs and benefits of mandatory rotation as well as related articles in the business press led to some great classroom discussions. Students identified many of the items provided in the list below during classroom discussion:

Potential Benefits of Mandatory Audit Firm Rotation

- Increased independence, objectivity, and professional skepticism, particularly in the last year or two of the term.

- Smaller audit firms may increase market share of smaller public company audits.
- Increased audit fees (benefit to audit firms).
- Regulator demonstrates willingness and ability to act.

Potential Costs of Mandatory Audit Firm Rotation

- Lower audit quality in the early years due to learning curve.
- Lower audit quality in the latter years of the term, as there would be reduced incentive to invest in steps to improve audit quality.
- Less incentive for the firms to develop industry expertise, which could reduce audit quality.
- Less attractive career for most qualified professionals, because of factors such as increased requirement to relocate, increased regulation, increased uncertainty particularly in smaller markets where mandatory rotation would be disruptive to supply and demand of professionals.
- The largest most complex issuers can realistically be audited by only a handful of audit firms. Most large complex issuers engage multiple audit firms, one to provide the external audit, and others to provide other professional services. If the issuer's board and audit committee are skilled at identifying the professional services firms most qualified to provide the needed services, then mandatory firm rotation will require issuers to terminate the services of the most qualified firm, in order to engage a less qualified audit firm.
- Increased audit fees to cover learning curve as audit firms cannot amortize costs over long terms.
- Increased audit fees for largest, most complex issuers as frequent rotation limits and already limited pool of potential audit firms that can effectively provide an external audit.
- Increased audit firm employee turnover.
- Some of the most qualified audit firms may choose to reduce the overall level of the audit services provided to the market and focus instead on non-audit services.

I attended the November 2011 PCAOB SAG meeting where the issue of how to boost auditor independence and professional skepticism was raised. It seemed some of the comments from SAG members representing the investor community assumed a perfect correlation between independence and audit quality, and as a result there seemed to be a focus solely on the potential boost to independence that may come from mandatory firm rotation. As potential costs were raised, some seemed unwilling to acknowledge there could be costs, others responded to concerns by asking, "If not mandatory firm rotation, then what action should be taken to boost independence." Similar questions are asked in the concept release. Again, the focus should not just be on boosting independence, but rather improving audit quality. Here are some other potential ways to increase audit quality that the PCAOB may want to consider:

- Improve the quality, training, competence, and performance of audit committees. An effective audit committee is essential to effective corporate governance, including the oversight of an effective and objective internal and external audit. It was asserted in the November SAG meeting that the audit committee

effectiveness has noticeably declined in the past several years as the audit committee has reverted to pre-SOX behaviors and has acquiesced to management instead of making decision based on what is best for the shareholders. If this is true, then there would seem to be significant upside and very little downside to boosting the quality of audit committees. A number of initiatives could improve audit committee performance such as required continuing professional education, minimum performance criteria, peer review, or federal inspection oversight. Audit committees have an important oversight responsibility, as set for in the Sarbanes-Oxley Act, which is not served by low quality audits and as such the committee has the right and ability to request rotation of audit firm personnel, the audit committee can fire existing audit firms and choose to rotate auditors on a regular basis. Before usurping all audit committees' rights and authority by mandating arbitrary term limits and rotation, it may be prudent first to foster ways to improve the effectiveness of subpar audit committees.

