Statement of Harvey L. Pitt
Before the Public Company Accounting Oversight Board
Concerning Auditor Independence and Audit Firm Rotation

Washington, D.C.

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Chairman Doty, Board Members Harris, Ferguson, Hanson and Franzel:

I. Introduction

I applaud and commend the Public Company Accounting Oversight Board ("PCAOB" or "Board") on its critical initiative to consider ways to improve the independence, objectivity and professional skepticism of external auditors. This is a long-standing core issue about the adequacy, integrity and accuracy of corporate financial statements. The current Board brings valuable and timely experience, wisdom and fresh perspectives to this critical issue. On a more personal note, I am most appreciative of this opportunity to provide my individual observations regarding mandatory audit firm rotation, as discussed in the Board's "Concept Release on Auditor Independence and Audit Rotation."[2]

I have spent a good portion of the past forty-four years considering the issue of mandatory auditor rotation, first as a member of the Securities and Exchange Commission's ("SEC" or "Commission") Staff for over ten years, including three years as the SEC's General Counsel, followed by a quarter century in private law practice, where I represented each of the then "Big Eight" public accounting firms, followed by a return to the SEC as its Chairman, and now as the head of two firms devoted to improving corporate governance, transparency and compliance. Having seen the issues of audit independence

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[1] Chief Executive Officer, Kalorama Partners, LLC and Kalorama Legal Services, PLLC. The views expressed in this Statement reflect solely the author's views, and do not necessarily reflect the views of the author's colleagues at, or the clients of, either Kalorama firm.

[2] PCAOB Rel. No. 2011-006 (Aug. 16, 2011) ("Concept Release").

and quality from a broad array of perspectives over four-plus decades, I believe that the quality of audits, in the U.S. and globally, must be strengthened and improved.

This Board is the unique instrumentality by which Congress and the SEC sought to ensure and improve audit quality, and concomitantly the integrity of financial statements. While yours is not necessarily the last word on the subject we are here to discuss—or even *your* last word—your word is most significant. The SEC's belief that it could not, and should not, *directly* address the myriad issues related to public company accounting compelled the Commission forcefully to support the creation of this Board, and promote its independent stature. The Board's overarching mission, in my view, is "quality control." When companies present investors with inaccurate, misleading, opaque, imprecise and doubtful financial reports, capitalism and our economic well-being are placed at risk. We have seen the incredible damage caused by companies thought to be stable and prospering that turned out to be frauds and shell games, houses of cards built on the flimsiest of foundations.

No matter what this Board does, unfortunately, and no matter what the SEC and the accounting profession endeavor to create, we will continue to be confronted by frauds, foisted upon unsuspecting investors by public company outliers, who hide behind technical explanations and the complexity of modern financial transactions to "pull the wool" over everyone else's eyes. Thus, in addressing the question of mandatory auditor rotation, the first principle those who come before you should acknowledge is that—at least for the question of mandatory auditor rotation—there is no "absolute truth." This Board should reject the notion—explicit or implicit—that anything it might do can *eliminate* all future audit failures. Conversely, I believe the Board should also reject the

notion that, merely because there is no "silver bullet" solution that can rid our markets of fraudulent financials, the Board should resign itself to doing nothing.[3]

But, crafting a solution to any problem requires that those entrusted with solving the problem first understand what the problem is that they are trying to solve, and then consider various proposals that might address and ameliorate the problem identified. In the realm of accounting requirements, and specifically vis-à-vis mandatory auditor rotation, far too many—on both sides of the issue—assume that there is only one answer and do not provide decision-makers with cogent arguments or empirical evidence to enable regulators and standard-setters to separate the wheat from the chaff. It is commendable that the PCAOB is endeavoring to foster a meaningful dialogue on this subject, one that permits commenters to question assumptions that underlie the consideration of mandatory rotation as a means to enhance auditor independence and skepticism.

II. Summary Views

For reasons discussed in more detail below, I believe the objective of improving audit quality is absolutely paramount, and that this Board should consider *any* and *all* alternatives that might achieve that result. But, simply because an alternative should be considered does not ineluctably mean that it should be pursued, or pursued in a single step. To warrant changes in the current system, any proposal to add to, subtract from or modify existing auditor rotation policies should:

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[3] The term "silver bullet" has become a descriptor for straightforward and unquestionably effective responses to specific problems. In folklore, a silver bullet was the only type of bullet effective against werewolves, witches and other monsters. Current usage may have been derived from the term "magic bullet," which was used to describe a medical breakthrough developed by Dr. Paul Ehrlich, which was the subject of the 1940 movie, "Dr. Ehrlich's Magic Bullet." *See* Wikipedia, "Silver Bullet," available at http://en.wikipedia.org/wiki/Silver_bullet.

