

Public Company Accounting Oversight Board

Proposal to Requite Rotation of Auditors

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I do not support the proposal of mandatory audit firm rotation for public companies. I do not think that it will improve the quality of audit work or strengthen the independence of outside auditors. It is a tempting idea but the auditing business is so competitive that I believe it will lead to undesirable effects.

I presume that the PCAOB has in an individual case where it has found audit deficiencies and any inappropriate relationship between an audit firm and its client, the power to require a change in auditor.

Based on my experience as an auditor and a regulator, there is a basic dilemma facing any auditor of a public company client. It is this. If the company is soundly profitable, has a CEO who understands the risks facing the business and takes responsibility for the accuracy and reliability of audited financial statements, is supported by a board of directors that takes its responsibilities seriously and has a competent chief financial officer with good cost accounting systems and strong internal controls, its auditor probably is well paid and does too much work. However, if any of these conditions do not apply, there is no end to the amount of work required to perform a good audit. In such situations, there is usually great pressure on audit fees.

I suspect that the great majority of cases where the Board found that the audit firm had failed to fulfill its fundamental responsibility in the audit, the conditions set out above were not present.

I believe the key is to have in place a competent, independent and effective audit committee of the board of directors. Such committees should enforce meeting agendas that address risk both those specific to the company and more broadly. I make this statement despite recent studies which indicate that all too often, board audit committees do not act independently of senior management and are not effective. This issue needs to be addressed.

One basic function is to ask both company management and the auditor to confirm that the accounting practices are at the conservative end of acceptability, and if not, to require changes. It could also ask if there are acceptable alternative accounting practices that would enhance the financial reporting. I should note that companies that follow very conservative accounting generally don't get into trouble.

Audit committees should sign off on a required public release every time there is a change of auditors. Such a release should disclose whether there have been any significant differences of opinion between management and the auditor in the prior two years. It should also disclose whether newly appointed auditors have accepted a significant reduction in audit fees. The audit committee should have the final decision on the selection of new auditors.

Audit committees should be satisfied that there is audit efficiency but where there is a push to drive down audit fees in the current highly competitive audit environment it will usually lead to trouble. The committee should annually review all non-audit services performed by the company's auditor, ensure that they do not compromise the auditor independence and are at fee levels which are reasonable compared to the audit fee and do not effectively subsidize the audit itself.

It goes without saying that the audit committee be satisfied as to the competence, experience and integrity of the audit partner in charge. Where a change is required, it should initiate it.

In my experience, really good audit committees have enormous influence on whether the company is getting good audit service. But having audit committees that are subservient to the CEO is worse than having no audit committee at all

Nowadays, audit firms require that partners and other senior audit staff be specialists in the industry in which their client operates. I think this, while necessary, can go too far. Only when there are audit people with general business experience in addition to specialized knowledge and experience will the audit firm have the all-important ability to stand back from the audited financial statements and determine that they not only follow the applicable accounting rules but in fact result in a fair portrayal of the company's financial position and results. All too often statements can conform technically to GAAP but misrepresent the situation.

In the case of regulated financial institutions, there should be an agreed process for direct regulator-auditor contacts. This happens in Canada (and the Board might like to explore this with the Superintendent of Financial Institutions) and with suitable protocols, works well and has saved a lot of trouble.

It is perhaps ironic, but where there is no constructive and positive relationship between the CEO and the audit partner in charge, and where the only relationships are between the CFO and its staff and the auditor are those situations most likely to lead to trouble and bad audits. Of course, there are situations where the relationship is too close. As noted above, audit committees are best suited to identify these.

As always independence is a state of mind and cannot effectively be legislated.

I believe the Board has the authority to meet with the CEOs of the major audit firms and express its concerns about the negative effects of too much competition. It could

remind the leaders of the profession that auditors are members of a profession with high standards which take precedence over profit making. In my view, and with experience as both an auditor and a regulator this is in the best interests of the audit profession itself. I fear that in America and around the world the profession is not in very good repute these days.

As you can see, I am dubious of the change proposed and doubt if effective solutions can be legislated.