McGladrey & Pullen, LLP

20 N. Martingale Road
Suite 500
Schaumburg, IL 60173
O 847.413.6900 F 847.517.7067

www.mcgladreypullen.com

PCAOB Meeting on Auditor Independence and Audit Firm Rotation

Statement of Joe Adams, Managing Partner and CEO

McGladrey & Pullen, LLP

March 22, 2012

Introduction

McGladrey & Pullen, LLP is the fifth-largest provider of accounting, tax, and consulting services in the United States. We serve middle-market issuers, brokers, and dealers. Like all independent registered public accounting firms, our firm is structured as a partnership, anchored in the principle that the auditing professional must be in control of, and financially at risk for, the quality of the audit services provided.

The professionals at McGladrey & Pullen know full well that independence is paramount to the auditing profession. Our firm therefore appreciates the opportunity to participate in the PCAOB's public meeting on auditor independence and audit firm rotation. My remarks today are consistent with our December 9, 2011 comment letter on the PCAOB's *Concept Release on Auditor Independence and Audit Firm Rotation,* but also include more recent observations.

Objectivity Is Critical to the Viability of Auditing as a Profession

The focal point of the PCAOB's *Concept Release on Auditor Independence and Audit Firm Rotation* is the principle of auditor objectivity. We believe virtually all auditors are personally committed to the principles of independence, objectivity, and professional skepticism. Although auditors are bound by a code of ethics that requires it, the exercise of independence, objectivity, and professional skepticism cannot be legislated through a set of rules that purport to mandate those qualities.

Auditors realize that a lack of independence, objectivity, or professional skepticism can have dire consequences, not only for their firm, but also for them personally. Auditors are subject to state laws that generally require CPA firms be owned by individual CPAs, who not only have capital at risk but are personally liable for the reports they issue on behalf of the firm. Also, the SEC, the PCAOB, and state regulators can impose disciplinary or financial sanctions on both the individual and the firm as a result of an investigation into the auditor's professional activities. Therefore the personal financial resources of our partners, and indeed even their livelihoods, are at stake with each audit opinion we sign.

Although objectivity is critical to the viability of auditing as a profession, it is important to remember that objectivity is not the only driver of audit quality. The quality of an audit is built on the competence, due care, independence, integrity, and objectivity of the people who perform the audit. If auditors are objective, but do not possess the competence and industry expertise to carry out their duties, audit quality is diminished. It therefore is imperative that our profession continue to enhance all drivers of audit quality, including independence and objectivity.

Investor surveys continue to indicate that the independent auditor remains the most trusted participant in the financial reporting process. It is a recognition that we place at the top of our priorities, is essential to our brand, and motivates us to perform our duties at the highest levels of integrity.

Mandatory Audit Firm Rotation Would Not Serve the Board's Goals of Protecting Investors or Enhancing Audit Quality

The PCAOB selects the audits for inspection that it believes present the highest risks and then reviews the areas within each audit that are the most complex and challenging. Inspections are designed to identify and focus on potential audit deficiencies. In Part III.C. of the Concept Release, the PCAOB stated the following regarding the limitations of its inspections data, “Preliminary analysis of that data appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports.” The root causes of audit failures are complex and vary in nature. Currently there is significant work being done to analyze root causes of audit failures that will provide further information on improving audit quality. It may be prudent to consider the findings from these analyses before mandating audit firm rotation.

Moreover, because audit engagements with short tenure are relatively riskier than those with a longer tenure, mandatory audit firm rotation could contribute to a decrease in audit quality. Audit quality may suffer in the early years of an engagement because the auditor does not understand the client’s business as fully as he or she does in subsequent years after more experience with the client. Mandatory audit firm rotation would only exacerbate this risk. Having a long-term relationship with a client should not breed a lack of objectivity. Rather, we believe we are more effective auditors when we have a deeper understanding of the client’s business model. The Cohen Commission reported that in its “study of cases of substandard performance by auditors, several of the problem cases were first- or second-year audits.”[1] Also, according to a survey by the United States General Accounting Office, 79% of larger audit firms and Fortune 1000 companies believed changing audit firms increases the risk of an audit failure in the early years of the audit.[2]

Ending a firm’s tenure with a client after a prescribed number of years would increase the amount of time and resources auditors spend proposing to enter new client relationships. This could lead to an unintended consequence of stretching already scarce resources even more and put at risk the amount of time auditors have to focus on audit quality. The competition that would result from mandatory audit firm rotation could actually decrease the amount of fees that a firm obtains in an audit as audit firms aggressively pursue replacement business. This could result in the unintended consequence of a decrease in audit quality because the amount of fees might put undue pressure on the number of budgeted audit hours committed to an engagement.

