IMPLEMENTATION CONSIDERATIONS

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The issue has been raised about how to implement mandatory auditor rotation. Someone suggested that rotation start with the largest companies. I believe that many other approaches would result in a smoother transition.

Control and monitoring areas have existed within publicly traded companies for decades. Those areas include accounting departments or accounting groups, internal auditors, computer programmers, data security administrators, network administrators, risk management, and treasury functions. These corporate employees are likely to be more critical to the control processes than which CPA firm does the external audit. A new external audit firm is unlikely to adversely impact those corporate employees continuing performance of their corporate functions. Those corporate employees comprise the key corporate stability which is needed.

The various computerized accounting systems and other operational systems have had internal controls built into them. Those systems have been thoroughly reviewed and tested by internal users, internal auditors, and the key segments have even been reviewed by the external auditors. The manual steps related to those systems have been reviewed by internal users, internal auditors, and external the external auditors.

The annual audit hours spent by a CPA firm conducting an audit are exceedingly low versus the time spent by the corporate control and monitoring groups. The external audit fees typically are very small versus the salaries and benefits paid to corporate control and monitoring groups. In essence, the instability that the CPA firms might want to suggest seems to have more to do with the CPA firms and their audit staffing.

The transition to mandatory rotation of CPA firms is likely to take 5 to 10 years. Using a ten year transition would seem to be the least disruptive to the CPA firms.

The profits of publicly-held companies comprise less than half of all business profits earned in the U.S., according to Bureau of Economic Analysis' (BEA) corporate profit measures. The smoother the transition for mandatory auditor rotation the less likely there will be any impact on profitability. This point alone would seem to be a compelling argument for a gradual ten year transition.

For the publicly traded companies, take a look at what percentage of corporate profits are represented by each industry. Next, take a look at what percentage of the industry is controlled by 3 to 10 of the largest companies in the industry.

Try to broadly evaluate how volatile are the income statements and balance sheets in each industry. For example, note which industries have been seeing income take the largest swings and which ones have taken the smallest swings. Take a similar look at the change in total assets for each company. Take a similar look at the change in total equity for each company.

Based on the analytics noted above, note which industries are the most stable. The most stable industries should be required to rotate auditors during the earlier years The least stable industries should be rotated during the last five years. This should help ensure that the various parties will have had more time to get ready for the changes. Assuring less chaos for investors, management, and the CPA firms is a good goal.

POSSIBLE APPROACH DESIRED BY CPA FIRMS

The goal should be to force mandatory auditor rotation in a way that roughly 10% of the external audit work is being rotated each year. It would be good to know how much in audit fees is paid by the publicly traded companies in each industry. It would be great if roughly 10% of the audit fees were being rotated each year. For CPA firm management, this gradual approach would seem to greatly ease the transition. I also believe that the companies should be required to sign a ten year contract with their new CPA firm. Regulators should be involved in drafting any escape clauses to deter audit opinion shopping.

Perhaps the easiest approach for CPA firms would be to divide the industry groups into ten roughly equal parts. The parts might approximate roughly equal total audit fees. Rotate the least risky grouping the first year. Use risk to be the determining factor in sequencing the ten groups. Thus, the most risky grouping would not be rotated until the tenth year. The CPA firms are less likely to complain about the implementation approach if they are assured that they will get ten year audit contracts on their new clients.

INVESTOR APPROACH – MY FAVORITE

Investors might prefer to not worry about rotating 10% of the audit fees each year for ten years. Investors might prefer to rotate one or more entire industry groups each year for ten years. If this were to be done, then the least risky industries should be done earlier and the most risky done later. Fairness to investors should have a high priority when the implementation approach is determined.

A MIXED APPROACH

Another similar approach might be to require the largest electric and gas utilities to be rotated during the first year. It might be good to pick 20 to 40% of the medium sized companies in a second stable industry to rotate during the first year. Also, pick the smallest companies comprising 20 to 40% of the market for the smallest transportation companies.

The second year could see the largest auto manufacturers rotated. The banks comprising the bottom 20% of the banking market could be picked. The telecommunications companies comprising the middle 20% to 40% of the market could also be rotated.

The third year could see the largest health care companies rotated. The insurance companies comprising the bottom 30% of the market share could be rotated. The middle 20% to 40% of the electric power and gas utilities could be rotated in the third year.

The fourth year could have the largest insurance companies rotated. The medium sized transportation companies could be rotated. The smallest banks could be rotated during the fourth year.

The fifth year could see the largest transportation companies rotated. The smallest manufacturing companies could be rotated during the fourth year. The medium sized health care companies could be rotated. The smallest telecommunication companies could be rotated.

The sixth through the tenth years could be done in a similar manner.

CONCLUSION

The transition to full mandatory auditor rotation should be done gradually. A ten year transition would seem to be much smoother.