Consumer Federation of America

December 14, 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: PCAOB Release No. 2011-006, Docket Matter No. 37
Concept Release on Auditor Independence and Audit Firm Rotation

Dear Sir/Madam:

I am writing on behalf of the Consumer Federation of America (CFA)[1] in response to the Board's request for comments regarding auditor independence and audit firm rotation. CFA has long advocated strengthened standards to improve the independence and quality of public company audits. Our advocacy in this area is founded in the belief that the mandatory audit of public company financial statements only has value to shareholders if it is independent and objective. It is therefore of grave concern to us that both the Board and its international counterparts continue to find evidence, as we do, that auditors do not consistently approach the audit "with the required independence, objectivity and professional skepticism" and that this continues to contribute to significant audit deficiencies. We therefore congratulate the Board for undertaking this examination of the policy reforms, including mandatory auditor rotation, that could be adopted to enhance auditor independence and audit quality.

The goal of policies in this area is not auditor independence *per se* – a practical impossibility as long as auditors are paid by the firms they audit – but independent conduct. By independent conduct we mean objective audits that are marked by an attitude of professional skepticism and a willingness to stand up to management. Policy proposals can take a variety of approaches to achieve this goal, including: minimizing the magnitude of the conflict inherent in the issuer-pays audit business model; restricting management's influence on the audit; and creating incentives to counter-balance the conflict. All three approaches are incorporated in our current policy framework. For example:

- Restrictions on the non-audit services that auditors are permitted to provide are intended to limit the magnitude of the conflict that results when auditors have more lucrative business than just the audit itself on the line.

[1] CFA is a non-profit association of approximately 280 national, state and local pro-consumer organizations founded in 1968 to represent the consumer interest through research, advocacy and education.

- Putting audit committees in charge of hiring, firing and overseeing the audit firm is intended to limit management's ability to influence the audit and ensure that auditors act on behalf of their true clients, the shareholders.

- Both the threat of legal liability and the threat of regulatory sanction have the potential to provide an effective counter-balance to the substantial financial incentive auditors have not to put the audit engagement at risk by too aggressively challenging management.

When the Government Accountability Office released its report on audit firm rotation in November 2003, questions remained about whether the Sarbanes-Oxley Act reforms would be sufficient to solve problems mandatory audit firm rotation was intended to address.[2] The GAO therefore concluded that more experience needed to be gained with the Act's requirements before a conclusion on the merits of the mandatory rotation proposal could be reached. We believe the evidence is in, and the only possible conclusion is that existing policies have not been sufficient to bring about the desired level of auditor independence and professional skepticism.

A closer look at those policies shows that none has enjoyed more than partial success. For example, even without the added inducement of lucrative consulting fees, for example, audit firms have proven reluctant to risk losing major audit clients. This reluctance is exacerbated by the long tenure of the typical audit relationship. According to a recent analysis by Audit Analytics, roughly 58 percent of all Russell 1000 companies have had the same auditor for more than two decades, and 16 percent have had the same auditor for more than 40 years. Thus, policies to restrict consulting activities of auditors, while important, do not sufficiently reduce auditors' incentive to hold on to the audit client at any cost. Perhaps because corporate boards continue to be hand-picked by management, perhaps because the rules requiring that a financial reporting expert sit on every audit committee were fatally weakened, audit committees have also been less effective than they could and should have been in promoting high quality audits. Until shareholders gain more say over corporate director selection, this is likely to continue to be a problem. Finally, the Private Securities Litigation Reform Act and a series of subsequent court decisions have drastically limited the ability of shareholders to hold auditors accountable when they aid and abet accounting fraud or are grossly negligent in fulfilling their responsibilities. As a result, there is little effective counter-balance to the conflict at the heart of the audit relationship.

The insufficiency of current policies was starkly illustrated in the 2008 financial crisis. While the crisis was not first and foremost an accounting crisis, accounting and audit failures appear to have played a secondary but significant role. Specifically, there is evidence that in some cases auditors allowed financial institutions to hide risks off-balance-sheet even though the company remained exposed to the risks. Similarly, there is evidence that in certain instances auditors signed off on, and may even have helped to design, transactions whose only purpose was to hide from investors (and perhaps regulators) the degree of leverage or other risks the company had taken on. And inadequate testing of, and insufficient challenges to, some financial institutions' questionable asset valuation practices left investors in the dark about the companies' true financial status. All these practices help to explain why dozens of major financial

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[2] Government Accountability Office, *Required Study on the Potential Effects of Mandatory Audit Firm Rotation*, GAO-04-216, Nov 21, 2003 available here.

institutions failed, or were prevented from failing only by massive government intervention, without a hint of prior warning to investors.

