

December 14, 2011

Mr. J. Gordon Seymour, Secretary  
PCAOB  
Office of the Secretary  
1666 K Street, N.W.  
Washington, DC 20006-2803

**Re: PACOB Rulemaking Docket Matter No. 37 *Concept Release on Auditor Independence and Audit Firm Rotation***

Dear Mr. Seymour:

WeiserMazars LLP appreciates the opportunity to submit comments to the Public Company Accounting Oversight Board (the "PCAOB" or the "Board") on its *Concept Release on Auditor Independence and Audit Firm Rotation*.

Independence, objectivity and professional skepticism are unquestionably the foundation upon which our profession is built. We applaud and support the Board's initiative to strengthen these fundamental principles. However, we do not believe that the proposal for audit firm rotation is the most effective or efficient means of achieving the Board's goal for the reasons outlined below.

#### **Audit Firm Rotation is Against the Public Interest**

We believe that mandatory audit firm rotation is not in the public interest and would, in fact, have a direct detrimental effect upon both corporate governance and the investing public.

##### *A) Loss of Institutional Knowledge*

We do not believe that length of audit firm tenure is, in itself, a direct threat to auditor independence, objectivity or professional skepticism. There are existing safeguards in place to enhance these principles in the form of mandatory partner and engagement quality reviewer ("EQR") rotation. While the partner and EQR will rotate on an engagement, the remainder of the team retains core knowledge of the entity and its industry. We refer to this as institutional knowledge.

When a company changes auditors, there is a steep learning curve on the part of the new auditor as the engagement partner and team gain an understanding of the entity, its industry and its transactions. When auditing the most complex companies or those in highly specialized industries, the loss of institutional knowledge has the potential, among other things, to result in an increase in audit failures in the first or second year of tenure because the new firm did not fully understand the complex transactions of the specific client or industry. Any potential decrease in audit quality leading to audit failures negatively impacts the reputation of issuers and auditors. A series of such failures or restatements that could be directly attributed to audit firm rotation would shatter the confidence of the investing public on the value of any audit opinion.

Furthermore, the cost of this learning curve would result in a substantial increase in audit fees for the first and second year of an engagement. This cost would be borne, ultimately, by the shareholders of the entity by way of decreased earnings per share. The United States General Accounting Office's 2003 *Required Study on the Potential Effects of Mandatory Audit Firm Rotation* indicated that such cost would be as high as 20%. Under the PCAOB proposal, this would be repeated every X number of years as companies rotated firms throughout their existence. Based on the 2010 audit fees reported by the Fortune 100 only, that 20% would equate to approximately \$450 million for those 100 entities only. Increased cost is discussed later in our comments.

#### *B) Weaken Corporate Governance and Audit Committees*

The underlying principle of corporate governance is to ensure that companies operate for the benefit of their shareholders. Corporate boards have the duty and responsibility to act in the best interest of the shareholders. The audit committee, a sub-group of the board of directors, is entrusted with the responsibility of engaging the audit firm and monitoring that firm's performance. The Sarbanes-Oxley Act of 2002 ("SOX" or the "Act") went a long way toward strengthening the audit committee by requiring the inclusion of a financial expert on the audit committee. Mandatory audit firm rotation would effectively communicate to audit committees the Board's belief that the committee is not capable of adequately monitoring the audit firm's performance. Rotation should not be mandated. Audit committees, are in the best position to determine if an audit firm's independence or objectivity has been compromised. Audit committees should continue to be responsible for determining when a change in auditors is warranted.

In addition to the above, mandatory rotation would have the effect of limiting, severely in some cases, an audit committee's choice of auditors. Each audit firm possesses certain skills and industry expertise and not all firms are equally qualified to serve certain issuers or industries. To force an audit committee to select a new auditor every X number of years and to restrict the services that its auditor can perform, while remaining independent, leaves the largest companies few alternatives. Potentially hiring a firm

that is less qualified to address the complexities of the entity or is less capable of encompassing the entity's global reach would not appear to result in an improvement in audit quality. Another unintended consequence is that costs would also be driven up due to audit firms having to hire additional resources. Increased costs are addressed later in our comments.