- **Be predicated upon sound empirical data demonstrating that the proposed change will do more good than harm;**
- **Avoid a rote (or one-size-fits-all) approach that would take informed decision-making out of the hands of the independent directors of all public companies, comprising the audit committees of those entities;**
- **Utilize carefully-gathered evidence to support the conclusion that the cost of such a change (or changes) is not disproportionate to empirically verifiable benefits that legitimately could be expected to result from the adoption of the change;**
- **Implement incremental change, or the careful phasing-in of proposed new rules, ensuring that the effects of any appropriate changes are truly evolutionary, not revolutionary; and**
- **Require the on-going and frequent gathering of empirical data to ensure that the effects of any changes that are implemented can be measured before additional changes are made.**

The Board could, and in my view should, distinguish changes that can be effected immediately from those that should properly be considered only after adequate experience is had with any short-term rule changes it decides to implement. My immediate and short-term recommendation is that independent audit committees be *required* to consider (and document their consideration) whether the performance of auditors over a prescribed period of time—say five years—*affirmatively* warrants the reappointment of, or dictates a movement away from, the accounting firm that currently audits the particular company's financial statements. As part of that effort, I believe the Board and the SEC need to provide audit committees with critical information that would enhance their ability to make sensible judgments about the quality and performance of their company's outside auditors.

Conversely, I believe this Board should be reluctant simply to command that, after the passage of a specified number of years—irrespective of the particular number of years chosen—*all* companies *must* replace their current outside audit firm, no matter how well, capably and independently those

auditors have performed. In this regard, my individual views remain the same as those I articulated on behalf of a unanimous SEC, exactly ten years ago to this day (and predating this Board's existence), before the Senate Banking Committee, addressing auditor independence in connection with the Senate's deliberations on what ultimately became the Sarbanes-Oxley Act ("S-OX" or the "Act")[4]:

> Some have suggested the possibility of requiring that public companies replace their auditors after a specified number of years. The Commission believes that this approach, often referred to as "mandatory rotation," would be unwise. Studies over the last three decades suggest that the number of financial frauds in the first years of a new auditor's engagement is unacceptably high. Mandatory periodic rotation of firms also could lead to "opinion shopping" in the decision on which new firm to select. Another concern is the unique strengths particular audit firms bring to the clients in certain industries. Large accounting firms are not fungible; one firm is not identical to another, and there can be valid market-driven reasons, such as expertise in a certain industry, for selecting and retaining one firm over others. This freedom of choice should lie with the corporation; it should not be a Government-imposed mandate or a decision delegated to the stock exchanges.[5]

Requiring audit committees formally to consider whether, and then to explain and document the reasons that they have determined, to retain their outside auditors can be an effective short-term method of addressing auditor independence and the quality of audits, but only if two conditions precedent are satisfied—first, the Board should articulate the general standards it wishes to

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[4] Sarbanes-Oxley Act of 2002, P.L. 107-204, 116 Stat. 745 (2002).

[5] Testimony and Prepared Statement of Harvey L. Pitt, Chairman, SEC, before the Senate Committee on Banking, Housing, and Urban Affairs (Mar. 21, 2002), at 1122 ("2002 HLP Testimony"), available at http://www.gpo.gov/fdsys/pkg/CHRG-107shrg87708/html/CHRG-107shrg87708-vol2.htm. (internal citation omitted).

see audit committees apply, and second, the Board and the SEC should share information with audit committees in the possession of both bodies that could prove important to audit committees in making an independent judgment whether to retain their company's outside auditors.[6]

III. The Operative Statutory Framework

Enacted in the wake of a number of massive failures in corporate financial reporting (including Enron, WorldCom, Tyco, Adelphi and many others), S-OX was intended to protect investors, and restore their confidence, by imposing reforms that were intended to improve audit quality and enhance auditor independence. Although mandatory audit firm rotation was specifically considered by Congress before it passed S-OX, after Congressional hearings exploring the feasibility and efficacy of this approach, the decision was made to eschew mandatory audit firm rotation; instead, the statute directed what is now the Government Accountability Office ("GAO") to conduct a study and issue a report on the wisdom of such an initiative.[7]

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[6] **Audit committees likely would find it valuable to have access to information about PCAOB quality reviews, the experience of a particular firm in auditing companies in the same or similar industry, and the pendency of possible enforcement action against the firm. There are practical and statutory impediments to the disclosure of some of this data, however, and the PCAOB and SEC would need to work together to overcome these challenges. *See, e.g.,* S-OX § 104(g)(2), 15 U.S.C. § 7214 (g)(2) (restricting public access to "portions of the inspection report that deal with criticisms of or potential defects in the quality control systems…if those criticisms or defects are addressed by the firm, to the satisfaction of the Board, not later than 12 months after the date of the inspection report"); S-OX § 105(b)(5)(A), 15 U.S.C. § 7215 (b)(5)(A) (restricting public access to "all documents and information prepared or received by or specifically for the Board" for inspection purposes).**

[7] **As noted in the Concept Release, the GAO's Report was issued in 2003, and concluded "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality." GAO, "REQUIRED STUDY ON THE POTENTIAL EFFECTS OF MANDATORY AUDIT FIRM ROTATION 8 (2003) ("GAO Report"). The GAO also observed that "more experience needs to be gained" with S-OX's requirements, and that "it will take at least several years for the SEC and the PCAOB to gain sufficient experience with the effectiveness of the act in order to**

Recognizing the critical role audit committees serve in our system of corporate governance, however, S-OX did substantially reinforce the importance and integrity of *independent* audit committees,[8] first and foremost by vesting in public corporations' audit committees, *rather than* in management, the ultimate responsibility for hiring auditors and deciding upon auditor retention.[9] The Act also imposed a requirement that specific engagement partners rotate with a single firm,[10] and restricted auditors from providing

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adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed to further protect the public interest and to restore investor confidence." Concept Release at 3, nn. 4, 5 & 8.

