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Via e-mail: [comments@pcaobus.org](mailto:comments@pcaobus.org)

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington, DC 20006-2803

Re: **PCAOB Release No. 2011-006, Rulemaking Docket Matter No. 037,**  
***Auditor Independence and Audit Firm Rotation***

Dear Members and Staff of the Public Company Accounting Oversight Board:

BDO USA, LLP welcomes this opportunity to comment on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Concept Release, *Auditor Independence and Audit Firm Rotation* (the "Concept Release"). BDO is committed to a continuous evaluation of audit quality and development of ways to enhance its fundamental attributes of independence, objectivity and the use of professional skepticism. For this reason, we welcome the discussion about how best to improve audit quality and whether mandatory rotation of auditors is among the appropriate mechanisms by which that goal may be achieved.

Audit quality is not a static concept, but rather is influenced by a multiplicity of factors, which may vary over time. For this reason, we believe there is no one single alternative that will resolve the challenges in achieving audit quality. Rather, it is a holistic and continuous process that reflects the nature of the business environment. In our comments, we have noted some ways that we believe enhancements to audit quality can be accomplished.

### Overall Views

Objectivity, independence and professional skepticism form the basis for how quality audits are conducted. The effectiveness with which audit firms demonstrate their adherence to these foundational principles is assessed by the firms themselves during their ongoing monitoring processes, including annual inspections and engagement quality reviews performed in accordance with Auditing Standard No. 7.

In addition, the passage of the Sarbanes-Oxley Act of 2002 ("SOX" or the "Act") and the establishment of the PCAOB contributed to enhancing independence, objectivity and the exercise of professional skepticism, particularly through the sections of SOX that discuss auditor independence, the inspection of registered audit firms, and corporate responsibility. However, we recognize that despite the reforms initiated by the Act and implemented by audit firms to enhance audit quality, the PCAOB has noted in the Concept Release that deficiencies in audits continue to persist because "it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism."



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We share the Board's concern regarding the frequency and types of audit deficiencies found during inspections; however, we do not believe mandatory firm rotation is the appropriate or necessary response to that concern. While we are committed to the performance of high quality audits, we believe that understanding the root causes of identified deficiencies and addressing them with targeted responses is the best way to achieve improvements in audit quality.

In that regard, we note that the Concept Release itself acknowledges the weakness of the presumed correlation between audit quality and firm tenure when it states that preliminary analysis of inspection results "appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports." In addition, as cited in the Concept Release, there have been various academic studies that have analyzed the relationship between audit quality and the length of firm tenure. The results of these studies do not support such a correlation. In our view, mandatory firm rotation would result in significant adverse consequences, including additional costs, without addressing the central issue—reducing the deficiencies noted during inspections and enhancing audit quality.

We note that the Concept Release recognizes that the root causes of audit failures are complex and vary in nature, and that they continue to be explored by the Board, but that a root cause analysis has not yet been performed and that such an analysis would be needed before a clear cause and effect relationship could be determined. It is likely that the root causes of certain of the deficiencies are attributable to factors unrelated to independence, objectivity and professional skepticism. We are performing our own in-depth root cause analysis of any deficiencies encountered during the current year internal and PCAOB inspection processes. We believe that after identifying root causes, the appropriate action is to determine whether any changes to auditing standards, quality control policies, inspection programs, the responsibilities of audit committees, and/or other drivers of audit quality would be appropriate. Proceeding in this manner would be in the interests of all stakeholders.

While we have not yet completed our own root cause analysis, we have identified some areas where we believe overall improvements to audit quality can be made in a cost effective manner. In that regard, we support exploring the following suggestions to improve audit quality, recognizing that some of them would require coordination with other bodies. We are committed to working with the PCAOB, audit committees, and investors in these efforts.

- Explore ways to build upon and strengthen audit firms' quality control systems
- Strengthen communication between the audit firm and audit committee to require a discussion of PCAOB inspection activities as it relates to the audit of the issuer's financial statements
- Strengthen the definition of a "financial expert" in the context of membership of an audit committee



- Promote transparency regarding the role the audit committee plays in the appointment and oversight of the independent auditor through enhancements to the audit committee report

We have set out below in greater detail our suggestions for improving audit quality as well as what we believe to be the more significant unintended consequences of mandatory firm rotation and other matters relating to the Concept Release. Our views on certain of the individual questions posed in the release are provided within the section headings below, with a reference to the relevant questions shown parenthetically, where applicable.

