CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION

PCAOB Rulemaking
Docket Matter No. 37

TRANSITION FROM A MONOPOLISTIC BIG FOUR TO A COMPETITIVE BIG TWENTY-FIVE

"Creating greater competition is the best way and may be the only way to protect consumers and investors," Len Canty, Chairman of the Black Economic Council

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The PCAOB is to be commended for raising key issues as they relate to the independence of auditors and the accuracy of audits in protecting investors and consumers. As events over the last five years have made clear, the Big Four are not up to the task of being independent, exercising a substantial amount of professional skepticism or conforming to generally accepted accounting principles.

The three days of PCAOB hearings conducted in Washington DC and San Francisco have made clear that there is far from a consensus as to the need for auditor rotations.

Although we favor mandatory auditor rotation, as set forth in Section III of PCAOB Release No. 20011-0066, we also raise in these comments the larger issues that arose during the three days of hearings, including the over 650 comments filed.

We note that the Black Economic Council, the Latino Business Chamber of Greater Los Angeles and the National Asian American Coalition appear to be the only minority business groups that have offered comments and to date, the only minority business/consumer groups that have actually testified on behalf of our nation's 120 million minorities and six million minority owned businesses.[1]

I. Undue Concentration of Power

Historically, concentration of power by four entities nationwide, if not worldwide, would be viewed with great concern by U.S. antitrust officials and in recent times, by the European Union officials. But what the evidence demonstrates here is far worse than an oligopoly of four. Generally, just two of the Big Four CPA firms dominate most major industries.

That is, over 98 percent of all the assets of Fortune 500 companies are audited by the Big Four. But, within key industries that affect our financial and economic

[1] On March 22, 2012, Mia Martinez testified before the PCAOB in its Washington DC hearings on behalf of the three minority business groups. Their statement, "Preventing Another Greece or Iceland: Time for Truly Independent Audits by a Multitude of Firms," is available at http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Martinez.pdf.

health, such as the financial industry, more than 80 percent are dominated by just two of the Big Four.[2]

The *American Banker* of July 16, 2012, "Auditors Are Asleep at the Switch of Banks' Risk Controls," confirms these observations in its highly critical analysis of the Big Four firms' failure to analyze clear fiscal risks at JP Morgan Chase, Barclays and HSBC. It states, for example, that only two firms audit the four largest financial institutions and that Wells Fargo has used KPMG for 81 consecutive years. In addition, Citigroup, despite its long history of questionable accounting, has continued to use KPMG for 43 consecutive years.

CPA firms are not a natural monopoly, just as the legal profession is not a natural monopoly. Therefore the maintenance and, in fact, the deepening of this concentration should be examined with a healthy dose of professional skepticism and suspicion. If, for example, the evidence demonstrates that there are between 25 and 100 CPA firms with the size and audit experience to potentially compete, the PCAOB should request an early antitrust investigation by the Department of Justice and/or the Federal Trade Commission. This should occur even if the Big Four firms always provided independent audits with healthy professional skepticism that were invariably accurate and in accordance with generally accepted accounting principles.

However, the PCAOB's findings, as well as those of other globally important nations, demonstrate that the problem is getting worse, not better. That is, in at least a third of all audits of major public companies, including financial institutions, there is evidence of lack of independence, lack of professional skepticism and failure to comply with generally accepted accounting principles.

Should the PCAOB not take the lead in examining this concentration, it is likely that the European Union will do so, possibly to the detriment of Fortune 500 corporations headquartered in the U.S. and doing substantial business in the U.S.[3]

A decision to closely examine the nature of the Big Four monopoly should be accomplished quickly since there are growing calls for a global set of accounting principles that could be put into effect by next year.[4]

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[2] PricewaterhouseCoopers, for example, oversees audits for banks representing over $5 trillion or possibly half of all U.S. deposits. Similarly, Deloitte & Touche signed the audits for four of the ten largest financial institutions that failed during the recent financial crisis (Ameriquest, Bear Stearns, Merrill Lynch and Washington Mutual).

