December 14, 2011

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

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

Members of the Board:

Thank you for the opportunity to provide comments to the Board with respect to your recent *Concept Release on Auditor Independence and Audit Firm Rotation* (the Concept Release).

Even if the Board had presented a persuasive evidence based argument that auditor independence is negatively impacted by the potential for a long-term fee stream, I believe that the Board's proposal fails to remove the financial incentive purported by the PCAOB to negatively influence auditor independence. I propose that it would be more appropriate for the PCAOB to recommend termination of the incumbent auditor to the company's Audit Committee in engagements where failed PCAOB inspections demonstrate material failures by the auditor in maintaining independence.

The Board argues that "[b]y ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper."[1] This argument is fundamentally flawed in that it confuses the firm and the auditor. Auditors, the lead partner in particular, rather than firms, are responsible for exercising their professional skepticism to ensure that independence is maintained and their responsibilities are effectively met. The responsibility of individual professionals, rather than the larger firm, to remain independent is supported by the Board's discussion of auditor independence in the Concept Release where it notes that "notwithstanding the relationship that provides **him or her** with a livelihood, the auditor must be an independent professional [emphasis added]."[2]

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[1] Concept Release, page 9
[2] *Ibid.*, page 4

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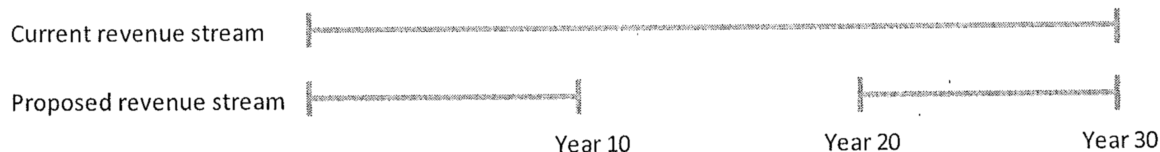
Research indicates that progression to partner in large firms takes approximately 13 years.[3] This implies that partners achieve that title at approximately 35-years-old, assuming that most college graduates enter the profession at age 22. The public accounting profession is also known for mandatory retirement ages resulting in few partners working past the age of 65. This implies that an individual's career in the partner role is limited to 30 years. Further research indicates that partner compensation in retirement is based primarily on their income level *during their working career*, which is influenced not only by the profitability of their own client engagements, but also by the profitability of the broader firm, practice area, geographic office, etc.[4]

Today, before implementation of the mandatory firm rotation regime outlined in the Concept Release, the longest potential income stream that could influence a partner's independence and judgment is 30 years. A client being served by a 35-year-old partner could be retained by the audit firm for the partner's entire 30-year tenure, thereby favorably influencing the partner's compensation during employment and in retirement. In contrast, under the mandatory firm rotation regime contemplated in the concept release, a client being served by the 35-year-old partner would be relinquished by the firm when the partner is 45-years-old due to mandatory firm rotation. However, it is reasonable to assume that the partner would be motivated to maintain a favorable relationship with the client during the initial 10-year term in order to increase the firm's likelihood of winning the client again after the issuer spends 10 years with a competitor firm. If successful, the client would be regained for another 10-year term when the partner is 55-years-old and retained by the firm until the partner's retirement at age 65.

The potential revenue streams associated with this client under the current environment and under an environment of mandatory firm rotation are outlined in the graphic below:

Partner is 35-years-old when client is obtained



Given these assumptions and a 12% discount rate, the regime of mandatory firm rotation reduces the present value of the potential income stream by only 22.6%.[5] If the negative

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3 *Promotion to Partner in Big Firms: Truths and Trends* by Robert E. Guinn, Sak Bhamornsiri, and Cindy Blanthorne accessed from The CPA Journal Online on November 17, 2011 from http://www.nysscpa.org/cpajournal/2004/404/essentials/p54.htm

4 *Primer on Partnership-Compensation Models* by Denise Dickins, Thomas G. Noland, and Kenneth M. Washer from the CPA Journal Online on November 17, 2011 from http://www.nysscpa.org/cpajournal/2005/805/essentials/p62.htm

5 Assuming $1,000,000 in annual audit fees, the present value of the 30-year potential fee stream relevant to the newly promoted partner is $8,055,184 assuming a 12% real rate of return. (Assumptions are as follows: Periods per year = 1, Number of periods = 30, Discount rate = 12%, Payment amount = $1,000,000, Future value = $0)

influence on auditor independence resulting from a potential long-term revenue stream is as strong as is purported by the Board, I believe that a 22.6% reduction in the present value of the potential income stream is highly unlikely to result in significant gains in independence and audit quality.