### Improving Audit Quality

#### Enhancing Quality Control Processes

An audit firm's internal quality control process is an essential element of audit quality. When a firm's quality control procedures are operating effectively, they ensure quality audits are consistently performed. Monitoring programs, such as internal engagement quality reviews, provide an assessment of the effectiveness of the quality control systems.

We believe that strengthening the quality control standards, in addition to improvements in monitoring the effectiveness of such programs, would provide a more direct and meaningful response to the audit deficiencies noted in the PCAOB's Concept Release than mandatory auditor rotation. Strengthening the quality control standards is consistent with the Board's current standard setting agenda, which indicates that a proposed quality control standard is expected to be released for public comment in the 3rd quarter of 2012.

If the PCAOB continues to be concerned about the potential negative effects of firm tenure on audit quality, it might want to consider including tenure as one of the attributes used to select engagements for inspection. Any resulting findings could then have an impact on the inspected firm's quality control processes.

#### Improving Communication between Audit Firms and Audit Committees

Audit committees play a key role in assisting the board of directors in fulfilling its responsibility to investors to oversee the integrity of the company's financial reporting process. Robust and candid communication between the auditor and audit committee is critical for an audit committee to effectively fulfill this role, thereby promoting audit quality. As such, we would support efforts by the PCAOB to strengthen the existing requirements for auditor communications with audit committees to ensure audit committees understand the auditor's responsibilities, risk assessments, audit strategy, and the basis for significant audit judgments, among other matters.

While auditors regularly engage in discussions with audit committees, we believe there are additional means by which such communications could be expanded that would improve audit quality. For example, best practices could be identified that include discussion of such matters as (1) informing the audit committee about PCAOB inspection findings relating to the company's audit engagement and (2) the evaluation by the audit firm of the root causes for



any deficiencies identified and the corrective actions taken. This may be accomplished through revisions to the proposed auditing standard on communications with audit committees that the PCAOB initially released in March 2010<sup>1</sup> and is scheduled to re-propose later this year, as indicated in its November 2011 Standard-Setting Agenda.

### **Strengthening Audit Committees**

As established by SOX, audit committees are directly responsible for the appointment, compensation, and oversight of the work of the registered public accounting firm. To ensure that these duties are carried out in the best interest of investors, the Act further explains that audit committees are to be composed of independent directors, and that each audit committee is to identify at least one member as a financial expert.

Given the audit committee's central role in appointing and overseeing the work of the audit firm and the quality of the company's financial statements, we believe that the role of the financial expert needs to be strengthened through a more rigorous definition. Currently, audit committee members may qualify as the financial expert without a sufficient depth in accounting or auditing. However, as accounting and financial reporting have grown more complex in recent years, and in response to the concerns about audit quality, we believe that the definition of financial expert should include the need to have a certain level of practical financial accounting or auditing knowledge and experience. We believe that such knowledge and experience is essential to conducting an effective dialogue with the auditor on key accounting and auditing areas and to empowering the audit committee to critically assess the issues raised, as well as the performance of the auditor, particularly as it relates to the exercise of professional skepticism.

In addition, as set out in our May 28, 2010 comment letter on the proposed Auditing Standard, *Communications with Audit Committees And Related Amendments to Certain PCAOB Auditing Standards*, we encourage the Board to initiate efforts to work with others such as the National Association of Corporate Directors in the development of guidance to enhance the effectiveness of audit committees, with audit quality specifically in mind.

We have provided the above suggestions for strengthening the effectiveness of audit committees because we recognize their importance in promoting audit quality and the integrity of the financial reporting process. As such, we urge the PCAOB not to dilute the audit committee's role in this process that would otherwise occur under a mandatory audit firm rotation regime, by removing the audit committee's judgment in determining whether and when to change auditors.