[8] Aside from these provisions, S-OX § 301, 15 U.S.C. § 78j-1, codified as § 10A(m) of the Exchange Act, incorporated additional mechanisms also aimed at enhancing the independence of the audit committees, including: requiring that all members of audit committees be independent ("independence" defined as not accepting any compensatory fee from the issuer, including for consulting or advisory services, but excluding the audit committee member's service on the board of directors), § 10A(m)(3); requiring that audit committees establish procedures to obtain and respond to complaints received by the issuer relating to accounting and auditing matters, § 10A(m)(4); authorizing audit committees to engage outside advisers that *it* determines are necessary to perform its duties, § 10A(m)(5); and giving audit committees the authority to determine the appropriate funding for it to function and requiring the issuer to abide by such determination, § 10A(m)(6).

[9] S-OX § 301; 15 U.S.C. § 78j-1(m)(2) (vesting direct responsibility in the audit committee for "the appointment, compensation, and oversight of the work" performed by the audit firm for the corporation—including responsibility to resolve any disagreements between management and the auditor regarding the corporation's financial reports—and requiring that audit firms report directly to the audit committee. These requirements are intended to empower the audit function by separating it from management control, which is one of the SOX's key goals. As the SEC noted: "One of the audit committee's primary functions is to enhance the independence of the audit function, thereby furthering the objectivity of financial reporting . . . The auditing process may be compromised when a company's outside auditors view their main responsibility as serving the company's management rather than its full board of directors or audit committee. This may occur if the auditor views management as its employer with hiring, firing and compensatory powers." Standards Relating to Listed Company Audit Committees, Exchange Act Release No. 33-8220 (Apr. 9, 2003), at II(B)(1), *available at* http://www.sec.gov/rules/final/33-8220.htm ("SEC Audit Committee Release").

[10] S-OX § 203, 15 U.S.C. § 78j-1(j), codified as Exchange Act § 10A(j) (establishing a five-year mandatory rotation of the "lead partner," defined in Regulation S-X Rule 2-01(f)(7)(ii)(A) as the audit partner "having primary responsibility for the audit or review," and the "concurring partner," defined in Regulation S-X Rule 2-01(f)(7)(ii)(B) as the partner "performing a second level of review to provide additional assurance that the financial statements subject to the audit

clients with certain non-audit services to prevent the potential compromise of audit quality.[11] If we take seriously the propositions that the Board of Directors owes a fiduciary duty to shareholders, and that the independent members of the audit committee are required and equipped to perform their role with integrity—which presupposes independence—mandatory rotation (or for that matter, any reform that would displace power from the audit committee) necessarily warrants careful consideration.

S-OX also mandated that public companies report annually on the quality of their systems of internal control, and required outside auditors to certify management's assessment of their company's systems of internal control.[12] And, the Act provided for the formation of this PCAOB.[13]

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or review are in conformity with generally accepted account principles and the audit or review . . . are in accordance with generally accepted auditing standards and rules promulgated by the Commission or the Public Company Accounting Oversight Board." The SEC's rules also expand several aspects of the Act's rotation requirements. *See, e.g.,* SEC Rule 2-01(c)(6)(i)(B)(1) (imposing an additional five-year cooling off period for lead and concurring partners).

[11] S-OX § 201(a), 15 U.S.C. § 78j-1(g) (prohibiting audit firms from providing audit clients, and their affiliates, the following services: bookkeeping, financial information systems design and implementation; appraisal or valuation services, fairness opinions, or contribution-in-kind reports, actuarial services, internal audit outsourcing services, management functions or human resources, broker-dealer, investment adviser, or investment banking services, legal services and expert services unrelated to the audit, and any other service that the Board determines, by regulation, is impermissible). Under the same section of the Act, U.S.C. § 78j-1(h), audit firms are permitted to engage in non-audit services apart from those enumerated, including tax services, only if pre-approval is obtained from the audit committee in accordance with § 202.

[12] S-OX § 404, 15 U.S.C. § 7262.

[13] S-OX § 101, 15 U.S.C. § 7211 (giving the Board broad oversight authority over the audit of public companies, including registered accounting firms, setting standards relating to the preparation of audit reports, and conducting investigations and disciplinary proceedings of, and imposing appropriate sanctions against, registered public accounting firms and associated persons of such firms).

***In Free Enterprise Fund v. PCAOB*, 561 U.S. —, 130 S. Ct. 3138. (2010), the Supreme Court held that the "for cause" restrictions for removal of members of the Board violated the separation of powers, but found that the unconstitutional tenure restrictions were severable, thereby leaving unaffected the Board's structure, functions and operations.**

IV. Operative Principles

The concept of mandatory audit firm rotation should be viewed in the context of certain general principles that, in my view, are critical to the development of any appropriate regulation: it should neither be too general nor too complex, and must be pragmatic.[14] Regulations that are designed categorically may have the seeming allure of simplicity, and of ease of compliance, but can cause substantial harm and create a host of unintended consequences. On the other hand, the search for optimal regulation can sometimes lead to regulatory schemes that are so riddled with complexity that they are rendered unworkable in practice. And still, while striving for optimal regulation is commendable, regulators must remain pragmatic about their goals; no rule will ever be perfect. To paraphrase both Voltaire and von Clausewitz, the worst enemy of a good solution is sometimes a perfect one.[15]

Pragmatism in the context of regulatory design requires that regulators be open to a regulatory plan, even if it may not solve *every* aspect of a problem and, conversely, even if it may engender *some* negative consequences. The same holds true in diagnosing the underlying circumstances that are referenced as creating the need for a regulatory response; a regulatory "fix," in a sense, is only warranted when the reality it is addressing is, at least to some extent, "broken."[16] When proposing a regulatory solution, therefore, it is important to

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14 *See*, *e.g.*, S. Shapiro & R. Glicksman, RISK REGULATION AT RISK: RESTORING A PRAGMATIC APPROACH 24-26 (2004).

