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Mr. J. Gordon Seymour
Secretary

Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

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

Dear Mr. Seymour,

For consideration of the Board, here are my thoughts about audit firm rotation and auditor independence. First, I suggest better alternatives to solve problems faced by investors and audit committees.

BETTER ALTERNATIVES

PCAOB regulates auditors in an environment where audit firms and their partners have been relieved from penalties important to excellence. Audit work is based on auditor risk. Now, we have too few, expensive auditors, too big to fail or be failed. Auditors are becoming protected Government Sponsored Entities, with no capital, a situation with little auditor risk, not assuring individual commitment to correct misleading financial statements.

You should study rotation and independence. But, the following measures would be better to get more financial statements correct:

1. Increase "at risk capital" of audit firm partners. Restore auditor risk to improve their work and self regulation. One idea, not the only one, would be to require partners of registered firms to be obligated for additional capital contributions equal to the last three years of income distributions.
2. Expand the market of available audit firms. Either restrict top tier audit firms from doing consulting for public companies if the work would disqualify them from becoming auditor of the consulting client, or alternatively, require auditors be available for all audits, regardless of conflicts, accepting the auditor risk that comes when financial statements are wrong.
3. Put more severe consequences in PCAOB review of auditors. If auditors are failing, financially or professionally, report it now. If the PCAOB knows of problems, audit committees and investors need to know, even if there is disagreement.

4. Do not add more things for auditors to do or upon which they must report. The deficiencies you have discovered in auditing will not be solved by spreading the auditor thinner. Get the basics right.

AUDITOR ROTATION

The most important consideration about rotation is whether it will more likely produce correct financial statements.

Required audit rotation is likely not the best answer, but I honestly don't know whether it would produce better or worse results. There are commonsense concern about the cost and loss of knowledge when auditors rotate. Arguments for rotation stress the "fresh eyes" a new auditor brings and the incentive of both old and new auditors to get things right before they hand off to another auditor. These all are logical arguments.

The concept release asks for "empirical evidence." The SEC and the PCAOB are the best source of information. There have been many changes in auditors, restatements, audit failures, mergers of registrants, mergers of audit firms and demise of audit firms that have left a record of what happens when auditors change and when they do not. Use the information. Allow for debate. Don't make a decision in the dark just for the sake of change.

Be careful in the analysis. U. S. auditor changes in the past brought a sense of competitiveness among auditors about who is best. If you were to mandate rotation and it becomes the norm rather than the exception, the energy brought to the change will lack the enthusiasm and sense of achievement that now exists. It will not be the same.

The same lack of excitement will affect companies being audited. Auditors now "chosen" for expertise and better service will likely become the "...auditors we had to hire for the next five years because the government said we had to..." It's different.

Recent high profile audit failures and misleading financial statements raise legitimate concern. Industry and accounting firms should address these failures. Law changed, but what have companies, auditors and industry organizations done to improve audit effectiveness irrespective of the law?

In 1933, faith in private side accounting principles and audit standards, and the relative strength of the American Institute of Accountants as a profession standard setter, carried the day for private side audits. Today, these arguments are weak.

Unfortunately, the debate takes us back to the decision in 1933 to use private auditors not government auditors. Many disagreed then. This idea of required auditor rotation suggests that government audits are still an alternative, maybe for some the objective.

INDEPENDENCE

Nearly every letter you have received supports your pursuit of auditor independence. I have a different perspective, with a different solution.

Management interest is the difference maker in getting financial statements right, not auditor independence. Auditors are not independent, but some are less conflicted. Consider the situation, the impact on the state of mind of an auditor:

1. Auditors are paid by those subject to audit.
2. Auditors have interest to conceal errors made in audits of prior years.
3. Auditors are in primarily consulting firms, not audit firms.
4. Auditor organization and capital structure drives the firms and individual auditors to pursue revenue, accepting more audit risk for investors, not to auditors.
5. Audit firms provide lobbying services to public companies and industry organizations for tax positions, patent and trade matters, and pension and benefit matters, even for their own independence definition, more audit work and further limitations on their liability.
6. Auditors take sides in legal cases; they value things for pay; they coordinate political contributions.

The situation is not necessarily fatal, maybe not even bad, for getting financial statements right, but there are too many conflicts today to describe what we have as independence. The situation, by the way, does not get better with rotation requirements; it gets worse. Auditor independence is more than not owning stock or not having a sister in a key position.

As large auditing firms expand their consulting practices, they frequently shrink the pool of audit firms available to a public company, placing audit committees and regulators in the awkward position of rationalizing to some arguable conclusion that "independence" requirements are met. While it is fine for us to say the available market includes the "big 4" or "big 6" or that there are two thousand registered firms, for many large companies there is only one, maybe two, from which to choose. Audit costs rise from scarcity not improved audit quality.

The brutal fact is the audit industry has evolved through consolidation and lobbying to compromise the possibility of independence. But, the objective is to get financial statements of public companies right; independence of auditors is noble, not the objective. "Right," is possible without auditors being independent, even without auditors.

The last ten years has produced far too many latently discovered problems and probably many undiscovered. The discovered problems were mostly disclosed by things like cash flow proving the falsity of journal entries, good journalism and whistle blowers, not by auditors that qualified as independent.

If the PCAOB requires some defined independence, you provide a defense for negligent decisions based on every tiny variation from your definition. Your best answer for investors is being quiet on the subject. Let those who claim independence stake out their positions and, when necessary, defend them.

If independence of auditors is retained as one of their own standards, that is fine, even great. But, don't you define it as a Federal matter. Let auditors and audit committees make the determination of, contract for and accept responsibility for relationships that serve proper interests. If financial statements are then discovered to be misleading, let investors and regulators challenge the independence determination using hindsight, in court if necessary, based on facts without regard to what auditors' standards say.

CONCLUSION

You have a tough job, but it is vital. Thank you for your efforts and consideration. Please call if you have any questions or interest in pursuing these thoughts.

Sincerely,

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