

DEC 4 2011

December 13, 2011

Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, NW  
Washington DC 20006-2803

**Re: PCAOB Rulemaking Docket Matter No. 037, *Concept Release on Auditor Independence and Audit Firm Rotation***

Thank you for the opportunity for UHY LLP to respond to the PCAOB's *Concept Release on Auditor Independence and Audit Firm Rotation*.

Our letter is presented in three sections. The first discusses the few arguments in favor of mandatory audit firm rotation presented by the PCAOB in its *Concept Release*. The second discusses the arguments against mandatory audit firm rotation including some not considered by the PCAOB in its *Concept Release*. The third provides some discussion on alternatives to a blanket requirement for audit firm rotation.

**THE FEW ARGUMENTS *IN FAVOR OF MANDATORY AUDIT FIRM ROTATION***

In its *Concept Release*, the PCAOB presents and discusses only a few arguments for why it believes it should require mandatory audit firm rotation for all issuers:

- Investors believe firm rotation will bolster auditor independence and skepticism.
- A fresh face will improve the quality of the audit and bolster professional skepticism.
- The European Commission has proposed requiring mandatory audit firm rotation.

What follows are our thoughts on those reasons.

**Investors believe firm rotation will bolster auditor independence and skepticism.**

Requiring mandatory rotation for all issuers will be fixing something that is not broken — and at a high price tag. We believe rotation should be used only in those situations where the *appearance* of independence has been diminished. For example, it could be required in the much touted *appearances* of coziness with a client—situations in which an issuer has used the same auditor for 50 or 100 years. This is consistent with current independence requirements, which require auditors to be independent both in appearance and in fact.

**A fresh face will improve the quality of the audit and bolster professional skepticism.**

The Senate Banking Committee once used the phrase “fresh and skeptical eyes” (page 14 of the Concept Release). Others suggest the axiom, “a new broom sweeps clean.” Yet, throughout this Concept Release, the PCAOB notes academic studies and other evidence that conclude chances of an audit failure are much higher in the first year. We believe this *documented* risk is too strong to disregard in favor of unsupported arguments by assertion that “some investors” believe all companies should be subject to mandatory rotation.

**The European Commission has proposed requiring mandatory audit firm rotation.**

It is interesting that the Board cites what the European Commission *might do* as one of its three primary arguments for proceeding while the European Commission cites the PCAOB Concept Release as one of its few reasons for requiring auditor rotation. When has something some other body might do become an appropriate justification for a very costly regulatory action? Only Italy currently requires auditor rotation. The academic study of that requirement, cited in endnotes 79 and 80 of the Concept Release, found that audit quality tends to improve with auditor tenure. In addition, we note that the EC currently does not require internal engagement partner rotation, limit the amount of nonaudit services an auditor may provide, or require the audit process to be overseen by an audit committee. The Sarbanes-Oxley Act of 2002 (SOX) required all these changes in preference to mandatory rotation in 2002.

In 2003, the GAO suggested that more time was needed to judge the effectiveness of these requirements before further enhancements [mandatory rotation] can be considered. We believe the PCAOB needs to step back and examine the effects of the changes required by SOX as well as its more recent requirement for an Engagement Quality Review before considering if and when mandatory audit firm rotation is needed.

## **THE MANY ARGUMENTS AGAINST MANDATORY AUDIT FIRM ROTATION**

We believe there are many arguments *against* mandatory audit firm rotation. Some are discussed in the Concept Release, others in Board member statements, and some not at all.

- Cost/benefit and effect on small businesses.
- Mandatory rotation will force auditors into becoming salesmen.
- Most large accelerated filers use all four “Big 4” firms.
- The PCAOB would be eliminating a current “red flag.”
- PCAOB Evaluation of internal partner rotation, audit committees hiring/firing and overseeing auditors, and engagement quality reviews.

We discuss these arguments below.

### **Cost/benefit and effect on small businesses.**

No one disputes that audit costs are higher in the first years of an audit for both the auditor and the client. Often firms do not charge the client at all or offer reduced rates for these start-up costs because they assume that they will have a long-term and continuing relationship with the client. There would be no reason for firms to absorb these initial costs if they know the relationship will end, say, in five years. At the same time, issuers also incur much higher internal costs, both direct and indirect, for the initial years of audits in order to familiarize their auditors with accounting and reporting and other systems, to reformat reports in the manner requested by the new auditors, and so forth. Large issuers have the “luxury” of having fully staffed accounting departments but most small issuers do not. We believe the PCAOB should give appropriate consideration to the concerns of small issuers because the SEC is mandated by Congress to do so by Presidential Executive Order 13563, “Improving Regulation and Regulatory Review.” This Order seeks to reinforce the principle that the nation’s regulatory system must protect public health, welfare, safety and our environment while promoting economic growth, innovation, competitiveness, and job creation through small businesses. For small businesses, the costs of auditor rotation far exceed any possible perceived benefits.