[3] The PCAOB and the SEC should consider whether implementing a set of accounting standards would be beneficial to improving audit quality. In addition to potentially providing greater investor confidence and improving overall audit quality, adopting a set of global standards might also advance the cause of mid-size, U.S.-based accounting firms (Top 100 and possibly Top 500) that currently lack the resources to effectively compete with Big Four firms under often widening global standards.

II. Top 25 to 100 Firms Can Effectively Compete

As set forth in the minority business groups' opening comments of March 22, 2012, there is no greater reason for a concentration among CPA firms than among legal firms.[5]

There are, for example, more than a hundred legal firms successfully competing for the business of Fortune 500 corporations. Many are doing so with professional staff one-twentieth or less the size of the Top Five law firms in the nation.

Our suggestion is that the PCAOB, which has received relatively little oral testimony from Top 25 or Top 100 CPA firms, convene an additional hearing this fall in Washington DC. Representatives from the Top 100 firms should be urged to testify as to their suggestions on how to expand competition within the industry. In order to accelerate the process, we would also suggest that the PCAOB invite comments from the antitrust divisions of the Department of Justice and the Federal Trade Commission.

We also urge that comments on this issue be requested by the federal regulators and perhaps state regulators. For example, comments should be sought from the Federal Reserve, the Office of the Comptroller of the Currency, the Department of Treasury, the Federal Deposit Insurance Corporation, the Federal Communications Commission and the Federal Energy Regulatory Commission, as well as state regulatory institutions, such as the previously referred to California Public Utilities Commission.[6]

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[4] See, for example, *New York Times* of July 7, 2012, "SEC Wary on Global Accounting Standard." It appears that the SEC is skeptical of global accounting standards. However, we do not share most of the SEC's concerns.

[5] See statement by the minority business groups of March 22, 2012, "Preventing Another Greece or Iceland: Time for Truly Independent Audits by a Multitude of Firms," available at http://pcaobus.org/Rules/Rulemaking/Docket037/ps_Martinez.pdf.

[6] The California Public Utilities Commission on June 29, 2012, denied without prejudice the minority business groups' request for an independent investigation of the monopoly by the Big Four by deferring at this time to the PCAOB. The proposed decision is available at http://docs.cpuc.ca.gov/efile/PD/169863.pdf, and the minority business groups' response of July 16, 2012 is available at http://docs.cpuc.ca.gov/efile/CM/170891.pdf.

III. Mandatory Audit Rotation

A very substantial number of Fortune 500 corporations have used the same auditor for 25 consecutive years or more. This includes over one-third of all Fortune 500 firms that existed 100 years ago continuing to use the same auditor.[7]

One solution recommended by many independent commentators, which we support, is mandatory rotation every five to seven years. Although the upfront cost in the first year may be slightly higher (up to 20 percent), this is a trivial cost. For example, an additional $1 million for a company whose revenue is $40 billion is far less than one-hundredth of one percent of revenue. (Amortized over five to seven years, it is essentially zero.) Most importantly, the benefits greatly outweigh any costs since it is likely that the existing firm auditing the company will perform at a heightened level of scrutiny in its last years to avoid future criticisms by the new auditor.[8]

Some critics have suggested, however, that this problem could in very large measure be solved by a mandatory bidding process every five to seven years in which not just the Big Four but also other CPA firms are encouraged to bid.

Others have suggested that this problem could be solved by strengthening the independence of corporate audit committees.

As to the first suggestion of mandatory audit bidding, it may have some merit. But it does not address the need to expand the number of CPA firms competing to 25 or 100.

The strengthening of the corporate audit committees does not appear to be a solution. Audit committee members are selected by the corporation that is subject to the audit. It is highly unlikely that any member of the audit committee under present circumstances will effectively question an auditor or demonstrate an appropriate degree of professional skepticism unless the entire corporate culture is revamped. A revamping of the corporate culture should, for example, require that members of the audit committee be approved by the PCAOB and/or are paid from

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[7] Eight Fortune 500 corporations have used the same Big Four auditor for 100 years or more. However, less than 20 firms have been Fortune 500 corporations for 100 years or more, and the overwhelming majority did not exists in any form 100 years ago.