*C) Attracting and Retaining Qualified Audit Staff*

The current rules require partner and EQR rotation, but do not require the staff to rotate. We believe that staff may be tempted by the successor firm to "jump" firms. This way the new auditor will be able to leverage off of the staff's knowledge of the entity to increase their efficiency in the first year of the engagement. This would create a hardship for the predecessor firm who has spent years training their staff. Rotation could also make it difficult for medium sized firms to adequately succession plan as their partners retire. It would, in effect, create a revolving door through audit firms, which in the long-term would be detrimental to audit quality. The goal of the profession is to produce high-quality audits. The unintended impact of the Board's recommendations on non-public entities and their audits also has to be considered. We believe that the ability of audit firms to attract and retain staff will be greatly compromised which would lead to a decrease in audit quality on all engagements, not just audits of public entities.

**Audit Firm Rotation Will Unduly Stress Company Resources**

Public companies consider auditor rotation costly. Aside from reputation risk discussed elsewhere in this response which can generate cost, first year audits require a dedicated commitment from company management and staff to help the new audit team. Auditing standards require, among other things, documented knowledge of a company's operations, IT systems and internal controls, operating environment, unique industry characteristics and financial reporting practices. For all issuers, but especially for a smaller public company, this can stretch their staff to the point where financial reporting suffers. Institutional knowledge accumulates over many years and has a great deal of value to the company and its investors through suggestions for operating and financial reporting improvements and efficiencies. Rotation would cause these years of knowledge to be lost and would unquestionably increase internal costs in preparation for audits.

**Mandatory Audit Firm Rotation Will Negatively Impact the Audit Profession**

Audit firm rotation will have a disruptive effect and negative impact on audit firms by increasing audit costs, placing a disproportionate demand on firm resources, and increasing demand on firm professionals. Studies performed on rotation provide further support for this position.

A study in South Korea on mandatory audit firm rotation in South Korea concluded that:

“Since the Korean government mandated audit firm rotation in 2006, (1) audit hours increased, (2) audit fees increased, and (3) audit quality...remained unchanged or decreased slightly. These results... suggest that mandatory audit firm rotation increases the cost for audit firms and clients while having no discernable positive effect on audit quality.”<sup>1</sup>

In 2005, the Bocconi School of Management in Milan, Italy reported on The Audit Firm Rotation Rule: A Review of The Literature as follows:

“(T)his study reviews the conclusions and findings of 26 reports by regulators or other representative bodies from around the world. Of the 26 reports, 22 conclude against the benefits of mandatory audit firm rotation and while 4 are in favour. The study also looked at 34 academic studies (9 opinion based and 25 based on empirical evidence). The majority did not support mandatory audit firm rotation....Based on the academic literature collected the present analysis supports the idea that the benefits of the rotation rule are largely doubtful.”<sup>2</sup>

It is during the first year of an audit engagement that risks for a firm are at their highest. Consequently, firms would have to factor in the additional costs associated with first year audits, such as:

- Potential litigation
- Increased marketing costs
- Proposal and meeting costs
- Professional staff training that is client/industry focused
- Costs incurred in using outside specialists
- Increased liability insurance rates due to increased risk
- Increased engagement planning time
- Reduced fee realization

Audit fees would have to increase to cover a firm’s increased first year costs. The increased work required in the early years of an audit will also create an increased demand for audit professionals.

Rotation will also reduce competition as fewer audit firms will be able to afford to audit public companies. Fewer audit firms for a company to choose from will also result in increased fees. Thus,

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<sup>1</sup> Dr. Youngdeok Lim, Mandatory Audit Firm Rotation and Audit Quality: Empirical Evidence from the Korean Audit Market (2010)

<sup>2</sup> Mara Cameran P.h.D., Assistant Professor Bocconi University, et al, The Audit Firm Rotation Rule: A Review of the Literature (2005)

overall audit fees may become the primary selection factor instead of value and audit quality. The increased competition among a smaller pool of firms could threaten audit quality and auditor objectivity as the Firm's are forced into more competitive bidding situations. The auditor selection process would cause even more time incurred by management and further disruptions to a public company's operations. In addition, the potential decrease of small and medium sized firms that are willing to audit public companies will directly impact the smaller registrant who must then go to a large firm who may not understand its unique business and operating issues. The quality of the audit that these smaller registrants will receive will not be as robust as for the firm's larger public clients as the firm may not have the resources to devote to these smaller companies.