### **Improving Audit Committee Communications to Stakeholders**

We also support enhancing requirements of the audit committee report to stakeholders to describe more clearly the ways in which they fulfill their responsibilities. Without a

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<sup>1</sup> PCAOB Rulemaking Docket Matter No. 30, *Proposed Auditing Standard Related to Communications with Audit Committees*, and related *Amendments to Certain PCAOB Auditing Standards*, March 29, 2010, [http://pcaobus.org/Rules/Rulemaking/Docket030/Release\\_No\\_2010-001.pdf](http://pcaobus.org/Rules/Rulemaking/Docket030/Release_No_2010-001.pdf)



transparent process, investors are left with an incomplete picture about the effectiveness of the oversight process and its impact on audit quality. For example, to address the issues of independence, objectivity and professional skepticism, we suggest including a description of the following in the audit committee report:

- How the audit committee discharged its responsibility to oversee the financial reporting and audit process
- The process the audit committee used to assess the extent to which the auditor exercised professional skepticism, in particular in relation to significant management estimates and assumptions
- The process the audit committee used to assess threats to the auditor's independence and objectivity
- The process and criteria used to evaluate the performance of the auditor, including whether to recommend their reappointment or to appoint a replacement

#### **Potential Unintended Consequences of Mandatory Audit Firm Rotation**

##### **A New Learning Curve** (questions 3, 9, and 11)

As it relates to the effectiveness of first time audits, it is likely that the audit learning curve is significantly steeper if an entire audit firm is replaced, rather than just the lead partner and engagement quality reviewer. In replacing an entire firm, the institutional knowledge a firm gains during its tenure is lost and the successor firm would need to devote substantial time in building an appropriate level of knowledge. While companies do change auditors in the normal course of business in today's environment, these voluntary changes are effectively managed. In contrast, the exponential increase in the rate of audit firm changes under a mandatory rotation regime would place excessive burdens on management, the audit committee, and the new audit firm in implementing a smooth transition, with the potential negative effect on audit quality.

##### **Challenges Relating to Industry Specialization or Geographic Coverage** (questions 7 and 9)

Beyond our basic concerns about the need for mandatory firm rotation, we believe there are significant practical challenges to implementing a mandatory rotation requirement. One such challenge relates to the development of specialized industry expertise that a particular audit firm may possess. Some audit firms have established practices within certain geographic regions that require specialized accounting and auditing knowledge and there may not be sufficient similarly qualified firms in that region to provide for acceptable alternatives. A firm rotation requirement in this circumstance would result in an audit committee engaging a firm with less expertise than the predecessor auditor.



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### **Challenges for Audits of Multinational Companies** (questions 7, 9, 10, and 13)

We believe mandatory firm rotation would create particular challenges for audits of multinational companies. Developing or acquiring experienced staff to position a firm to be able to demonstrate competencies in a given industry sector in which they do not currently have sufficient expertise would increase costs and may not be practicable. Having to physically relocate staff to provide coverage in certain locations for new or potential audit clients imposes a burden on firms that they might not otherwise have chosen to incur. Conversely, when an audit firm rotates off a multinational engagement, and a replacement engagement of equal size and geographic dispersion within that industry sector is not found, it may not be practicable to find roles for the staff who were assigned to the former engagement. In both scenarios, there will be a toll on a firm's ability to attract and retain audit staff with the requisite skill set.

Further, companies may be required to change non-audit service providers in order to allow those who currently perform prohibited services to be available to be selected as the auditor. In that regard, large multinational companies are more likely to have prohibited services performed by various firms throughout the world. In order to increase the pool of available auditors, mandatory firm rotation could cause a simultaneous rotation of one or more of them if they are engaged to participate in the audit, resulting in a substantial increase in other costs not directly related to the audit.

### **Adverse Impact on Audit Firm Concentration** (questions 7, 13, and 15)

We believe there is currently significant audit firm concentration in the market for the audit of the largest issuers and that mandatory firm rotation would exacerbate this concentration issue (1) by removing at least one firm from the pool of available replacements and (2) by further restricting the choice of available firms if those currently performing prohibited services continue to do so. This would have an unhealthy impact on the competitive landscape, given the reduced choice of audit firms available to companies.