This concern is borne out by the findings of PCAOB inspections and other regulators. Not only do PCAOB inspectors continue to find audit deficiencies in areas important to the accuracy of financial reports, but they have found that “the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results” has frequently been a significant contributing cause of those deficiencies. Foreign regulators from the United Kingdom to Australia have reached similar conclusions, with the United Kingdom’s Audit Inspection Unit finding, for example, that auditors there sometimes “approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients.” Evidence that auditors too often see their role as supporting management can also be found in marketing materials that promote the audit firm as “partners” with issuers and pledge not to “second guess our joint decisions.” While no policy can be expected to eliminate all such problems, the evidence overwhelmingly suggests that this is not just a case of a few bad apples.

At the same time that questions are being raised about auditors’ independence, a move towards financial reporting that relies more heavily on professional judgment has heightened the importance of professional skepticism to the audit. Any move to adopt International Financial Reporting Standards would only heighten that concern. The major audit firms have been big advocates of IFRS, and they’ve argued that more deference should be given to professional judgments. But that approach, questionable at best, can only work if the auditors making those judgments are truly independent. The less objective financial reporting decisions are, the more prone they are likely to be to manipulation, and the harder it will be for auditors to challenge those decisions. (This is particularly true in an environment, for example, where financial regulators are all too willing to aid and abet financial institutions as they seek to hide their deteriorating financial condition.) Only a truly independent, objective, and skeptical auditor will be able to stand up under those pressures and ensure that shareholders receive accurate and complete financial information on which to base their investment decisions. If auditors lack that independence, or view themselves as partners with management, then the inevitable result for investors will be less reliable and less comparable financial reporting.

It is in this context that the proposal to require periodic rotation of the audit firm is being considered. It responds, for example, to the findings of the Canadian Public Accountability Board “that there is a higher risk of inappropriately reducing professional skepticism in instances where there is a greater familiarity or comfort with the reporting issuer and its historical accounting policies and practices.” In addressing the problem, mandatory auditor rotation incorporates aspects of all three principles for auditor independence policy listed above.

- Reducing the magnitude of the conflict.

  By limiting the total stream of audit fees a firm can expect to earn from a single audit engagement, mandatory rotation has the potential to significantly reduce the magnitude of the conflicts of interest. The shorter the rotation period, the less auditors have to lose if, by standing up to management, they risk lose the audit engagement.

- Limit management's influence on the audit.

  Management's influence on the audit can be further reduced under a mandatory rotation scheme if auditors receive some protection against dismissal, except for cause, before their rotation is up.

- Creating an incentive to counteract the conflict.

  The knowledge that another audit firm will soon be looking over the books provides a particularly strong incentive to get the audit right, since a new audit firm will have little if any reason to cover up or excuse a predecessor's lax audit practices. Fraud, in particular, relies on the perpetrators' ability to keep their activities hidden. Auditors who know the audit engagement will soon be coming to an end will be less likely to believe they can keep their activities hidden and will therefore have a strong disincentive to accede to fraud.

While not a panacea, mandatory rotation does have the potential to significantly reduce conflicts of interest that undermine professional skepticism and, with it, the quality of audits.

The chief arguments against auditor rotation are that it would increase the costs and decrease the quality of public company audits. We recognize that there can be additional costs on the front end when an auditor takes on a new audit client, and that mandatory rotation could have the effect of institutionalizing these added costs. But investors have repeatedly expressed a willingness to bear some added costs if the result is a better audit. There may also be a steep learning curve when a firm takes on a new audit client that temporarily puts audit quality at risk. But most of the biggest accounting frauds in recent years – Enron, Waste Management, Parmalat, to name a few – involved cases where the same firm had conducted the audit for many years or even many decades. This suggests that the risks associated with loss of independence in long-standing audit relationships may be at least as great as, if not greater than, the risks associated with auditor rotation. If mandatory auditor rotation were effective in reducing such long-festering frauds, which impose a hefty cost in the form of investor losses and diminished confidence in the integrity of the markets, it would more than justify the risks inherent in any significant policy change.

We find two arguments against mandatory rotation to be more persuasive. The first is that it simply would not be effective in bringing about the necessary improvement in auditor objectivity and professional skepticism. Ultimately, more radical solutions may be required, such as expanding auditor liability or abandoning the mandatory audit in favor of a financial statement insurance scheme, for example.[3] Given that neither of these approaches seems remotely likely to be adopted in the current environment, however, auditor rotation may be the best option we have to provide at least an incremental improvement in auditor independence. If reforms were simultaneously adopted to improve audit committee oversight of the audit – by giving shareholders greater say in the election of corporate boards and strengthening the

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[3] See, for example, Joshua Ronen, "Post-Enron Reform: Financial Statement Insurance, and GAAP Re-visited," 8 *Stanford Journal of Law, Business & Finance* 39, 48 (2002).

financial expertise requirement for audit committee members, for example – the chances would increase that we would see a meaningful improvement in auditor independence and audit quality as a result.