Another factor to consider is the unrecorded cost rotation will take on human capital. Every firm has limited resources, and, during these poor economic times, such resources are stretched to capacity. Smaller firms have more limited resources and may try to extend them even further in their efforts to propose on new engagements. This could cause the quality of their other audit engagements to decline, or even drive firms out of the market to perform public company audits. As second-tier and regional firms leave the market of performing public company audits, audit fees will increase and the audit quality of smaller reporting entities' financial statements will decline as addressed above.

All size firms might find it harder to match existing professional staff to new engagements creating greater burdens on the staff. Long-time clients have always been excellent training grounds for staff to "grow up on"; rotation limits those opportunities.

#### **Alternate Approaches to Improve Objectivity and Professional Skepticism**

We believe that there are other ways that the PCAOB can bolster independence, objectivity and professional skepticism that are more effective and less costly.

##### *A) Role of the PCAOB*

The PCAOB was created to oversee and enhance the credibility of registered public accounting firms as it relates to the audits of public entities. We fully support the monumental task that the Board faces in writing a comprehensive set of auditing standards specific to the challenges facing the audits of public entities, in inspecting all audit firms to ensure compliance with the PCAOB standards and in taking action when firms fail to comply. We encourage the Board's pursuit of the root causes of their inspection findings. To us, most appear to be issues of documentation or sufficiency of evidence. We do not see a clear connection between the Board's published findings and the auditor's lack of independence, objectivity or professional skepticism.

Furthermore, Auditing Standard No. 7, *Engagement Quality Review*, requires the engagement quality reviewer to review and assess the significant judgments made by the engagement team and the conclusions that were reached as they relate to the audit as a whole. This standard has not been effective for two full years yet, and, therefore, the result of this increased oversight on audit quality has yet to be adequately assessed by the PCAOB through its inspection process.

Should the PCAOB find specific instances where they have concluded through the enforcement process that the audit firm's objectivity or professional skepticism has become so compromised as to decrease audit quality to an unacceptably low level, we would support the PCAOB requiring the audit firm to rotate off the engagement in question for a prescribed period of time and be subject to PCAOB approval to recommence an audit relationship with the entity.

*B) Increase Audit Committee Responsibilities*

Since the enactment of SOX there has been an increase in rigor with which audit committees deal with auditors and management. We believe that there is, however, still improvement that can be made in this area as not all audit committees are created equal. The PCAOB and Securities and Exchange Commission ("SEC") can assist in this area by enhancing and prescribing in greater detail the communications that must occur between the audit committee and the auditor, and between the audit committee and management.

Boards of Directors should enhance their audit committee's independence from management. The SEC might consider requiring the members of the audit committee to sign a statement, which would be an exhibit to the quarterly and the annual filings attesting to their independence from management. Another possible means of improving the quality of audit committees would be to enhance the capabilities of the audit committee in terms of accounting knowledge and knowledge of the audit profession.

*C) Increased Interactions*

We believe that the best way to ensure the needs of all parties – the shareholders, the audit committee, the PCAOB, the company, and the auditor – are met is by increasing the interactions among them. The SEC could improve and enhance requirements for what must be communicated by the audit committee to the shareholders. The PCAOB could also communicate directly with audit committees regarding inspection findings related to their entity.

Another means of increasing interactions between the parties would be through increased disclosure on proxy statements. Let the shareholders affirm that the audit committee has the requisite skills to perform their responsibilities and the auditors have sufficient industry knowledge to conduct a high quality audit.

**Summary**

Independence, objectivity and professional skepticism are essential to the practice of public accounting and the performance of high-quality audits. We support the PCAOB in its endeavors to strengthen auditor independence, objectivity and professional skepticism. We do not believe that audit firm rotation is the right approach. We believe mandatory auditor rotation will unnecessarily increase costs to issuer with out the corresponding benefits sought. We favor the current safeguards, plus other improvements to communications between audit committees and auditor, including increased audit committee responsibilities. We look forward to a continued dialog between the profession and the PCAOB on this issue, and encourage the Board to further study the root cause of the deficiencies since it began its inspection program.

Should you wish to discuss any of the issues raised in this response, please contact Victoria L. Pitkin, CPA or David Bender, CPA at (212) 812-7000.

Very Truly Yours,



WeiserMazars LLP