[8] In light of concerns of limited auditor choice expressed by industry members, including audit committee members, mandatory rotation will advance the prospects for Top 25 to Top 100 accounting firms by necessitating that companies with limited options look outside the field of the Big Four for audit and/or consulting work. Further, one of the industry concerns relating to mandatory rotation relates to increased cost. With more company rotation, any audit cost increases, which we contend are minimal, should be further reduced. And it is possible, with increased competition, some corporations may realize savings that actually exceed the cost of new auditors.

an independent fund.[9] (The auditor could not be terminated except for good cause over a specified period.)

As set forth above, however, changing the corporate culture or the culture among the Big Four Family may be an impossible task and should only be a very last resort. Instead, the PCAOB should promote by every means possible, mechanisms, including financial incentives, so that within five years there are at least 25 and possibly 100 CPA firms in the U.S. capable of auditing virtually every U.S.-based company.

IV. Separation of Auditing From Other Services

It is evident that independent auditing with professional skepticism is endangered whenever a CPA firm is seeking to provide services other than an auditing function. Therefore, a minimum solution to a lack of competition should be a requirement that any firm auditing a Fortune 500 or Fortune 1,000 company be banned from providing any other services but auditing. But, we would go further.

We would also urge that new firms be created from the Big Four that are exclusively auditing firms. Should this occur, we will see an immediate increase in a number of other large firms capable of competing for the auditing business, since many of these firms are primarily audit firms and/or would decide to become audit firms in order to compete for the "lucrative" Fortune 500 businesses.[10]

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[9] Several panelists opposed to mandatory rotation suggested that mandatory rotation "inappropriately prohibits an entity's ability to continue with its existing auditor, even if the audit committee determines it is in the best in interest of the entity's shareholders." (See statement by Moss Adams LLP of June 28, 2012.)

Given the apparent infrequency with which audit committees actually propose changing their auditor, it is unclear as to whether audit committee members are being properly incentivized to fulfill their primary role as risk monitors and fraud preventers. The PCAOB should therefore examine whether equity options are being encouraged to meet corporate goals, such as unrealistic earning expectations rather than prevent fraud and accounting oversight. The PCOAB should explore how audit committee compensation and incentives can be constructed to encourage greater member skepticism.

[10] Some industry representatives, such as the director for The Home Depot, Inc. and Yum! Brands, Inc., suggested at the June 28, 2012 hearings that mandatory audit rotation would leave firms that employ one of the Big Four firms for non-audit work with few available choices for a new auditor. This is just another reason why greater competition and expansion of CPA audit firms is essential.

V. Public Release of PCAOB Inspection Findings

The PCAOB does not currently release the results of its audit inspections to the public. The PCAOB should consider whether releasing the details of their audit inspection, whether positive or negative, would encourage greater audit skepticism and therefore investor confidence. Greater PCAOB transparency might permit other regulators (such as the Federal Reserve, the Office of the Comptroller of the Currency and the California Public Utilities Commission), investors and the general public to analyze and detect trends in the audit process that warrant improvement.

According to the written comments of Moss Addams LLP, "…the PCAOB inspection process has helped firms identify and improve audit quality." Since the PCAOB can conduct only a limited number of inspections, this "help" can only be imparted to a limited number of industry participants. Broad and effective public disclosure, however, with regard to deficiencies found during PCAOB inspections, could help to improve the overall quality of the audit process by informing far more parties of potential issues. This includes pending utility rate increases before utility commissions as referenced by the minority business groups.[11]

The minority business groups also urge that the PCAOB secure comments from the recently formed Systemic Risk Council, chaired by former Federal Deposit Insurance Corporation Chairman Sheila Bair. This group includes many prominent financial experts, such as former Federal Reserve Chairman Paul Volcker. It might also be beneficial to secure comments from the Systemic Risk Council as it relates to the following section, "Legislation to Break Up the Big Four."