15 2002 HLP Testimony at 1104-1105 (citation omitted):

> "As we work together, we need to identify the problems requiring solutions, consider alternatives to, and criticisms of, those alternative solutions, and accept the timeless truth that, in matters of this nature, there are no perfect answers, there is no absolute truth. Indeed, to paraphrase both Voltaire and von Clausewitz, the worst enemy of a good solution is a perfect one."

16 The modern, colloquial, expression is "if it ain't broke, don't fix it." This is frequently attributed to Bert Lance, the head of the Office of Management and Budget under President

try to identify both the extent of the problem (*does it warrant a regulatory response*?) and the expectation for what will constitute a solution (*what results will be considered a "fix"*?).

V. The Rationale for Mandatory Rotation

The stated impetus for considering the imposition of a mandatory auditor rotation for public companies is improving auditor independence and professional skepticism.[17] As noted by the Board,

> Since its creation, the Board has conducted hundreds of inspections of registered public accounting firms each year. These inspections provide the Board with a unique insight into the state of the audit profession and the conduct of public company audits. Based on this insight, the Board believes that the reforms in the Act have made a significant, positive difference in the quality of public company auditing. Yet, . . . the Board continues to find instances in which it appears that auditors did not approach some aspect of the audit with the required independence, objectivity and professional skepticism.[18]

In the view of some proponents of this change, a major flaw in the current system is that auditors have a financial incentive to continue their client relationships, and that factor influences auditors to appease management,

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Jimmy Carter, as quoted in *Nation's Business*, the newsletter of the U.S. Chamber of Commerce, in May 1977:

> Bert Lance believes he can save Uncle Sam billions if he can get the government to adopt a simple motto: "If it ain't broke, don't fix it." He explains: "That's the trouble with government: Fixing things that aren't broken and not fixing things that are broken."

An earlier version of this aphorism, attributed to a nameless old farmer, appeared in the Texas newspaper, THE BIG SPRING HERALD, a half year earlier. *See* The Phrase Finder, available at http://www.phrases.org.uk/meanings/if-it-aint-broke-dont-fix-it.html.

[17] Concept Release, at p. 2 & n.2

[18] *Id.* (internal footnote omitted).

rather than to function independently and with professional skepticism.[19] The cure for this flaw, those who propound it suggest, is to restructure the relationship between the auditing firm and its client in a way that eliminates (or substantially mitigates) this incentive, and therefore allows the auditing firm to perform its role independently.[20]

At its core, the argument in support of implementing mandatory rotation rests on the following syllogism:

- Current audit quality, despite legislative/regulatory efforts, remains sufficiently deficient and requires appropriate regulatory reform;
- Deficiencies observed in audit quality are principally attributable to a lack of independence on the part of the outside auditors; and
- A system of mandatory rotation would resolve the independence problem and therefore improve audit quality.

Given legislative requirements, and recent judicial decisions, there must also be a finding that there are no acceptable, less costly, alternatives that could achieve a comparable result.[21]

A. Audit Quality Concerns

In its Concept Release, the Board discusses its experience with worrisome instances of audit quality issues it has found. But, the Concept Release does not set forth a quantifiable framework that contextualizes the current state of audit quality in any relative sense. To be sure, the Concept Release does state that the Board's inspectors have analyzed "more than 2,800

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19 *See* Concept Release at 2, 5-9, and 15.

20 *Id.*

21 *See Business Roundtable* v. *SEC*, 647 F.3d 1144 (DC, 2011).

engagements" of the largest audit firms over the past eight years, and of those, they "discovered and analyzed *several hundred cases* of what they determined to be audit failures."[22] However, as the Board also acknowledges (in the pages of the Concept Release immediately following the recitation of this data), its inspection results do not offer a representative or even a truly random selection of the auditing profession because the Board understandably focuses on "the most error-prone situations," indicating the strong likelihood of selection bias.[23]

What would be helpful—principally to the Board, but also to commenters—is an analysis of the public companies and the accounting firms for which these deficiencies were noted. For example,

- Were these large public companies or smaller ones?
- Were they national firms or international enterprises?
- What was the median cost of these audits?
- How do the costs of these audits compare with the median costs of the remainder of the sample in which the Board's inspectors did not observe any significant deficiencies?
- How much statutorily-performable non-audit work do these companies require?
- How much non-audit work was performed for these companies by the firm that also performed the audit?