The greatest reduction in present value associated with a mandatory firm rotation regime would be accomplished if the new client was being served by a 45-year-old partner, as outlined in the graphic below:

Partner is 45-years-old when client is obtained

Under these assumptions, the present value of the potential fee stream is reduced by 24.4%[6] assuming a 12% discount rate. The reduction in the present value of the fee stream is highest at age 45 as the client is served for 10 years until the partner is 10 years from retirement. Once the client mandatorily rotates to another audit firm, the client could not return before the partner's retirement.

Once the partner reaches age 55, the mandatory firm rotation regime would have no impact on the present value of the potential fee stream, as outlined in the graphic below. The partner is not motivated by the potential for fee income past their anticipated retirement at

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Real cash flows and a real discount rate are used to avoid additional assumptions regarding the general rate of inflation and the rate of audit fee inflation.

Using similar assumptions, the present value of a 10-year engagement under the Board's proposal is $5,650,223 (Periods per year = 1, Number of periods = 10, Discount rate = 12%, Payment amount = $1,000,000, Future value = $0). As the second 10-year period is 20 years in the future, the present value of the second 10-year fee stream is $585,740 (Periods per year = 1, Number of periods = 20, Discount rate = 12%, Payment amount = $0, Future value = $5,650,223). The total value of the potential fee stream under the Board's proposal is the sum of the present values of the two 10-year fee streams, or $6,235,963 ($5,650,223 + $585,740).

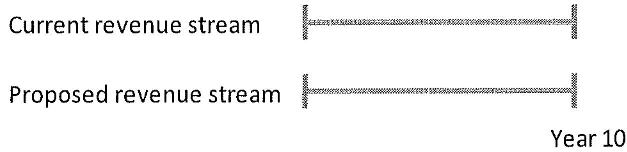
The present value of the potential fee stream under the proposal is 77.4% ($6,235,963 / $8,055,184) of the present value of the fee stream available ignoring mandatory firm rotation, which represents a 22.6% (100.0% - 77.4%) reduction in the present value of the potential fee stream available to the auditor in the current environment.

Note that the amount of the annual fee stream ($1,000,000) is irrelevant to the calculated impact (22.6%).

[6] The present value of the 20-year potential fee stream relevant to the 45-year-old partner is $7,469,444 assuming a 12% real rate of return. (Periods per year = 1, Number of periods = 20, Discount rate = 12%, Payment amount = $1,000,000, Future value = $0)

The present value of the 10-year potential fee stream under the Board's proposal is $5,650,223, as calculated in a previous footnote. Thus, the present value of the potential fee stream under the proposal is 75.6% ($5,650,223 / $7,469,444) of the present value of the fee stream available ignoring mandatory firm rotation, which represents a 24.4% (100.0% - 75.6%) reduction in the present value of the potential fee stream available to the auditor.

age 65 under the current system, so mandatory firm rotation would have no impact on the partner's independence.



A table detailing the reduction in present value of the potential fee stream associated with a client being served by partners of various ages and discount rates is outlined below:

Sensitivity Analysis - % of Annuity Present Value Eliminated by Rotation

		Rate of return (real)				
		8.0%	10.0%	12.0%	14.0%	16.0%
Partner's age	35	27.6%	25.1%	22.6%	20.1%	17.7%
	40	29.1%	26.1%	23.2%	20.5%	18.0%
	45	31.7%	27.8%	24.4%	21.2%	18.5%
	50	21.6%	19.2%	17.0%	15.1%	13.3%
	55 & over	0.0%	0.0%	0.0%	0.0%	0.0%

The greatest reduction in present value of the fee stream is achieved if the partner is 45-years-old when the new client is won. However, once the partner reaches age 55, mandatory firm rotation has no impact on the present value of the potential fee stream as the partner will retire at the same time mandatory firm rotation would be required.

