

## Heads Up

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The PCAOB announced that it will hold a public roundtable on the concept release in March 2012.

## PCAOB Issues Concept Release on Auditor Independence and Audit Firm Rotation

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On August 16, 2011, the Public Company Accounting Oversight Board (PCAOB or the "Board") issued a [concept release](#)<sup>1</sup> that seeks public comment on mandatory audit firm rotation and other ways in which auditor independence, objectivity, and professional skepticism could be improved. The PCAOB announced that it will hold a public roundtable on the concept release in March 2012. Comments on the concept release are due by December 14, 2011.

### Background

In an August 16, 2011, [statement](#), PCAOB Chairman James Doty emphasized that the concept release explores ways to mitigate the "fundamental conflict of the audit client paying the auditor." While the concept release largely focuses on mandatory audit firm rotation, it also seeks comment on whether measures other than firm rotation could meaningfully enhance auditor independence, objectivity, and professional skepticism.<sup>2</sup>

The concept release provides background on mandatory audit firm rotation and an overview of rulemaking by the Securities and Exchange Commission (SEC), PCAOB standard setting associated with auditor independence, and related reforms (e.g., audit committee oversight of auditor independence, audit partner rotation requirements, scope of service limitations) that were put in place as a result of the Sarbanes-Oxley Act of 2002. While the concept release notes that changes enacted as a result of the Sarbanes-Oxley Act have "made a significant, positive difference in the quality of public company auditing," it also says that the PCAOB inspection staff "continues to find instances in which it appears that auditors did not approach some aspect of the audit with required independence, objectivity and professional skepticism."

The concept release acknowledges that not all audit deficiencies detected by the PCAOB inspection staff necessarily result from a lack of objectivity or professional skepticism; rather, such deficiencies could "reflect a lack of technical competence or experience, which may be exacerbated by staffing pressures or some other problem." In addition, the concept release notes that because the PCAOB's inspection program is risk-based, "the Board may be looking at the most error-prone situations." During the open meeting, the Board and PCAOB staff discussed the staff's ongoing research to analyze whether audit deficiencies it had identified could be tied to a lack of professional skepticism, independence, and objectivity. This discussion revealed that though the PCAOB's research thus far was inconclusive, it was also incomplete. Nevertheless, it is clear that

<sup>1</sup> PCAOB Release No. 2011-06, *Concept Release on Auditor Independence and Audit Firm Rotation*.

<sup>2</sup> Footnote 2 of the concept release states, "While the terms 'independence,' 'objectivity,' and 'professional skepticism' have slightly different connotations, they all relate to the auditor's ability to perform the audit in a disinterested manner, free from influence by the client. An independent auditor is more likely to exercise appropriate professional skepticism and make objective auditing judgments."

the PCAOB's intent is to focus on the lack of independence, objectivity, and professional skepticism as potential root causes of audit deficiencies and to consider mandatory rotation as a means of addressing these potential root causes.

The concept release points out that the notion of mandatory audit firm rotation is not new and that it has, in fact, been discussed in various forums since the 1970s. In addition, the release presents summaries of various academic and other studies of the issue, including a 2003 [study](#) by the U.S. General Accounting Office (GAO),<sup>3</sup> which was required by the Sarbanes-Oxley Act.<sup>4</sup>

The study concluded that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record . . . . The potential benefits of mandatory audit firm rotation are harder to predict and quantify." The GAO report also stated 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 to further protect the public interest and to restore investor confidence." Chairman Doty and other Board members cited this latter point in stating their belief that now is an apt time to revisit this issue.

The concept release states that opponents of rotation have expressed concerns about the attendant costs (especially for large multinational companies) as well as the view that audit quality may suffer in the early years of an engagement.

## Overview of Release and Request for Comment

The concept release notes that proponents of rotation believe that setting a term limit on the audit relationship could mitigate the effects of client pressures and "offer an opportunity for a fresh look at the company's financial reporting." However, it also states that opponents of rotation have expressed concerns about the attendant costs (especially for large multinational companies) as well as the view that audit quality may suffer in the early years of an engagement. At its August 16, 2011, meeting, the Board emphasized that it is looking for comments that expand on these traditional arguments as well as for empirical data supporting commenters' views.

The concept release includes 21 numbered questions as well as numerous questions embedded in or implied by the text of the release. On the basis of those questions, the PCAOB seems interested in constituents' views on the following general themes:

- Whether the current model in which the auditor is paid by its audit client in fact causes an inherent conflict that is not sufficiently mitigated by existing regulatory and other safeguards.
- Whether audit firm rotation would enhance auditor independence, objectivity, and professional skepticism or whether there are other alternatives that the Board should consider.
- The advantages and disadvantages of mandatory audit firm rotation.
- The effect that a rotation requirement would have on costs to auditors and companies (direct and indirect), whether steps could be taken to mitigate such costs, and how transitions between auditors are currently conducted.
- How the recently implemented engagement partner rotation and audit committee rules and regulations should factor into the consideration of audit firm rotation.
- Whether the Board should conduct a pilot program to further study mandatory rotation and, if so, how it could be structured.
- The significance of auditor independence, objectivity, and professional skepticism in relation to the Board's other possible areas of focus.