### **Audit Costs**

As mentioned in the Concept Release, according to the 2003 GAO Report, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. We agree that audit costs in the initial year of an audit engagement are ordinarily greater than in subsequent audit periods, due to the need for the engagement team to obtain and document for the first time its understanding of the company, including its internal control environment. In addition, more supervisory time and resources may need to be devoted to the engagement than may be necessary in subsequent years. While these start up costs are not always passed on to issuers in the form of higher audit fees, under mandatory firm rotation the rate of firm transitions would increase, negatively impacting an audit firm's ability and willingness to absorb such costs as a one-time start up cost. Further, there would be additional costs incurred by companies, as they devote additional resources



to assessing prospective audit firms on a more frequent basis and work with the newly appointed auditors in helping them climb the learning curve.

#### **Transitional Issues - Special Considerations** (question 11)

There may be transitional challenges to implementing mandatory firm rotation that should be more fully considered by the PCAOB. For example, a company could be in the midst of a major acquisition or other transaction at year-end when it will soon be required to rotate to another audit firm. This could result in significant challenges for the newly appointed audit firm in connection with the company's first quarterly filing, if it compresses the time the new firm and management can devote to ensuring that the new firm gains an appropriate level of understanding of the company and the transaction or acquisition, resulting in a steeper learning curve.

#### **Impact on Smaller Audit Firms** (questions 6, 7, 11, and 15)

We believe there is a strong possibility that smaller firms will be disproportionately impacted by the increased costs of providing services under a mandatory firm rotation regime. As a result, they may decide to leave the public company auditing market, exacerbating audit firm concentration. Such smaller firms will likely struggle more than larger firms with the potential for overlap (e.g., a new large job that starts one year before rotating off another large job that is not replaced with an equivalent size engagement would require an increase in staff for one year only) and is likely to incur disproportionately increased costs due to a variety of factors, including investing in and maintaining the necessary specialized industry skills when they may lose the related clients to other firms; incurring costs related to preparing proposals on an ongoing basis to replace engagements that will be "rotating" to different audit firms; and reduced fee realization in early years that may result from the need to compete with larger firms with the ability to absorb first year "learning curve" costs.

In addition, we believe that smaller firms that have audited companies that have rotated to a larger audit firm would be less likely to be able to replace those lost engagements with companies of a similar size because of the bias that still exists in some parts of the marketplace in favor of larger audit firms.

#### **Other Matters**

##### **Conduct of a Pilot Program**

The Concept Release requested views on whether the Board should conduct a pilot program so that mandatory firm rotation could be further studied, since there is little empirical data directly on mandatory rotation available. We are skeptical about the ability to structure a program in such a way so as to provide sufficient appropriate data about the impact of mandatory firm rotation because (1) it would be exceedingly difficult to conclude on the correlation of deficiencies and tenure in a limited sample and short time period, and (2) the



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practical impact of mandatory rotation stems from its universal application, so developing a microcosm would create an artificial environment unlikely to mirror that which would be evident in a full application of mandatory rotation and which ignores the domino effect of the actual implementation of a mandate.

**Communication Between Predecessor and Successor Auditors**  
(question 18)

With respect to the question about whether a predecessor auditor should be required to provide a report outlining audit risks and other information to the successor auditor, we do not believe that such a requirement is necessary, because working papers are ordinarily reviewed by successor auditors under current practice.

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We are committed to participating in discussions about how to implement provisions that would further enhance audit quality and the core principles of independence, objectivity and professional skepticism, and we support efforts by all stakeholders in the financial reporting process to explore ways to enhance audit quality. While we share the Board's concern regarding the frequency and types of audit deficiencies found during inspections, we do not believe mandatory firm rotation is responsive to that concern.

We would be pleased to discuss our comments with you at your convenience. Please direct any questions to Chris Smith, Audit and Accounting Professional Practice Leader, at 310-557-8549 (chsmith@bdo.com) or Susan Lister, National Director of Auditing, at 212-885-8375 (slister@bdo.com).

Very truly yours,

/s/ BDO USA, LLP

BDO USA, LLP