From: Jim Johnston
To: Comments
Subject: Comments Regarding Audit Firm Rotation
Date: Wednesday, July 25, 2012 12:22:15 PM

To The Public Company Accounting Oversight Board:

In re: Concept Release On Auditor Independence And Audit Firm Rotation

I submit these comments primarily as a small investor, as well as having been a former auditor – now mostly retired. Frankly, in my view, there are many reasons that audit relationships that stretch over decades are ridiculous. In the interests of time, permit me to just point to a couple of potential problems.

1) Client manipulation of audit firm management. Leaving aside the possibilities of corruption on either the client or audit firm side, almost no likes being audited. Yes, there may some exceptions such as when a business owner suspects some form or other of employee theft, but any time ownership and/or management feels they are being looked at and/or second guessed, they are annoyed. Thus, management (and I will use the term "management" to represent both owner and management for my present purposes) normally has some degree of desire to guide where the auditors go, and what documentation/activities they inspect.

Auditor's managers have a set of performance goals they attempt to meet. It may be completing the audit within a given time frame. It may be maintaining a cordial working relationship with company management to either maintain the client or avoid legal entanglements with the client. It may be protecting the audit firm from legal liabilities to shareholders arising from the results of the audit. Whatever those goals may be, client management is very much aware of some, if not all, of said goals – and here I speak not just of the goals of the auditor's immediate managers, but also the audit firm's upper management. Client management usually has a set of routines they use to try to guide the auditors in the directions in which they wish them to proceed.

On top of the standard "bag of tricks" (if I may use that phraseology), client management tests the onsite audit managers to find the methodologies that allow them to play upon the audit manager's fears and/or ambitions – or his/her manager's fears and/or ambitions. The two managements (client and audit firm) develop a relationship over time that makes the audit firms practices and procedures predictable, and, therefore, subject to increasingly sophisticated manipulation.

Permit one quick example – net amounts. I can't speak directly to how public audit firms normally address net amounts, but I've seen this battle elsewhere. A company will typically not itemize all of their expenses, resulting in a category such as "other." If a breakdown of other expenses is requested, there will normally some catchall category, and, within that catchall category may be certain line items which are small net amounts. Sometimes an auditor wants to examine the small net line item to determine exactly what it is on the theory that two or more large items may have been netted to arrive at the small line item. When the auditor requests detail from the client, client management turns to the auditor's manager and objects because the expense doesn't rise to a given materiality threshold. If client management knows the auditor's manager will yield on this point, potential problematic result should become obvious.

2) Burnout. It is my opinion there is a learning curve on any large audit client or any client that operates in an industry with business practices which are unique that industry (or, perhaps, the client itself has unique business practices). During the first audit cycle, the auditor spends a good deal of time learning how the client/industry operates. By the third audit cycle, the audit team has a pretty good feel for the client – although an outsider is unlikely to ever develop the level of comfort with client business operations as a company insider would have. I once heard a client manager talk quite indiscreetly to some of his associates about how the auditors were no problem because he would simply "bury them in [nonsense]." In other words, he would provide them with so much worthless documentation that they would never have time to figure out where the true problems lay.

But I digress. Again, in my opinion, 10 years is probably the outer limit of an acceptable client/auditor relationship. By that time, the audit team is so used to how the client operates (and how it manipulates the audit team), that they begin to just go through the steps. Granted this doesn't apply to every auditor, but I think every auditor needs a change of pace, and I think the same rule probably applies to every audit firm.

Recommendations:

There probably should be more recommendations than I am going to make here, but I forgot about the deadline for comments, and, thus, I am scrambling to submit these comments. Plus, admittedly I didn't have time to read the entire PCAOB document.

1) On page 13 of the PCAOB discussion paper, former SEC Chairman Harvey Pitt alluded to the fact that specialized companies and industries require auditors who have developed expertise in a client's unique practices, and, thus, this perceived expertise justifies a longer client/auditor relationship. While there is some validity to this point, I think it is overstated. In the first place, that loss of expertise is going to have to be addressed by someone at some point in time because of rotation, retirement, whatever. Secondly, there are publications by the AICPA and governmental agencies which provide guidance for unique industry practices. Thirdly, a fresh set of eyes may see something that the "expert" was overlooking. There are more points that can be made, but that's enough for now.

Solution: If there is some legitimate concern that changing audit firms will damage the audit process, then the purported experts from the departing audit firm (hereinafter, Old) should be loaned out to the new audit firm (hereinafter, New) for the period of one audit.

It should be made clear to all parties that the Old "experts" on loan should be fully forthcoming with their New trainees. If New personnel believe they are not being properly trained, they should submit the matter to the PCAOB for investigation, and, if appropriate, penalties.

2) Oversight - Certain difficulties probably cannot be overcome (Congress comes to mind), but audit firm management should be subject to periodic review by the PCAOB. Perhaps, one or two individuals, should be assigned to several audit teams, and they should periodically review audit firm practices, procedures, and, perhaps more importantly, firm culture. This should include private interviews of audit team members. There should also be a secret reporting hotline set up for when an auditor believes he/she is not being allowed to pursue proper audit methodologies. However, such reports should represent nothing more than a caution flag unless the report is sufficiently detailed as to make it highly credible. In the latter case, the PCAOB should have investigative and penalty capabilities. I guess I am, to some degree, agreeing with Mr. Pitt here except that I support audit firm rotation.

Will these suggestions eliminate all the potential problems? Of course not. But, as an investor, publication of these steps along with some evidence of follow-through would lead me to be more comfortable with the financial statements I review to determine whether or not to buy a given stock. If the U.S. stock market loses credibility – which I think it is in danger of doing, we risk becoming a second tier (third tier?) economy in which the costs of borrowing and selling stock are going to become far more expensive and difficult.

Maybe these processes are already in place to one degree or another, but if they are, they aren't being sufficiently touted to the investing public. Thanks for your efforts on this matter.

Sincerely,

Jim Johnston, MBA, CPA