

**Auditor Independence
and Audit Firm Rotation**

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I am very pleased to be with you today, and to discuss this very important issue of auditor independence and audit firm rotation. As the history section of the PCAOB concept paper pointed out, audit firm rotation was debated in the wake of the Penn Central Crash and in 1977 Metcalf hearings. I was involved in both situations and, for most of the subsequent debates over the last 30 years, including the hearings on the Sarbanes/Oxley legislation.

Audit Independence

Nothing is more important than the issue of “audit independence” regarding the interface of the professional audit firm and their client. There is an “inherent conflict of interest” when the big corporate clients are paying the audit fees. The same is true of the rating agencies. So you must decide on how best to strengthen “audit independence.”

I believe that the Sarbanes/Oxley legislation has been a big success in strengthening and improving the audit independence in the vast majority of the small and medium size client situations. However, many people believe that in the 2008 financial crisis, there were far too many incidents where the audit firms did not insist on full disclosure of risks and material weaknesses of their biggest clients. And all too many of the financial statements did not “fairly present” the financial position of the client.

A partial list of companies in this situation would probably include Bear Stearns, Lehman Brothers, Morgan Stanley, Merrill Lynch, Citibank, Bank of America, AIG, General Motors, General Electric, Fannie Mae, Freddie Mac and some of the other big GSE's.

I believe it is very timely and somewhat overdue that the SEC and PCAOB consider additional issues that would further strengthen auditor independence in addition to ones enacted in the Sarbanes/Oxley legislation.

Auditor Rotation

I believe the most important change/improvement would result from the requirement of “audit firm rotation” for the biggest clients of the Big 4 firms.

I believe the “comment memorandum” that John H. Biggs, Retired Chairman and CEO of TIAA-CREF submitted to the PCAOB is an excellent paper on the history of the audit firm rotation issue, and why the events of the last 10 years (since Sarbanes/Oxley was passed) clearly show the need for requiring that public companies periodically rotate their audit firms.

The main two benefits of firm rotation were featured in the Cohen Commission report in 1978. First, “since the tenure of the independent auditor would be limited, the auditor’s incentive for resisting pressure from management would be increased.” Second, “a new independent auditor would bring a fresh viewpoint.”

The main three arguments against “rotation” are:

- (1) Increased cost
- (2) Steep learning curve for the new auditing firm which might lead to an “audit failure”
- (3) Too much disruption for the auditing firms

I believe that it would be wise to limit the adoption of audit firm rotation at the beginning to somewhere between 25 and 40 very large companies. The selection should include all the major financial institutions (and certainly any firm that is designated as “Too Big To Fail” by the FDIC). Also, the selection should include some of the biggest industry leaders, such as General Motors, General Electric, etc.

In addition, it might be prudent to include any large companies that appear to have significant audit and/or accounting problems.

If the rotation is limited to very large companies, the cost issue becomes moot. The cost of an audit for the very largest companies is a very small percent of their overall cost structure.

The "steep learning curve" issue can be addressed by requiring a dual audit by two firms in the last year of the audit term (the 10th year). And, in addition, by requiring each firm to submit a report to the Board of Directors, the investors (public document), the PCAOB and the SEC on overall condition of the financial statements and systems and controls (Section 404 of SOX). This would result in what John Biggs called in his November 21, 2011 paper....a "real-time" peer review. His paper goes on to state "The outgoing auditor would want the work papers to be complete and of high quality with all problems clearly resolved. The new firm would review them, and could either challenge their results, or start with fresh eyes."

The third issue is that it would be too disruptive for the auditing firms if rotation is required every 10 years. I have never been convinced of this argument, and when I was Comptroller General of the United States when we issued the auditing standards for all the states and large cities and other municipalities (Yellow Book), we included a rotation of auditors every five years. It also should be noted that the European Commission is considering that audit firms will be required to rotate after a maximum engagement period of six years (with some exceptions).

However if, at the beginning, you limit the number to 40 companies, and stagger the rotation over 10 years, the result is probably each of the Big 4 firms losing 1 or 2 firms each year, and maybe picking up 1 or 2 firms. In each year now, they all lose and gain many more clients because of mergers, sales, etc., of clients. In 2002, the number of companies that were forced to change auditors by the demise of Arthur Andersen & Co. was in the hundreds, and it was successfully accomplished.

As the "last" Chairman of the POB, I strongly recommended to the Congress, the creation of the PCAOB because of the POB's inability to oversee the Big Firms and the AICPA. I salute the current leadership of the PCAOB for taking on the major issues that are now on your agenda. And as I said at the beginning, the rotation issue is No. 1, and we have debated it for over 30+ years. The last 10 years have provided more than enough evidence that it should be adopted.

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