

Please note that the comments expressed herein are solely my personal views

Public Company Accounting Oversight Board
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Actuary

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- **Release No. 2011-006**
- **PCAOB Rulemaking Docket Matter No. 037**
- **Concept Release on Auditor Independence and Audit Firm Rotation**

Dear Sir,

Thank you for giving us the opportunity to comment on your Concept Release on Auditor Independence and Audit Firm Rotation. The Public Company Accounting Oversight Board (PCAOB / Board) is issuing a concept release to solicit public comment on ways that auditor independence, objectivity and professional scepticism could be enhanced. I agree that the PCAOB should focus on enhancing auditor independence, objectivity and professional scepticism, as these are the foundation of professional auditing, and its own inspections have found significant deficiencies in this area. One possible approach on which the Board is seeking comment is mandatory audit firm rotation. In general I support this. Mandatory audit firm rotation would enhance auditor independence, objectivity and professional scepticism in the following ways:

- the audit firm has a fixed engagement term, without renewal, and therefore has less incentive to accept the company's perspective, and consequently subsuming its judgement into maintaining a long-term relationship with the company

- each new audit firm will bring a new perspective and approach to the company's audit, which will increase the likelihood of uncovering problems and potential issues with the financial statements
- the audit firm knows that its audits and judgements will be reviewed and challenged in the near-future by a new audit firm, and will therefore act in a more professional, detached and challenging manner with the company

I accept that mandatory audit firm rotation would increase audit costs, mainly in the first year. According to the 2003 GAO Report quoted in the Concept Release, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. I would suggest that this additional cost would reduce in the future as companies and audit firms gain experience of mandatory audit firm rotation. I further suggest that a small increase in first-year audit cost would be a small price to pay for enhancing auditor independence, objectivity and professional scepticism, and critically, for improving confidence in the veracity and integrity of audited financial statements, and public perception in the integrity of the audit process. It is also important that the audit process is perceived and seen to be independent and objective.

I have some specific comments, which I will address in answer to your specific questions.

Answers to specific questions raised by the PCAOB

1. If the Board determined to move forward with development of a rotation proposal, what would be an appropriate term length?

The appropriate term length would be 5 years. This balances the need for a shorter term length in order to enhance independence, and a longer term length in order to reduce disruption and costs.

2. Should different term lengths for different kinds of engagements be considered? If so, what characteristics, such as client size or industry, should this differentiation be based on?

I would not support different term lengths in the absence of evidence that this would be appropriate for different clients or industries.

3. Does audit effectiveness vary over an auditor's tenure on a particular engagement? For example, are auditors either more or less effective at the beginning of a new client relationship? If there is a "learning curve" before auditors can become effective, generally how long is it, and does it vary significantly by client type?

There is clearly a learning curve; however I do not believe that this learning curve implies that auditors are not effective at the same time. The learning curve is greater for more complex companies and businesses. This would be mitigated by the fact that there are sufficient audit firms with greater experience of such complex audit cases that would be well-prepared to take them on. There are very few (niche) cases where there would be a lack of audit firm capacity that would be appropriate to audit them.

4. Some have also suggested that, in addition to being less effective at the beginning of an engagement, an auditor may be less diligent toward the end of the allowable term. On the other hand, others have suggested that auditors would be more diligent towards the end of the allowable term out of concern about what the replacement auditor might find. Would auditors become more or less diligent towards the end of their term? Does the answer depend on the length of the term?

Auditors would certainly be more diligent towards the end of the allowable term out of concern about what the replacement auditor might find. The increased competitive factor and reputational focus would ensure that the current auditor will optimise its professionalism, independence, objectivity and professional scepticism here.

5. How much time should be required before a rotated firm could return to an engagement?

An initial compromise would be to allow the rotated firm to return after one replacement engagement. For example, if Firm A audits a particular company for 5 years, and Firm B for the following 5 years, then Firm A could return for the subsequent 5 years.

6. Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers? Should the Board consider applying a rotation rule to some other subset of issuer audits? For example, are there reasons for applying a rotation requirement only to audits of companies in certain industries?

The absolute magnitude of potential financial misstatement is correlated with company size. There would also be greater relative increased costs when applying mandatory audit firm rotation to smaller companies. A compromise would be to set a minimum company size based on, for example market capitalisation¹ or revenue, above which mandatory audit firm rotation would apply.

7. To what extent would a rotation requirement limit a company's choice of an auditor? Are there specific industries or regions in which a rotation requirement would present particular difficulties in identifying an auditor with the necessary skills and expertise? Is it likely that

¹ E.g. as required under the Sarbanes-Oxley Act.

some smaller audit firms might decide to leave the public company audit market due to the level of uncertainty regarding their ongoing client portfolios?

I do not accept that this is the issue. If a company is limited in its choice of auditor, then this is by definition already a serious problem. Furthermore, any problems in this regard would be mitigated by requiring mandatory audit firm rotation only for companies above a certain size, as mentioned in my answer to question 6.