### **Mandatory rotation will force auditors into becoming salesmen.**

SOX included a number of provisions that were intended to bolster the auditor’s independence. One, for example, prohibits auditors from providing certain nonaudit services to their clients or from being compensated based on sales or revenues from nonaudit engagements. This change turned auditors’ attention away from selling and back to their core responsibilities—auditing. We believe mandatory audit firm rotation will effectively *undo* the efforts of SOX.

Assume that the PCAOB adopted the European Commission's proposed requirement to change auditors every six years. A firm whose clients were all issuers would lose 17 percent of its book of business each year—34 percent in two years. Although SOX, implemented via SEC Regulation S-X, Rule 2-01, prohibits partners from receiving compensation based on sales, the de facto requirement to replenish 17 percent of one's clients each year would have the same effect. Compensation would invariably be connected to the ability to sell audit services to new clients.

**Most large accelerated filers use all four "Big 4" firms.**

Because SOX prohibits auditors from providing non-audit services, most large issuers now use all four "Big 4" firms in some capacity. Rotating auditors will require them to change not only their auditors but may also result in having to change their income tax preparers, valuation specialists, and so forth. We assume that the PCAOB would also continue to require a one-year "cooling off" period if in its nonaudit capacity one or more of the firm's members had a "financial reporting oversight role" with the issuer. UHY LLP and other smaller firms very well may stand to gain from this mandatory juggling act. Nevertheless it is our firm's view that this requirement would be cumbersome and disruptive for large issuers. Large companies will have to plot out who their next auditor will be well before a change is required. Although Chairman Doty noted in his statement that 52 percent of companies voluntarily changed auditors in the period between 2003 and 2006, we suspect that most of these changes were as the result of major firms shedding smaller clients to enable them to focus their resources on the much more profitable work on internal controls mandated by SOX legislation.

**The PCAOB would be eliminating a current "red flag."**

When an issuer changes auditors frequently or unexpectedly, it is considered to be a "red flag," sign of "opinion shopping" or worse -- an indicator for potential fraud. Requiring an issuer to change auditors, say, every six years, will mask such red flags, making the issuer simply appear to be complying with the rules.

**PCAOB Evaluation of internal partner rotation, audit committees hiring/firing and overseeing auditors, and engagement quality reviews.**

In 2002, the U.S. GAO concluded that "more experience needs to be gained" on the provisions of SOX before further enhancements are needed "to further protect the public interest and to restore investor confidence" (page 3 of the Concept Release). Page 14 of the Concept Release quotes the GAO's 2003 report 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 adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed." This leads us to wonder about the effects of requirements for five-year internal engagement partner rotation, auditor reporting directly to issuer audit committees, and new engagement quality review

requirements (effective for fiscal years beginning on or after December 15, 2009). Has the PCAOB considered the effects of these new requirements and somehow decided that they are of little or no benefit?

The Concept Release cites the global financial crisis as a more recent test of “the credibility of the audit in the public mind,” yet no audit firm, much less an audit firm independence issue, has been cited as playing a part in the *U.S. Financial Crisis Inquiry Commission’s Report*, issued this past January. Board member Ferguson cites the larger role of complex estimates in reporting fair value, an observation with which we do not disagree.

There is no discussion of any of these new requirements and their effects on auditor independence in the Concept Release except for reference to Lynn Turner’s 1977 testimony on internal rotation of audit partners that was included in the Metcalf Report. We suggest that the PCAOB consider the effects of internal partner rotation, engagement quality reviews, and other SOX requirements before moving on to the broader issue of mandatory audit firm rotation. Here we agree with Board member Hanson’s calls for information about the effect of audit committees on auditor tenure in his statement about the Concept Release. Board member Harris also notes that these reforms “have clearly improved auditor independence and, along with it, audit quality.”

#### **ALTERNATIVES TO A BLANKET REQUIREMENT FOR AUDIT FIRM ROTATION**

If the Board truly has made up its mind on the audit firm rotation issue, as Board member Harris indicates in his statement, that “the status quo is not an option,” there are four possible solutions that we believe would be much better than a blanket requirement for audit firm rotation.