The goal here should be to determine whether these general numbers are representative of the profession at large, and determining—if it is possible—whether the deficiencies were the result of efforts to curry favor with a valued

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[22] Concept Release, at 5 (emphasis supplied). The use of the term "audit failure" is said by the Board to reflect "a failure to obtain reasonable assurance about whether the financial statements are free of material misstatement," but as the Board notes, this "does not mean that the financial statements are, in fact, materially misstated." *Id.* As I read the Board's Concept Release, it is the failure of the auditors to obtain sufficient appropriate evidence that the financial statements "are free of material misstatement" that is of concern, not whether the possibility of material misstatement was actually realized. This makes a great deal of sense, since it is the *possibility* of a material misstatement that poses the most worrisome danger to the users of financial statements. At least in the realm of financial statement audits, there is no comfort to be taken from "inadvertent compliance."

[23] *Id.* at 6.

client, or simply a function of human error. For those reasons, among others, interpreting the significance of these numbers presents challenges. On the one hand, no one can argue that "several hundred" instances of "audit failures"—however that term is defined—is nominal. It is not. But, it is not clear whether all or a significant percentage of these "failures" are roughly comparable, or whether they reflect particularized circumstances (so-called "one-off" situations). Is the current situation one that reflects a system that is "broken," or merely imperfect? Have the quality of audits devolved to a point where dramatic regulatory reform is clearly required, or is it possible to address the concerns these numbers raise as part of a comprehensive effort to improve a financial system that is still emerging from a period of deep crisis?

These questions are important, for several reasons. As the Concept Release itself notes, the utility of expending resources on mandatory rotation presupposes that it is an issue that requires a major focus by all participants. [24] However, without a framework that offers a methodology to contextualize the Board's data, it is possible some will claim that any conclusions drawn are an inherently speculative endeavor. As an initial consideration, the Board may wish to provide commenters with a generic analysis of the data it has reviewed, to allow them to assist the Board in interpreting the data it has collected.

B. The Link Between Audit Failures and a Lack of Independence

Beyond the need to enhance the ability of commenters to analyze the data presented in the Concept Release, the causal connection on which the argument in support of mandatory rotation is founded—that a lack of independence is the cause of a significant number of the audit deficiencies the Board's inspectors have observed—leaves a number of questions to be answered, as the Concept Release recognizes. After noting anecdotal evidence

[24] Concept Release at 18-19.

indicating that recent audit deficiencies "appeared to have been caused, at least in part, by the failure to apply an appropriate level of professional skepticism when conducting audit procedures and evaluating audit results," the Concept Release acknowledges that there is no ability to claim that all the failures and deficiencies "necessarily resulted from a lack of objectivity or professional skepticism."[25]

While the impetus for mandatory rotation certainly does not require that "all" quality issues are "necessarily" the consequence of a lack of professional skepticism, the goal is to understand the extent to which a lack of professional skepticism is responsible at all. Curiously, the PCAOB's own data analysis suggests that there may not be *any* connection at all. In response to the GAO Report's suggestion that the PCAOB utilize its data for evaluating mandatory rotation, the Concept Release states that "[p]reliminary analysis of [the Board's inspections] data appears to show *no correlation* between auditor tenure and number of comments in PCAOB inspection reports."[26]

On a theoretical plane, is it likely, much less clear, that there is a causal relationship between compromised independence and the deficient quality of audits the PCAOB has observed? Is the lack of auditor independence and professional skepticism the most compelling source of audit failures? Or, are there other factors, such as standard incompetence and typical laziness, and perhaps the complexity of today's financial information, that could explain the PCAOB's inspection results?

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[25] **Concept Release at 6.**

[26] ***Id.* at 16 (emphasis supplied).**

C. Mandatory Rotation Will Not Necessarily Increase Independence

In addition, consideration must be given to the possibility that mandatory rotation would not ineluctably translate into enhanced independence. Putting aside the fact that the prospect of a steady stream of income from an endless audit engagement, which theoretically compromise independence, can be effectively curtailed by an active audit committee, in some cases a lack of independence or willingness to "cozy up" to management can stem from other incentives, such as the possibility of future employment at the issuer as its Chief Financial Officer or in its internal audit or risk departments.

No doubt there are also instances where an individual's mindset is simply not focused on independence, be it intentionally, by dint of personality or simply because he or she fails to comprehend the nature of the services being provided and the intended beneficiaries of those services. And, there are other instances where, as some of the Board's inspection reports observed, "the lack of professional skepticism appears to stem from the [f]irm's culture that allows, or tolerates, audit approaches that do not consistently emphasize the need for an appropriate level of critical analysis and collection of objective evidence."[27]

These questions are important because mandatory rotation would engender a dramatic change in the current structure of the auditing profession, and could lead to enormous costs and inefficiencies. If the current state of audit quality were one of utter despair, then experimental and drastic initiatives might be warranted, even in the absence of compelling evidence. But, if our current situation is not as dire, or is even relatively positive, either on a historical perspective or with respect to other initiatives to which the PCAOB could be dedicating its resources, then taking dramatic action at the present time, and in the absence of more comprehensive data—such as mandatory rotation—might

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27 Concept Release at 7.

rest on speculative assumptions, and lack the empirical clarity the courts have required.