- Collaboratively work with the CAQ, academics, firms, and standard setters on important quality initiatives for the profession. Understandably, the PCAOB focuses a lot of attention on detection of what it perceives as the current audit deficiencies. Another perspective that may have merit would be to look forward to fundamental improvements. The innovations may not come from the PCAOB per se, but rather from the collaborative initiatives it can foster. These initiatives could include rigorous analysis of pooled (across firm) data looking for “positive deviants” (where things went well compared to other settings where, even under similar pressures and constraints, things didn’t go so well). They could come from working with the CAQ and firms to foster pilot programs to try different audit approaches, methodologies with oversight to examine the costs/benefits (with appropriately adjusted inspections for the pilot programs). It could come from ways identified to recognize and celebrate quality successes.
- Continue audit deficiency root cause analysis. The concept release indicates, “even well-intentioned auditors, as with other people, sometimes fail to recognize and guard against their own unconscious biases.” If the deficiencies are caused by unconscious bias, mandatory auditor rotation may not mitigate them. There is a rather extensive body of academic literature on auditor judgment, including techniques to mitigate bias and avoid common judgment traps. The release also suggests “coziness” between the auditor and the issuer is the cause of audit deficiencies. It is important to remember that there is already a requirement to rotate the lead audit partner, the large firms experience average employee turnover of 15 to 25 percent each year, and the average tenure of “C-Suite” executives at issuers is relatively short. Thus, perhaps many of the potential benefits of rotation to reduce “coziness” may already be achieved by natural turnover, mandatory partner rotation, and regular federal inspection of audit engagements by the PCAOB. Without a better understanding of root cause or evidence linking mandatory rotation to improved audit quality, a regulatory reaction to mandate rotation in the near future may not achieve the intended outcome.
- Improve audit quality via revised PCAOB inspection process and approach. There is no question federal oversight and inspection has significant potential to improve audit quality. The PCAOB may want to re-consider whether the current inspection model is (1) an accurate measure of audit quality, and (2) provides an

effective means whereby the PCAOB can contribute to the improvement of audit quality. The language in your inspection reports caution users from drawing quality conclusions from the inspection reports as the engagement and audit area selections are not intended to be representative, but rather focused on specific areas of risk. The current inspection process is largely adversarial. Inspectors have incentive to find deficiencies and given the level of complexity and judgment involved in preparing and auditing issuers' financial statements, there will always be judgments inspectors can question, particularly with the benefit of hindsight. Inspector's interpretations of audit standards and their preferences for audit methods can result in a quasi standard-setting process via inspection findings. Certainly, I recognize that there are situations where there actual audit deficiencies and failures, but to the extent the current inspection process introduces noise and distraction into the system, such that the audit firms' logical reaction is to modify audit methodologies to provide "inspector repellent" rather than address issuer risk, audit quality may actual suffer. (See article in Accounting Horizons, June 2009, by Glover et al. 2008, for additional insights and recommendations). The PCAOB may also want to investigate whether other governmental or other oversight agencies have developed inspection approaches that are capable of rooting out significant and meaningful quality problems as well as improve the quality, reliability, safety, and consistency of the products and services they inspect.

Preparing and auditing large issuer's financial statements is a highly complex process involving significant judgment and as such, regulators need to carefully consider the potential unintended consequences of imposing regulation such as mandatory firm rotation. The concept release indicates that after thousands of PCAOB inspections over many years, there appears to be no correlation between audit firm tenure and audit quality. At this juncture, without more evidence linking mandatory firm rotation to improved audit quality, there appears to be significant risk that the costs of the unintended consequences associated with mandatory firm rotation will outweigh the benefits. I believe that audit quality as well as the audit quality bar has been significantly raised since SOX was passed. I understand that a focus by inspectors on a risk area such as fair-value measurements over the last 4 to 5 years, in the face of the worse economy in the past 80 years, could raise concerns. However, I'm not convinced these data provide sufficient, appropriate evidence with which to form a conclusion on audit quality overall.

I applaud the PCAOB's role and interest in improving audit quality in the U.S. and in further restoring the public trust in our capital markets. I encourage the PCAOB to focus on improving quality as the fundamental goal, and consider potential enhancements to auditor independence within the broader context of audit quality. The concept release acknowledged common judgment tendencies that can lead to biased judgment. Even experienced decision makers can fall prey to these biases, which is why following an open process to carefully and objectively consider multiple perspectives, potential costs, benefits, and alternatives is so important.

Please feel free to contact me should you have any questions about comments in my letter.

Sincerely,

A handwritten signature in blue ink, appearing to read "Steven M. Glover", with a long horizontal flourish extending to the right.

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