- Require rotation when PCAOB inspections indicate the need.
- Identify factors that make a client “too big to lose.”
- Require rotation based on situations cited by investors.
- Require rotation first for the top 50 or 100 accelerated filers.

Here is how each of these possible solutions would work.

#### **Require rotation when PCAOB inspections indicate the need.**

Page 5 of the Concept Release notes that “Based on the Board’s inspections and other oversight activities, auditors still, at times, fail to display the necessary independence in mental attitude.” We suggest that the PCAOB should use the very information it gains through these activities to require auditor rotation when auditors do not display the necessary independence. The PCAOB notes that since 2003 it has already conducted reviews of some 2,800 audits (over 20 percent of all public companies, assuming no repeats), many of which focused on high risk audits and audit issues. Requiring auditor

rotation on a case-by-case basis would certainly dispel the cost benefit/unnecessary disruption arguments heard against auditor rotation for all. Combine this with the argument made by the PCAOB itself that "because skepticism is a state of mind, its absence may be particularly difficult to detect unless evidenced somehow in the audit workpapers or elsewhere" (page 6). UHY LLP would support the PCAOB (or SEC) being given the power to require issuers to change auditors when it has documented concerns. And, the infrastructure is already in place to require the investing community to bear the cost of these inspections.

### **Identify factors that make a client "too big to lose."**

Regrettably, we are all familiar with the term, "too big to fail." We suggest that the PCAOB focus on the relative *size* of the "long-term income stream" that certain clients provide to their auditors. All agree that there is a fundamental conflict in our current framework because the client pays the auditor. Rather than requiring auditor rotation for all issuers, the PCAOB should focus its efforts on identifying situations that make audit clients "too big to lose." Chairman Doty put it this way in his statement, "the long association of the largest audit firms with their major audit clients." If fees paid by the client are at the crux of the fundamental conflict, we suggest that the PCAOB consider situations in which a single issuer becomes a "major" client, for example, by providing more than X percent of an auditor's revenues over time, or using X number of offices, or employing X number of engagement personnel.

While we are certain that many who respond to this Concept Release will note that accountants are and have been capable of overcoming this financial conflict, the fact is that it is difficult for *investors* to overcome its *appearance*. In our current independence standards, it is important that each individual maintain an appearance of independence even when, in the individual's view, there is no question concerning independence in fact. We believe our profession would benefit if the PCAOB were able to establish a qualitative measure or series of measures or factors that, when met, would indicate that the appearance of independence may be impaired *for investors* and that would require rotation when met.

### **Require rotation based on situations cited by investors.**

If investors and others cite certain examples of long-term auditor tenure as egregious, start there. What are the stumbling blocks to the appearance of independence? Based on our reading of the Concept Release, investors currently point the number of years that an auditor has been engaged by the same client. Ask investors and other users what other factors impair the *appearance* of independence.

**Require rotation first for the top 50 or 100 accelerated filers.**

In this way, the PCAOB can effectively field test the costs and benefits that audit firm rotation may hold for both smaller issuers and what are often the smaller firms that audit them. This is similar to the "pilot program" suggested on page 18 of the Concept Release.

**AUDIT ANALYTICS' DATABASE AND RESEARCH**

Finally, we also point out that Audit Analytics recently generated some interesting statistics related to audit rotation/changes in auditors, including the following:

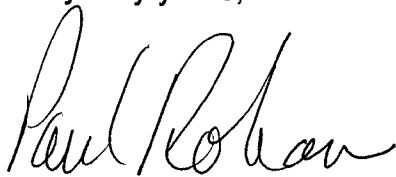
- Both the Russell 1000 and the Russell 2000 companies with auditor tenure of five years or less paid substantially more in audit fees (per million dollars in revenue) than companies with longer tenure.
- 16.1% of Russell 1000 companies have engaged the same auditor for 40 or more years.

Audit Analytics' research was derived simply from the filings in their database. We believe the PCAOB and its staff would benefit from working with Audit Analytics to provide more data about audit rotation and its effect before moving forward on this project.

\*\*\*

Thank you again for the opportunity to respond to this Concept Release. I will be pleased to discuss UHY LLP's views further and to answer any questions you may have. Please feel free to contact me at (203) 401-2101.

Very truly yours,



Paul Rohan

Partner

Director of Financial Reporting &  
Quality Control