The impact of mandatory firm rotation on the present value of the fee stream is modestly sensitive to the discount rate utilized. Given the franchise granted to the audit profession by the Securities Act of 1933, the relative lack of competition in the audit profession, high entry barriers resulting from the regulatory environment, and the high degrees of legal liability associated with the profession, it seems reasonable that long-run real rates of return should exceed market returns by a significant degree. However, even at a conservative real return of 8%, roughly comparable to long-run market rates of return, mandatory firm rotation has a relatively modest impact on the present value of the fee stream associated with a new audit client. Mandatory audit firm rotation is therefore unlikely to have a significant favorable impact on auditor independence or audit quality.

An Alternative

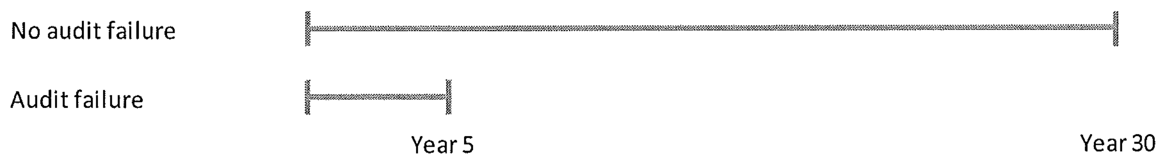
The alternative discussed above, whereby the PCAOB would recommend termination of incumbent auditor to the company's Audit Committee in engagements where failed PCAOB

inspections demonstrate material failures by the auditor in maintaining independence, would more effectively remove the financial incentive purported by the Board.

This alternative would likely result in a more immediate loss of fee income than the Board's mandatory firm rotation proposal. PCAOB inspections would obviously take time, but could result in termination by the Audit Committee within five years of a specific audit failure. Under this alternative, the replacement auditor would have the opportunity to retain the new client on a long-term basis if they provide effective client service while maintaining appropriate levels of independence and professional skepticism. Therefore, issuers would be far less likely to return to the former auditor due to the relationship likely to be built between the issuer and the new auditor. The incremental Audit Committee and management effort associated with hiring the replacement firm and educating them regarding the company and the industry in which it operates further decreases the likelihood that the issuer will return to the dismissed auditor.

The potential revenue streams associated with a client under this proposed alternative for a 35-year-old partner are outlined in the graphic below:

Partner is 35-years-old when audit under PCAOB inspection is conducted



Permanently losing a client after just five years of service would decrease the present value of the potential income stream by 55.2% for a 35-year-old partner.[7] The potential to lose a majority of the potential fee stream due to an audit failure identified by the PCAOB provides an effective financial counterweight to balance the potential influence of a long-term fee stream as purported by the board.

A table detailing the reduction in present value of the potential fee stream due to PCAOB imposed mandatory resignation at different partner ages and discount rates is outlined below:

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[7] The present value of a 5-year fee stream is $3,604,776 assuming a 12% real rate of return. (Periods per year = 1, Number of periods = 5, Discount rate = 12%, Payment amount = $1,000,000, Future value = $0)

The present value of the otherwise available 30-year potential fee stream is $8,055,184, as calculated in an earlier footnote. Thus, the present value of the 5-year potential fee stream under this alternative proposal is 44.8% ($3,604,776 / $8,055,184) of the present value of the fee stream otherwise available, which represents a 55.2% (100.0% - 44.8%) reduction in the present value of the potential fee stream available to the auditor.

Sensitivity Analysis - % of Annuity Present Value Eliminated by Resignation

		Rate of return (real)				
		8.0%	10.0%	12.0%	14.0%	16.0%
Partner's age	35	64.5%	59.8%	55.2%	51.0%	47.0%
	40	62.6%	58.2%	54.0%	50.0%	46.3%
	45	59.3%	55.5%	51.7%	48.2%	44.8%
	50	53.4%	50.2%	47.1%	44.1%	41.3%
	55	40.5%	38.3%	36.2%	34.2%	32.3%
	60 & over	0.0%	0.0%	0.0%	0.0%	0.0%

As demonstrated in the sensitivity analysis, the impact of this financial counterweight will be most relevant to younger partners, who are in the early stages of their responsibility to maintain independence despite the financial incentive toward client service purported by the Board. Further, the financial nature of this counterweight also makes it most relevant to those partners who are highly motivated by financial incentives, the very partners most likely to be susceptible to the purported incentive toward client service.

Again, thank you for the opportunity to provide comments on this matter.

Sincerely,

/s/ Craig A. Rabe

Craig A. Rabe
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