VI. Legislation to Break Up the Big Four

U.S. financial institutions are not permitted to expand once they hold more than ten percent of retail deposits. Yet, just one auditor, PricewaterhouseCoopers, oversees the audits for banks representing more than $5 trillion or about half of U.S. deposits. Similarly, one auditor, Deloitte & Touche, signed the audits for four of the ten largest financial institutions that failed in the recent crisis.[12] And, PricewaterhouseCoopers is also the longtime auditor of the key bank behind the Libor crisis and the related $450 million Barclays settlement with U.S. and U.K. regulators.[13]

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[11] See, for example, Petition for Rulemaking of February 23, 2012 filed by the minority business groups before the California Public Utilities Commission available at http://docs.cpuc.ca.gov/efile/PR/160308.pdf.

[12] See, for example, *GoingConcern* of July 16, 2012, "Deloitte Achieves Another Unflattering Milestone in Audit Quality," that is highly critical of Deloitte & Touche and other Big Four firms.

[13] As set forth by the *American Banker* of July 6, 2012, "Where Was Auditor PwC When Its Client Barclays Gamed Libor?" PricewaterhouseCoopers "missed, or maybe looked the other way at conduct that was 'regular and pervasive.'"

Legislation could effectively break up the Big Four oligopoly by limiting the number of Fortune 500 companies one CPA auditor could represent.[14] This option would limit systemic risk from auditor fraud and incompetence, and would at the same time increase the number of competing audit firms.

VII. Diversity

Despite minorities constituting more than 35 percent of the nation's population and likely to be 50 percent or more within a generation, the Big Four firms and possibly many others within the Top 100 have virtually no diversity, particularly in crucial senior partnership and leadership positions.

The Black Economic Council, as set forth in its written comments of June 28, 2012, contended that there are virtually no Black or Latino senior partners at the Big Four. And, the National Asian American Coalition has contended that among many of the major Asian American sub-ethnic groups, such as Vietnamese Americans and Filipino Americans, there are virtually no senior partners at the Big Four.[15]

It is likely that increased competition will create greater opportunities for diversity, since some of the Top 100 firms are far more diverse than the Big Four. As previously set forth, the PCAOB should immediately conduct a survey among the Big Four and separately for the Top 100 as to diversity.[16]

VIII. Broaden PCAOB Scope

The PCAOB was formed as a result of the Sarbanes-Oxley Act of 2002, which was largely precipitated by the Enron collapse by one of the then Big Five accounting firms, the late Arthur Andersen.

Given the widespread impacts of that single failure, plus the large number of financial company failures in the last several years and the growing complexity of

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[14] This legislation might also consider the use of key federal policies to encourage greater competition. This could include tax incentives, modified merger guidelines and federal contract preference for corporations that extend their auditor reach beyond the Big Four.

[15] See written comments of June 28, 2012 by Sheila Green on behalf of the minority business groups, "Ensuring the Financial Stability and Integrity of Fortune 500 Corporations," available at http://pcaobus.org/Rules/Rulemaking/Docket037/667_MM_BEC_LBCGLA_and_NAAC.pdf.

[16] On June 5, 2012, the minority business groups met with PCAOB staff, including Chairman Doty and board members Ferguson, Franzel and Harris in Washington DC. As part of the discussion, the minority business groups suggested that the PCAOB consider a State of Diversity Study with cooperation and support from CPA firms and foundations.

corporate accounting, the PCAOB should consider broadening, not narrowing, the scope of its responsibilities. It should therefore actively pursue all reasonable measures to prevent another Enron-like scandal, a JP Morgan Chase $5.8 billion improper risk loss, or a Libor scandal led by Barclays but participated in by a dozen prominent banks, in order to maintain a high level of investor confidence in all U.S. markets.[17]

This is especially important since the U.S., including the PCAOB and the SEC, are increasingly critical of the lack of Chinese government practices that may be allowing the Big Four and other CPA firms to reduce their professional skepticism and adherence to generally accepted accounting principles.

Respectfully submitted,

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[17] PricewaterhouseCoopers was the auditor for Barclays, but all the prominent banks involved in the scandal were audited by the Big Four Family.