Mandatory audit firm rotation could result in other unintended consequences that decrease audit quality. For example, in certain industries, there are a limited number of firms with the requisite specialization to serve clients. Mandatory audit firm rotation could result in an issuer being audited by a firm that does not have the level of industry specialization needed. Geographic constraints also may narrow the field of eligible registered public accounting firms that are able to serve a particular issuer. Realistically, there will be problems associated with the need to transfer audit firm employees to other locations.

Generally company management, audit committees, regulators and audit firms are aligned regarding the goal of producing accurate and reliable financial statements for investors. Thus, the merits of mandating change as significant as this for all publicly owned companies in the hopes of preventing a few misleading financial statements from slipping through the cracks could certainly be called into question. Mandatory firm rotation can also cause unintended consequences that are difficult to anticipate. A change such as this could change the competitive landscape among the firms who currently provide audit services to public companies.

Our Views on Other Measures that Could Meaningfully Enhance Auditor Independence, Objectivity, Professional Skepticism, and Ultimately Audit Quality

The PCAOB has issued a number of important auditing standards and guidance that we expect will have a positive impact on audit quality. In August 2010, the PCAOB adopted a suite of eight auditing standards related to the auditor’s assessment of, and response to, risk in an audit. In July 2009, the Board adopted the *Engagement Quality Review* standard. The PCAOB also has issued a number of *Staff Practice Alerts*.

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1 The Commission on Auditors' Responsibilities, *Report, Conclusions, and Recommendations* (1978) ("Cohen Commission Report") at 109.

2 United States General Accounting Office, *Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation* (2003) at 6.

Because these standards and guidance were only recently issued or effective, their effects have not yet been reflected in audits the PCAOB has inspected. It will take several years for the PCAOB to adequately evaluate the full effects of such improvements.

Rather than the PCAOB setting standards regarding mandatory audit firm rotation, audit committees should, and do, initiate firm rotation as they deem necessary or appropriate. Mandatory audit firm rotation would diminish this important role of the audit committee, which could adversely impact audit quality. Through their various discussions with the audit firm, audit committees are in an excellent position to evaluate the independence, objectivity and skepticism of the engagement partner. Therefore, audit committees need to be very diligent in dialoguing with their auditors in meaningful two-way communication, especially as it relates to areas that are highly subjective in nature.

The PCAOB's *Proposed Auditing Standard Related to Communications with Audit Committees* will expand current requirements for auditors to communicate with the audit committee on significant matters related to the audit and the issuer's financial statements. We believe the new standard will foster even more productive dialogue between auditors and audit committees on significant audit and financial statement matters that require the auditor to exercise objective professional judgment. It is during these types of discussions that the audit committee will have an improved ability to measure the objectivity, technical competence, and other attributes of their auditors.

Although audit committees can and should assess the objectivity, technical competence, and other attributes of its audit firm, it is the auditing profession that needs to take responsibility for improving audit quality, including the exercise of objectivity and professional skepticism. Audit firms should consider the sufficiency of formal training provided to their auditors regarding the use of auditor judgment. Because we believe that our reputation for quality is our most valuable asset, we will continue to provide more formal in-depth training to our auditors regarding the use of auditor judgment. Also, after evaluating the root causes of an audit deficiency, if it is determined that there has been a lack of due care on the part of any of our auditors or if an auditor has failed to exercise his or her professional skepticism, there are ramifications to the auditor initiated by our firm. We believe the auditing profession must take and does take responsibility for reprimanding or otherwise disciplining any auditor who exhibits a lack of due care objectivity, or professional skepticism. On the other hand, auditors who consistently exercise due care, objectivity, and professional skepticism must be supported and rewarded by the firm, even in light of the potential loss of a client that could result from the objective exercise of professional judgment in the service of the public interest.

Concluding Remarks

Given that PCAOB audit findings indicate consistent performance amongst CPA firms, we question how rotation will improve the results. The exercise of skepticism and objectivity cannot be legislated through a set of rules that purport to mandate those qualities. It is up to the profession to uphold our reputation as the most trusted participant in the financial reporting process and continue to maintain that trust.

In that regard, continued dialogue about enhancements to current requirements will play an important role in future improvements to audit quality. It has been our pleasure to participate in this important discussion. I would be pleased to respond to any questions the Board or its staff may have about these comments.