VI. Cost-Benefit Analysis

Although the Concept Release does not expressly solicit views on whether a cost-benefit analysis is either required or desirable, implicit in a number of the questions on which it does solicit input is the question whether there are be less burdensome means of achieving enhanced independence and professional skepticism. A comprehensive cost-benefit analysis is a critical step in any rulemaking process. Further, the District of Columbia Appeals Court has vacated rules adopted by the SEC where that court has not observed an adequate assessment of the economic impact and a thorough investigation of their benefits prior to the adoption of rules.[28]

Of significance in assessing cost-benefit analyses is whether the proposed rule is mandatory or discretionary. Where a regulator has no choice but to adopt *some* form of regulation in response to a legislative command, the standards of cost-benefit analyses may be somewhat relaxed. In those instances, Congress has made the judgment that *something* must be done, and left to the regulators the question of *what* should be done. In the case of discretionary rules—circumstances where it is the regulator that decides to adopt a rule for which it has authority, but no compulsion—the cost-benefit analysis must first consider whether there is a need for *any* regulatory action, and then consider whether the preferred regulatory action satisfies classic cost-benefit assessments.

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[28] As noted above, in *Business Roundtable v. SEC*, 647 F.3d 1144, the D.C. Circuit Court of Appeals vacated SEC Rule 14a-11—relating to so-called "proxy access"—on the ground that the SEC had "acted arbitrarily and capriciously for having failed" adequately to assess the likely economic effects of the new rule and for having failed to perform a comprehensive cost-benefit analysis (the new rule would have opened up companies' proxy statements to investor nominees for directors).

In the current context, we are dealing with a regulatory initiative that is not mandatory, but rather is discretionary. This is similar to the situation that confronted the SEC with its proxy access rule. The Dodd-Frank Act could have compelled the Agency to adopt a proxy access rule, but instead only authorized the Agency to do so, in the proper exercise of its discretion. When S-OX was under consideration, Congress considered requiring mandatory audit firm rotation, but eschewed that, in favor of a GAO Study. The GAO's conclusion nine years ago was that no such requirement was essential. In order to modify the status quo, the Board will need to consider the same kinds of data that the GAO considered, and explain the reasons that data dictates a different conclusion at the present time (assuming the Board concludes the status quo should be modified, of course).

When we consider costs here, it is the shareholders' capital that is at stake. Even more crucially, the relevant "costs" in this context also include the potential that mandatory rotation might lead to a *decline* in audit quality and a deterioration of investor confidence, which is antithetical to the goal that PCAOB hopes to achieve. Similarly, another "cost" may be the loss of enhanced corporate governance that could flow from a decline in the authority and substantive decision-making power vested in corporate board audit committees.

Overlaying all this is the fact that a cost-benefit analysis is a late-stage step that should be embarked upon only after the Board is convinced it has identified the underlying cause of the problem it is trying to solve, and that the proposed solution will be constructive and likely will remedy the perceived problem. At that relatively late stage, performing a cost-benefit analysis is critical for the purpose of exploring whether the solution under consideration is the most effective approach in light of its anticipated costs and benefits, when compared with a range of alternative solutions. While, in my view, the Board is not at the point of performing a cost-benefit analysis, I highlight some of the costs I believe the Board will want to assess when considering mandatory rotation.

A. Inferior Audit Quality

(1) Costs of the Rotation Process

One major concern that troubles me is that—whatever the length of the proposed audit term—both bookend years of the audit engagement may suffer deterioration in quality. Depending on the complexity of the company and the particular experience of the auditor, experts have indicated that it takes, generally, one to two years just to set up the basic audit infrastructure, and, as a result, that audit quality is at its most vulnerable during this initial period.[29] Moreover, with any sizeable company, and certainly with large and complex institutions, there is a steep learning curve at the beginning of an engagement, during which the audit firm must work to gain institutional knowledge of the firm's structure and familiarize itself with the company's business, operations and high-risk areas. These startup costs are inherent in the initial phase of any audit engagement, but mandatory rotation will effectively require companies to endure these growing pains more frequently than they currently do under our present system.

Similar challenges are likely to emerge in later years, at the end of the rotation term. As an audit firm is on its way out, there may be a diminution in quality of service provided to the client. As I stated in my testimony in 2002:

> "[E]mpirical data suggests that in the first couple of years of a relationship, and particularly as companies grow more complex, those are the years when auditors are at their most vulnerable.
>
> So if you think about it this way, let's say I am an auditor and I am going to assume the worst about auditors, even though I do not as a practical proposition.

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[29] *See, e.g.,* 2002 HLP Testimony at 1122 ("Studies over the last three decades suggest that the number of financial frauds in the first years of a new auditor's engagement is unacceptably high"); *id.* at n.42 ("The Cohen Commission Report recommended against rotation of audit firms based, in part, on its finding that most audit mistakes occurred in the first year or two of an audit engagement").

> In my first 2 years, I am not smart enough to know where all the problems are. And in my last year or two, I know I am losing this client, so I do not really care, even if I am now smart.
>
> Now if you have a 5 year rotation, you have knocked off four-fifths of the period. That doesn't answer your concern, however. And your concern is the one that bothers me because of the public interest."[30]

As for the "actual" costs associated with such a change, the 2003 GAO Report noted that most firms estimated that mandatory rotation would result in increased audit costs of more than 20 percent during the initial year(s).[31]

(2) Increased Burden: Retaining Audit Firms with Necessary Specialization and Geographic Network

The world is increasingly growing more complex. The rapid speed of innovation throughout our economy and financial system has resulted in increased specialization in the accounting and auditing profession. And, it is also important to keep in mind that accounting firms are not fungible. Some are better than others, at least with respect to certain types of audits and certain industries, and more importantly, they offer different degrees of specialization. As Senators Dodd and Bennett noted in 2002, accounting firms "are not cookie cutters of each other" and they are not "commodities" that can be exchanged for one another like bushels of wheat.[32]

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[30] 2002 HLP Testimony at 1079.

