**PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD**

**PUBLIC MEETING**

**REGARDING**

**AUDIT INDEPENDENCE AND AUDIT FIRM ROTATION**

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**Written Statement**

**of**

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## INTRODUCTION

In August 2011, the Public Company Accounting Oversight Board ("PCAOB") issued a Concept Release to solicit public comment on ways that auditor independence, objectivity and professional skepticism could be enhanced. The PCAOB is specifically seeking comment on mandatory audit firm rotation as well as other approaches to enhance auditor independence.

I want to thank the PCAOB for inviting me here today to express my views regarding the critical issues of auditor independence, objectivity and professional skepticism. For many years, I have investigated numerous major audit failures and accounting fraud and testified as an expert witness in litigation relative to these issues. In September 2000, I testified before the U.S. Securities and Exchange Commission ("SEC"). Such testimony stated, in part, that, based on my investigation of almost 50 audit failures which resulted in legal actions, I concluded that the underlying cause of the majority of such audit failures was compromised auditor independence.

## AUDITOR INDEPENDENCE

The compromised auditor independence in these audit failures resulted from many improper actions and relationships between the auditors and their audit clients. However, the underlying reason was that the auditor was hired and paid by the audit client. True auditor independence will never be achieved and audit failures will continue until the auditors are hired and paid by an entity independent of the audit client (preferably a regulatory entity or one that is designated by the regulatory entity). Until this change in the relationship between the audit client and the auditor occurs, there are other things that can be done to enhance auditor independence, objectivity and professional skepticism.

## MANDATORY AUDIT FIRM ROTATION

While mandatory audit firm rotation, which has been considered and debated for decades, will not achieve true auditor independence, as previously described, it is a viable and necessary step forward in enhancing auditor independence. While there may be different options to structure the rotation process, I believe the PCAOB should link the rotation process to its inspection program. The structure I propose is to have a rotation period of 10 years unless the PCAOB's inspectors submit a report that reflects an audit that failed to comply with the PCAOB's standards and is, in essence, an audit failure. If that happens, the PCAOB should require a total audit team rotation for the next audit of the client. If the next PCAOB inspection of the audit work for the same client reflects another audit failure and failure to comply with the PCAOB's standards, then the audit firm would be automatically rotated off the client's audit irrespective of which year in the 10-year normal rotation cycle such second audit failure occurs.

Mandatory audit firm rotation has the benefit of establishing a limit on the continuous stream of audit fees that an auditor may receive from a single client. This, in turn, would significantly free the auditor from pressure by client management to accept the client's financial reporting without necessary changes suggested by the auditor. Mandatory audit firm rotation also has the added benefit of a new and fresh evaluation of the client's financial reporting and eliminates long-term cozy relationships between the client and auditor which often leads to the auditor compromising its independence. Mandatory audit firm rotation is also beneficial when many of the audit firm's partners, managers and staff have accepted positions with the client which further influence the audit firm's decisions.

Opponents of mandatory audit firm rotation have expressed concerns that audit quality may suffer in the early years of an engagement and that rotation could exacerbate this issue. I believe just the opposite is true. In my view, audit quality tends to suffer the longer the auditor/client relationship lasts because the auditor becomes too cozy with the client, becomes complacent, and does everything possible to protect the audit income stream. In the audit failures that I have investigated, I saw time and time again where long periods of experience and depth of knowledge of a client did not improve audit quality but, instead, it caused audit quality to suffer because the auditors wanted to keep the audit income stream and failed to insist on needed changes in the client's financial reporting or to qualify the auditor's opinion on the client's financial statements. Enron was one of many examples that I investigated where this was very evident. Moreover, in a mandatory rotation, the new auditor would expend special additional effort to understand and audit the client's internal control systems and financial reporting.

Opponents of mandatory audit firm rotation have also expressed concerns about additional costs that changing auditors could impose on certain issuers. First of all, the additional costs of having a new auditor usually occur only in the first year or perhaps two years at most. Moreover, such additional costs will not significantly affect the larger clients. In addition, all clients, regardless of size, need to understand that the short-term additional costs are far less than the costs of litigation if their financial reporting is misleading and not caught by a long term, complacent auditor who is not on his toes like a new auditor would be with new eyes focused on the client's financial reporting.

It should be kept in mind that companies routinely change auditors. In fact, over the last decade, a large number of public companies have changed auditors, including all of the public companies that were clients of Arthur Anderson & Co. In addition, after all those changes in auditors, restatements in the U.S. have actually decreased. Thus, the evidence reflects that the audit quality actually increased, rather than decreased, after these auditor changes, irrespective of some additional costs.

Questions have been raised in the Concepts Release regarding implementation of the mandatory audit firm rotation. To avoid too much disruption at any one firm, I believe it would be beneficial to stagger implementation of the rotations at each firm with special emphasis placed at first on large clients that have high risk audit issues, as well as some smaller clients with high risk audit issues. It should be kept in mind that smaller clients have high risk audit issues caused, in part, by the fact that their internal control systems may not be as developed, complete or effective as the systems of larger companies.

## AUDITOR SKEPTICISM AND OBJECTIVITY

In the numerous audit failures which I have investigated, compromised objectivity and a lack of professional skepticism have been significant factors which caused such failures. The most common result of this lack of professional skepticism was excessive reliance on management representations without obtaining adequate corroboration with persuasive audit evidence. This is particularly evident in high risk audit areas that required critical management estimates and judgment. It was no surprise that such lack of auditor professional skepticism was found in many long-term client relationships.

The solution to this critical problem is not easy because audit partners are routinely judged and evaluated by how well they kept the client "happy" and satisfied. Thus, there is an inherent conflict for the audit partners in trying to keep the client satisfied while at the same time challenging the client's financial reporting and judgments. However, there are important steps that can be taken to enhance professional skepticism in any audit. The PCAOB should consider reemphasizing and incorporating into its professional standards the following steps:

a. Require that more emphasis be given to professional skepticism during the audit planning meetings of the audit firm. Have every one of the audit staff that will work on the audit attend such meeting.

b. Accept no management representation that cannot be adequately corroborated with appropriate persuasive audit evidence. This would be especially critical when auditing high risk areas that require management estimates and judgments.

c. The audit partner should “thoroughly” review all high risk audit areas with special emphasis on seeing that the appropriate degree of professional skepticism has been applied and persuasive additional audit evidence has been obtained where representations of management have constituted important or principal audit evidence.

d. Most of the second partner reviews in the audit failures which I have investigated have been highly limited in scope. The second partner reviews should be much more comprehensive in high risk audit areas and should also determine if professional skepticism has been appropriately applied in such high risk areas by obtaining persuasive audit evidence to corroborate management representations and judgments.