The second argument against auditor rotation that strikes us as having at least some validity involves its workability, particularly for the largest multinational firms. Excessive concentration in the audit profession has clearly limited the number of options that the largest public companies have when selecting an auditor. If such a company also employs one of the Big Four accounting firms as a consultant, the pool of available auditors would shrink even further, and the potential disruption associated with rotating the auditor could increase. Absent a break-up of the largest audit firms, there simply may not be a large enough pool of auditors available to make rotation for these firms practical. On the other hand, mandatory rotation could provide an opportunity for audit firms in the second rank to become competitive in seeking the audit business of the largest multi-national companies. At the very least, this is an issue that deserves careful scrutiny should the Board move forward with a proposal in this area. At the very least, the Board should seek to ascertain the interest of the second rank firms in expanding into that market, and it should have a clear idea of how the requirement would be implemented for these companies before finalizing a proposal.

A third counter-intuitive concern is that, by increasing competition for audit engagements, a mandatory rotation requirement could actually undermine auditor independence. After all, as long as issuers hire the auditors, and audit committees identify with management rather than shareholders, competition is likely to occur on terms that are harmful, rather than beneficial to investors. These could include driving down the cost of the audit below what is needed to support a robust audit or competing based on a pledge not to "second guess" management decisions. Rotation could conceivably have the effect of making such problems worse. Here again, effective reform of corporate boards would help to alleviate that problem. And, here again, the Board may need to take a closer look at the likely impact of mandatory rotation in this area in order to guard against any such effect as it moves forward.

If the Board decides to move forward with a mandatory auditor rotation rule, we offer the following suggestions with regard to its approach to rulemaking:

- The term of engagement should be no shorter than 5 years and no longer than 10 years, and the cooling off period should be roughly equivalent to the term of engagement.

- Under no circumstances should the Board limit the requirement to only the largest public companies. Smaller and mid-sized companies are more likely to have a larger pool of auditors capable of conducting their audits, making implementation of a rotation requirement easier for such companies.

- Mandatory rotation would work best if the firms were audit-only. Absent that fundamental change, if the Board adopts a mandatory rotation policy, it should also adopt a cooling off period before the audit firm could begin marketing non-audit services to their former audit clients.

- In order to minimize potential disruptions, the Board could and should phase in the requirement with adequate advance notice of the pending change.

- The Board should also consider whether additional rules are needed to govern the transition between auditors to minimize any potential for disruption during that process.

Conclusion

It has been a source of disappointment and frustration to us over the years that auditors and all too many issuers, while paying lip service to the importance of auditor independence, have consistently and strenuously resisted all efforts to achieve that goal. This was true in the 1990s when the Securities and Exchange Commission was considering auditor independence rules. It was true when Congress was drafting the Sarbanes-Oxley Act. And it is true now, as the PCAOB takes up this proposal to require periodic audit firm rotation.

Auditors who continue to respond to proposals to enhance their independence and improve the quality of their audits with a "just say no" attitude should take heed of the recent experience of the credit rating agencies. Rating agencies and auditors share many traits in common. Like auditors, ratings agencies' services only add value if they provide an expert and independent assessment, in this case of credit risk. Rating agencies operate with a serious conflict of interest, as they are paid (in the vast majority of cases) by the entity whose credit risk is being rated. For many years, they have profited handsomely from a government mandate that issuers use their services. And, despite repeated and egregious ratings fiascos, they have strenuously resisted all efforts to make them more independent and more accountable to the users of their ratings. In frustration over the ratings agencies' continued failures to meet acceptable professional standards, and the devastating impact that failure has had on the economy, Congress responded in the Dodd-Frank Act not only by subjecting ratings agencies to much more extensive regulation, but also by enhancing their liability and withdrawing their government mandate.

The same could happen to audit firms. Frustrated by auditors who seem to see their role as simply rubber-stamping management's disclosures, some have begun to question whether the mandatory audit is worth the high price that shareholders pay for it. For example, retired investment manager Tom Slee wrote the following in a blog post entitled "Are Auditors Becoming Irrelevant?"

> "I think that one of the main reasons public auditors have been marginalized is because they are no longer regarded as independent professionals. Certainly most institutional investors see them as an extension of management, fiercely loyal to their employers, the boards of directors … Moreover, auditors have lost a lot of credibility by hedging their opinions and making sure that management is solely responsible for the numbers."[4]

Instead of patting themselves on the back for dodging a bullet in Dodd-Frank, and digging in their heels in opposition to proposals such as this to enhance auditor independence and audit quality, auditors need to come to the table with meaningful alternatives if, in their view,

[4] See, for example, Tom Slee, "Are Auditors Becoming Irrelevant?" available here.

mandatory rotation is not the answer. For, while mandatory rotation may offer an imperfect solution and may pose implementation challenges, the one answer that is not acceptable to investors is a continuation of the status quo.

Respectfully submitted,

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