Statement Concerning Auditor Independence

And Audit Firm Rotation

Conrad W Hewitt

Former Chief Accountant

US Securities and Exchange Commission

June 28, 2012

I am very pleased to be participating in a panel of other distinguished panelists to discuss PCAOB's concept proposal on Auditor Independence and mandatory rotation of auditors.

I am also pleased that PCAOB had brought this important discussion to the West Coast. Based upon recent years I do not recall any SEC or PCAOB Roundtable on the West Coast. The West Coast is important because of the many public companies headquartered here, as well as the types of industries prevalent here such as high tech.

The subject for today's panel is important for everyone – the management, preparer, auditor, Board of Directors, regulators and investors. Auditors' independence has been debated for decades, with some changes such as mandatory rotation of the engagement partners every five years for public companies. I have observed several examples of audit partner's rotation and this is not an easy requirement to implement. There is not always an abundant supply of audit partners in a specialized industry. I do believe that the mandatory rotation of partners does bring a fresh approach to all aspects of an audit, such as objectivity, independence and skepticism.

My comments are based on my 33 years in public accounting, four years as a regulator of financial institutions (Commissioner, Department of Financial Institutions, State of California), Chairman of Audit Committees for 6 public companies, and 7 private companies, and most recently as Chief Accountant of Securities and Exchange Commission – SEC). I have had much exposure and experience concerning auditor's independence, professional judgment and skepticism, as well as being an investor for over 40 years. Investors use financial statements as one of many factors considered before an investment judgment is made.

Regarding auditor's Independence, the auditor has many different standards to adhere to. For example, the 50 states, the AICPA, the SEC, the International Ethics Standard Board, and now the PCAOB, are all involved with the independence of an auditor. It is almost impossible to comply with all the various independent standards.

As Chief Accountant of the SEC, I had several professional staff working on independence matters and investigations. Fortunately, many of the independent matters were volunteered to us by various accounting firms, and we noted that many of the larger firms had professional staff devoted internally to ensure that independence standards were complied with.

I am concerned about the multitude and differences in independent standards in this fast growing global economy. I have been a vocal advocate of a single high quality, international accounting standard, as well as a single, high quality set of international auditing standards. The SEC and PCAOB should consider promoting a single, high quality set of independence standards to comply with instead of the multitude of independence standards which exist today.

The Sarbanes Oxley Act has strengthened auditor's independence, objectivity and professional skepticism with focus on the duties and responsibilities of the audit committee.

Based upon my experiences as Chair of audit committees, audit committees need to be more involved with the auditor's independence. The PCAOB and SEC need to focus more on audit committees to ensure the independence of auditors without requiring mandatory rotation of auditing firms. SOX gave audit committees considerable power and authority over auditing firms. I believe they should exercise this authority more.

One problem that exists with audit committees is the credentials and qualifications of the members of the committees, and a lack of continuing education requirements for its members. The SEC could require that proxy statements would indicate that audit committee members would be required to obtain 4 hours of continuing education, with requirements eventually being increased to 8 hours. This could be the same type of disclosure which now exists for the attendance of board members to Board of Director meetings.

The PCAOB and the SEC should devise a set of guidelines for audit committees to consider annually, with respect to the independence of its audit firm. The guidelines would be the foundation of the audit committees to discuss and document all aspects of independence with its auditors. This would create a greater focus on independence and transparency.

As Chief Accountant, I created an Advisory Committee on Improvements to Financial Reporting. This committee did debate audit compliance and audit process. They focused on materiality, restatements and judgments related to accounting matters. The PCAOB and SEC spend considerable time on whether a professional judgment is properly made. Generally, regulators respect judgments if they are well documented, unbiased, and provide evidence to support a conclusion.

Creating an environment in which all bodies understand a reasonable judgment after the fact needs to be performed by the PCAOB and the SEC. This environment would aid in the independence of an auditor. The Advisory Committee recommended (Recommendation 3.5) that “the SEC should issue a statement of policy articulating how it evaluates the reasonableness of accounting judgments…when making this evaluation. The PCAOB should also adopt a similar approach with respect to auditing judgments.”

Before leaving the SEC, my staff and I developed such a policy on reasonable judgment, but it was never finalized nor made public. I also felt such policy should apply to the accounting profession in the making of professional judgments. I would strongly encourage PCAOB and SEC to implement a "reasonable judgment" internal policy. Also, the accounting professionals should be required to adopt such a policy. I believe that this would give some comfort to investors with respect to the reliability of financial statements and professional judgments made by the auditors. This would enhance the auditor's independence.

Lastly, I would like to comment on the mandatory rotation of audit firms. I do not believe that the policy would prevent accounting scandals and frauds, such as Enron, World Com, Sunbeam, AIG, Freddie Mac, Health South and Madoff. There has never been any evidence that a mandatory rotation of auditors would have prevented these frauds or improve the quality of an audit. Please keep in mind that these terrible events occurred over many years. Many of these accounting scandals were due to existing accounting standards which were based on rules and not principles, and permitted such abuses of GAAP. Fraud is always difficult to detect and prevent. A mandatory change in auditors would not stop such frauds.

I have been involved in cost/benefits proposals of regulations and standards. Based on my experiences, the costs(direct and indirect) would greatly exceed the benefits of a mandatory rotation policy.

In summary, I applaud the PCAOB to reexamine the auditor's independence and mandatory rotation of auditors. The solution to the problem is not simple. The PCAOB should focus on strengthening the audit committees so that they can carry out their responsibilities and auditing under SOX without making mandatory rules and regulations. Also, the PCAOB should focus on its own reasonable judgment internal policy, the training of auditing firm's staff with respect to independence, determining the root causes of past, current and future independence cases, and providing more transparency to the auditing firms and investors concerning independence problems. The PCAOB inspection process should identify, classify and determine solutions to any results concerning an auditor's independence.

I recommend:

1. PCAOB and SEC need to require continuing education requirements of all audit committee members, with adequate disclosure in the proxy statements similar to directors' attendance.
2. The PCAOB and SEC need to develop and implement a "reasonable judgment policy" for internal use and for accounting firm professionals.
3. The audit staffs of accounting firms need to have required annual training sessions in auditor's independence, professional skepticism, professional judgment and objectivity.
4. The PCAOB and SEC need to develop guidelines for audit committees concerning auditor's independence, professional judgment, professional judgment and objectivity. Annually, audit committees need to discuss and document compliance with the guidelines.
5. PCAOB needs to be more transparent with accounting firms and investors, the problems found with independence and subsequent remediation of the problem. Also, root causes would be very helpful, along with the best practices to reduce independence problems.

The Department of Treasury created a Federal advisory Committee on the Auditing Profession in 2007. I was an observer and participant in the meetings. As noted in the background of the committee there have been many studies about the auditing profession – 1978 Report of the Commission on Auditor's Responsibilities (Cohen Commission); The Trending Commission - 1987 and 1998 – SEC and the Public Oversight Board, and Sarbanes-Oxley Act of 2002. The Advisory Committee covered such important topics as Human Capital, Firm Structure and Finance, and Concentration and Competition. The Committee briefly discussed auditor's independence and mandatory rotation but decided that the topics did not warrant further deliberation. However, the Committee did focus on fraud prevention detection. Mandatory rotation was not considered or recommended.

If my recommendations were adopted I believe that auditor's independence would be enhanced for everyone. SOX has greatly improved the quality of audits, as evidenced by the decline in number of restatements. Because of SOX, Investors can have a greater reliability on the financial statements than existed 10 years ago.

Thanks for allowing me to participate in this important deliberation.