[31] Concept Release at 18.

[32] Senator Dodd, observed:

> [T]he accounting firms…are not cookie cutters of each other. They are not mere images of each other, different firms bring a different expertise to the table. Some do energy particularly well. Others may do financial services well. And so, by taking one firm and applying it, in a sense, assigning, if you will, to some other company when they do not really have the expertise, can pose real problems for the P in CPA, for us, the public, who may be relying on it.

2002 HLP Testimony at 1079.

What follows from these observations is that a program of mandatory rotation could hamper the ability of corporations, through their audit committees, to access high-quality auditors, and from an economic perspective, could result in limiting competition. These difficulties would be exacerbated for large multinational issuers, presented with the challenge of finding appropriately qualified auditors to cover the range of their geographical operations, areas of specialized services, and breadth of industry activity. To the extent that large multinationals employ the "Big Four" accounting firms for a range of non-audit services, which is hardly an unlikely supposition, a mandatory rotation program also will lead to difficulties for companies to rotate from one auditor to another due to S-OX conflicts between audit and non-audit services.[33] Under such a scenario, mandatory rotation could translate into a substantial limitation of choice, and therefore more limited competition, inferior quality, and increased costs. As scholars have observed, there are considerable entry barriers into the larger-scale segments of the accounting

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Similarly, Senator Bennett noted:

> **Number one, there is an assumption that in most of this conversation – I know that you are sophisticated enough that you do not share it, but it is certainly there with most editorial writers – that accounting is a commodity. . . .**
>
> **That an accountant is an accountant is an accountant. One accounting firm is just as good as another, and we can switch these things. It is just like switching one bushel of wheat for another bushel of wheat. It is a commodity.**
>
> **My own experience makes it very clear that this is not the case.**

***Id.*, at 1086.**

[33] ***See, e.g.,*** **Comment Letter of HSBC to PCAOB Rulemaking Docket Matter No. 37 (Dec. 9, 2011),** ***available at*** **http://pcaobus.org/Rules/Rulemaking/Docket037/118_HSBC_Holdings_PLC.pdf, at Questions 7 and 10.**

industry, and I view any step that has the potential to further dampen competition in that sphere with strong apprehension.[34]

B. Ancillary Costs

Ancillary to the "tangible" costs—the "actual" dollars that will need to be expended and potentially inferior audit quality stemming from a mandatory rotation program and the possible difficulties in identifying suitable audit firms—is the concern that mandatory rotation would transform the audit firm to, in essence, a one-time product provider, with little or no incentive to ensure that the product provided is top notch. Concomitantly, this would deprive audit committees of the ability to ensure that the audit firm provides quality service, since it would no longer be able to use one of the more powerful tools in its arsenal—the carrot of future work and the stick of termination.

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[34] *See, e.g., See* Chester Spatt, "Markets for Financial Information," Presented at the Federal Reserve Bank of Atlanta's 2010 Financial Markets Conference, at 15-16 (May 11, 2010), available at http://www.frbatlanta.org/documents/news/conferences/10fmc_spatt.pdf.

> The collapse of Arthur Andersen led to a permanent change in the industrial organization of the auditing industry—a change from the "Big Five" to the "Big Four." In auditing this change has been particularly important because of the lack of global presence of smaller auditors and because of auditor independence rules, which greatly reduced further the degree of competition, especially given the specialized nature of much of the auditing work. The issue of punishment is especially crucial in this context because the change in industrial organization not only influences future product market pricing (i.e., the pricing of audit services), but also the ability to impose punishment in the future. In the auditing context it appears that a global presence and expertise with many national auditing standards is required to credibly audit multinationals. While some market participants have revisited their choices of auditors, we have not seen the emergence of a major player to replace Arthur Andersen.

VII. Alternative Approaches

A. Empowering Audit Committees

As an alternative to mandatory rotation for improving the quality of audits, I would urge that the PCAOB consider measures to bolster the ability of audit committees to perform their mandated role vis-à-vis external auditors. Since discussion of S-OX first arose, and the SEC during my tenure proposed the creation of what ultimately became the PCAOB, I have been convinced that regulators should do more to empower independent audit committees. There are a number of ways in which this could be accomplished.

First, the PCAOB could require all audit committees, at least once every five years (the length of time is arbitrarily selected to provide content), to make a *de novo* determination that the continued retention of their company's current audit firm is appropriate in the interest of the company's shareholders. The Board could specify the types of data the audit committee should gather, or with which it should be provided, and the types of judgments the audit committee must affirmatively make. This would address the concern of those who worry that, without the imposition of an absolute obligation, "business-as-usual" may prevail. The committee could be required to articulate its decision in writing, and publish the information in an easily accessible form for its shareholders and regulators to see.

As part of this effort, the audit firm and the Board could assist audit committees by providing them with more information. For example, auditors could be required to prepare a report to audit committees, discussing instances where the auditor challenged management and management's responses and, where applicable, promptly report to the audit committee instances where the

PCAOB has observed lapses in professional skepticism.[35] Independently, the PCAOB could alert the audit committee when it had concerns regarding audit independence. Both the audit firm and PCAOB would work in tandem, empowering the audit committee to respond to the problem.