<sup>3</sup> Now known as the Government Accountability Office.

<sup>4</sup> More recently, the consideration of mandatory rotation and related issues has been a focus outside the United States, most notably by the European Commission, which raised the issue in its October 2010 consultation paper *Audit Policy: Lessons From the Crisis*. Currently, only a few countries have a form of mandatory audit firm rotation (which, in some cases, is limited by industry), while some countries that had introduced mandatory rotation in the past reversed their position after experiencing the implementation.

In addition, in the event that the PCAOB does consider rulemaking on mandatory rotation, the Board asks for views on the following four topics:

- Possible approaches to rulemaking, such as a rule under which an auditor would not be independent “if it has provided an opinion on the client’s financial statements for a certain number of consecutive years.”
- Potential maximum length of audit firm term, particularly the advantages and disadvantages of rotation terms of 10 years or more.
- Scope of the potential requirement, including whether a rotation requirement should apply to all audits conducted under PCAOB standards or only, for example, to audits of the largest companies or companies in certain industries.
- Transition and implementation considerations, including whether a rotation requirement would further limit a company’s choice of auditor and whether there is a higher audit risk in the early years of an engagement.

Also, as noted, the PCAOB has emphasized that it is seeking input on whether there are alternatives to mandatory rotation that could enhance independence, objectivity and professional skepticism.

### Opportunity for Public Comment

We encourage all financial statement stakeholders, including audit committees, company management, investor groups, and others to study the concept release and submit comments to the PCAOB. Note that a concept release is a step before official rulemaking but is a crucial stage in the PCAOB’s process. If, after considering feedback on this concept release and from the March 12 roundtable, the PCAOB decides to propose a regulatory requirement, it would also have to expose that proposal for public comment.

Interested parties can send comments to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C., 20006-2803. Comments also may be submitted via e-mail to [comments@pcaobus.org](mailto:comments@pcaobus.org) or through the PCAOB’s Web site at [www.pcaobus.org](http://www.pcaobus.org). All comments should refer to PCAOB Rulemaking Docket Matter No. 37 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EDT on December 14, 2011.

We encourage all financial statement stakeholders, including audit committees, company management, investor groups, and others to study the concept release and submit comments to the PCAOB.

### Additional Thoughts on Mandatory Firm Rotation

We agree with the PCAOB about the importance of auditor independence, objectivity, and professional skepticism. We also agree with Board member Lewis H. Ferguson, who emphasized, in his [statement](#) at the Board’s August 16, 2011, meeting, that “[I]n this, as in all other instances where we consider regulatory change, we take seriously the Hippocratic maxim, that has application to anyone attempting to ameliorate anything, of ‘first, do no harm’.”

The concept release refers to some of the risks of mandatory audit firm rotation that have been suggested by commentators; these risks are likely to receive further consideration during the comment period. The many well-known potential detriments to a universal mandatory rotation include:

- Mandatory rotation destroys the knowledge base and understanding developed by the audit firm, which threatens audit quality and effectiveness.
- Efficiencies that were developed over time by the preceding auditor are lost upon rotation, thereby increasing the costs of maintaining the same level of audit services.
- Each time rotation occurs, management faces the disruption, expense, and time involved in changing its audit firm.
- Some may see mandatory rotation as an opportunity to leverage competition and pressure auditors to decrease their audit fees below reasonable levels.

While supporters of mandatory rotation have cited some potential benefits, these benefits are untested and we believe that they will not outweigh the potential risks in the final analysis.

- Mandatory rotation could be a disincentive for audit firms to accumulate sector/industry expertise and could jeopardize their ability to attract and maintain talent, especially in specialized industries.
- Similarly, it could be difficult for companies in specialized industries or remote locations to find successor audit firms that have the requisite expertise, staffing levels, and independence.
- Mandatory rotation may give rise to significant problems for global companies, if, for example, different national regulations require rotation after varying amounts of time.

While supporters of mandatory rotation have cited some potential benefits, these benefits are untested and we believe that they will not outweigh the potential risks in the final analysis.

Moreover, in response to the Sarbanes-Oxley Act, the SEC adopted a number of rules and regulations designed to address the PCAOB's concerns; however, the impact of these requirements has not been fully assessed. The provisions included audit committee engagement of and oversight of the independence of the auditor, five-year rotation of the lead audit partner and concurring partner, and seven-year rotation for certain other partners serving on the audit engagement team. These requirements became effective for fiscal years ending after May 31, 2003; thus, for many public companies, the end of the fiscal year 2010 audit marks the completion of the first cycle of partner rotation under these rules.

The PCAOB specifically has asked for comment on potential alternatives to mandatory rotation that could address its concerns in these areas. Because we agree with the PCAOB about the importance of auditor independence, objectivity, and professional skepticism, in the coming months we will be exploring alternatives that do not present the same level of risk as mandatory rotation and will share these alternatives with the PCAOB. We note that the PCAOB's concept release also raises fundamental questions about the role of the audit committee (and how its role was defined in the Sarbanes-Oxley Act), and we expect that members of audit committees and public companies themselves will actively participate in the comment process.

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