The audit committee could be required to make a fresh determination about how well the company's relationship with the auditor is serving investor interests. This would be in line with listing standards at certain exchanges, such as the NYSE.[36] If the PCAOB does find this requirement worthwhile, more attention should be given to implementing such a requirement in a way that bolsters the rigor and seriousness of such a determination.

B. Selective Use of Audit Firm Dismissal

Rather than imposing mandatory rotation, at least in the first instance, consideration could be given to a more limited, selective application of the concept, by requiring audit committees to "dismiss" their auditors where the PCAOB or the audit committee concluded that there were indicia of insufficient auditor skepticism or, even where they found serious deficiency in audit quality, which could not necessarily be linked to a lack of auditor skepticism. I also

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[35] This approach also was suggested by at least one other commenter. *See* Comment Letter of HSBC (suggesting that audit firms be required to disclose deficiencies identified by PCAOB to the audit committee within 90 days with a remedial plan).

More generally, I would recommend that the PCAOB explore avenues to share more information regarding its inspections and other information to which it is privy to, with all relevant parties: audit committees, auditors, and the public. Any such initiative would need to consider concerns for privacy as well sensitivities regarding litigation, but those should not be preventative obstacles. Among other benefits, providing the public with greater access would offer observers an opportunity to better understand and assess the PCAOB's proposals and agenda.

[36] *See* Comment Letter by NYSE Euronext to PCAOB Rulemaking Docket Matter No. 37 (Dec. 9, 2011), *available at* http://pcaobus.org/Rules/Rulemaking/Docket037/174_NYSE_Euronext.pdf (citing to Section 303A.07(b)(iii)(A) of the NYSE Listed Company Manual).

supported this approach when I testified before the U.S. Senate in 2002, noting that selective auditor "rotation" could be used as a "stick" in both situations—instances where there may be a lack of independence or professional skepticism and in the case of poor quality audits.

> **[The PCAOB] could say, "listen, you may not have done anything illegal. You may not have even done anything unethical. But given the way you have handled this client, it is our view that either you are too cozy with it or you were too sloppy with it, and we are telling the client it has to find a new auditor." It seems to me that would be one of the punishments. To me that is the way that you deal with rotation. You have it as a meaningful stick, so that firms are afraid that if they do not do the best possible job, they will lose their clients.[37]**

> **I believe the answer . . . is to establish standards for the audit committee to interview the auditors, to talk to the national partners of the audit firm, find out what steps they are taking to review the quality, and then on top of that, to have every year the [PCAOB] come in and do a quality control review. This would not be a for-cause thing. It would be a quality control. And if they find that audits are not being done at the highest standards, if they think there is sloppiness or slovenliness, give them the power to take away the client. That to me is the incentive. So that an auditor will know, if I want to keep this client, I have to be tougher, not weaker.[38]**

C. Use of a Pilot Program

Before imposing any across-the-board mandatory rotation requirement, I strongly support the suggestion noted in the Concept Release of exploring a

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[37] **2002 HLP Testimony at 1089. *See also*, *id.* at 1122:**

> **[A]llowing the [PCAOB] to exercise judgment, subject to prompt Commission review, to direct auditors to step down from an engagement could address risks that auditors that have worked with a client for a number of years may become either complacent or too dependent on the audit client.**

[38] **2002 HLP Testimony at 1079.**

pilot program,[39] notwithstanding the attendant design challenges. Unlike pilot programs to assess the economic impact of certain trading rules (such as the pilot program used to determine the likely impact of the elimination of the "uptick" rule for short sales), it is not at all obvious that the impact of mandatory rotation can be determined reliably by quantifiable analysis. The design of any such pilot program would require careful consideration, including the selection of:

- **which firms would be required to participate;**
- **which engagements would be subject to mandatory rotation;**
- **the metrics that would be used to assess whether mandatory rotation enhanced audit quality; and**
- **the metrics to assess whether mandatory rotation enhanced independence or affected the relationship between an issuer's management and its auditors.**

Beyond these factors and other challenges, such a program of course would take years to complete. I note this only as a reality for which we should be prepared, not something that should deter the PCAOB from embracing such a pilot program.

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[39] *PCAOB Concept Release* at 18 ("Because there appears to be little or not relevant empirical data directly on mandatory rotation available, should the PCAOB conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the PCAOB determines whether to consider developing a more permanent requirement? How could such a program be structured?").

VIII. Conclusion

I appreciate this opportunity to express my views on these important issues and I am pleased that, while exploring mandatory rotation in its Concept Release, the PCAOB has not shied away from asking fundamental questions, including whether lack of auditor independence, objectivity and professional skepticism are significant relative to problems in other areas on which the PCAOB might focus and whether audit firm rotation would enhance auditor independence, objectivity and professional skepticism.[40]

In my view, it is premature to impose the requirement of mandatory rotation without a more developed record, drawn from a broader sample of PCAOB inspections than is currently available, supporting a causal connection between deficient audits and a lack of independence and demonstrating that mandatory rotation will achieve the intended goal, without impairing the quality of audits. I fully support, however, alternative measures designed to improve auditor independence, objectivity and professional skepticism immediately, which do not raise these concerns, as I have outlined in this Statement.

I stand ready to try to assist the PCAOB in any way I can to achieve its overarching goals of protecting investors, through improvements in the quality of audits and issuers' financial reporting.

Thank you.

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[40] Concept Release at 18.