8. If rotation would limit the choice of auditors, are there steps that could be taken to allow a company sufficient time to transition out of non-audit service arrangements with firms that could be engaged to perform the audit? Are there other steps that could be taken to address any limitation on auditor choice?

I would suggest that a company should be given a limited timeframe in order to transition out of such non-audit service arrangements. A company should be aware of these issues and plan accordingly.

9. If rotation were required, would audit firms have the capacity to assign appropriately qualified personnel to new engagements? If they do not currently have that capacity, could firms develop it in order to be able to compete for new clients, and would they do so?

There would almost certainly be no capacity constraints as long as mandatory audit firm rotation would only be required for companies above a certain size, as mentioned in my answer to question 6. The larger audit firms dealing with such large companies clearly have enough resources and capacity to deal with regular rotation.

10. Would rotation create unique challenges for audits of multinational companies? For voluntary rotations that have taken place, what have been the implementation and cost issues and how have they been managed?

Multinational companies above a certain size would be audited by large audit firms with international networks and capabilities. These audit firms are used to the complexities inherent in auditing multinational companies.

11. Would increased frequency of auditor changes disrupt audit firms' operations or interfere with their ability to focus on performing high quality audits? How would any such disruption vary by firm size? For example, would a rotation requirement pose fewer or more implementation issues for small firms than for large ones?

On the contrary: audit rotation would improve audit quality by enhancing auditor independence, objectivity and professional scepticism. Larger audit firms should be

experienced in planning their resources and capacities accordingly. I do accept that frequent audit changes might be disruptive for small audit firms, but these disruptions should be mitigated by requiring mandatory audit firm rotation only for companies above a certain size, as mentioned in my answer to question 6.

12. Would audit firms respond to a rotation requirement by devoting fewer resources to improving the quality of their audits? Would firms focus more on non-audit services than on audit services?

Either audit firms want the audit business or not. I suspect that they do want the business, and would respond to a rotation requirement by being more diligent towards the end of the allowable term, and therefore devoting more resources to improving the quality of their audits, out of concern about what the replacement auditor might find.

13. Would rotation have any effect on the market for non-audit services? Would any such effect be harmful or beneficial to investors?

If anything, audit rotation would probably increase competition in this arena, which would be beneficial to companies and investors.

14. Some have expressed concern that rotation would lead to “opinion shopping” or that in competing for new engagements firms would offer favourable treatment. Others have suggested that rotation could be an antidote to opinion shopping because companies would know that they could not stick with a firm promising favourable treatment forever. Would opinion shopping be more or less likely if rotation were required? If rotation limits auditor choice, could it at the same time increase opinion shopping?

This is one of the beneficial effects of mandatory audit firm rotation. Audit firms know that their engagements are limited, and that their audits will be reviewed and challenged by the replacement auditor. This would absolutely mitigate any “opinion shopping” as this situation is realised and expected by audit firms and, importantly, companies.

15. What effect would a rotation requirement have on competition for audit engagements? If competition would be increased, how might that affect audit quality?

Mandatory audit firm rotation will increase competition for audit engagements. Audit firms will act in a more detached manner and focus their resources and time on producing audits of the highest quality, rather than expending energy on trying to maintain the audit relationship, long-term, “at all costs”.

16. Are there any requirements the Board should consider to mitigate any risks posed by rotation? For example, are there enhancements to firms' quality control systems that might address such risks?

I am convinced that audit firms' quality control systems will improve in line with audit quality, given the knowledge that audits will be reviewed and challenged by replacement auditors.

17. If the early years of an auditor-client relationship pose higher audit risks than later years, should the Board require firms to provide additional audit supervision and oversight in the first year or two of a new engagement? Should the Board impose such a requirement for auditor changes even if it does not further consider requiring audit firm rotation? If firms are accepting new clients but are unable to perform quality audits for them until several years have passed, should the Board require enhanced client acceptance procedures? What impact would additional requirements of this type have on audit costs?

There is clearly a learning curve; however I do not believe that this learning curve implies that auditors are not effective at the same time. Once again, audit firms should be expected to provide additional audit supervision and oversight in the first year or two of a new engagement, given that they know that their audits will be reviewed and challenged by replacement auditors. This competitive "peer review" is sadly lacking now, given that: "For the largest 100 companies, based on market capitalization, auditor tenure averages 28 years. Average tenure for the 500 largest companies is 21 years."²

18. If mandatory rotation were required, are existing standards relating to communications between predecessor and successor auditors sufficient? Should additional communications be required? For example, should the outgoing auditor provide the incoming auditor with a written report outlining audit risks and other important information about the company?

This is a good idea, which should further enhance auditor professionalism, independence, objectivity and professional scepticism. I support that the outgoing auditor should provide the incoming auditor with a written report outlining audit risks and other important information about the company.

19. Are there other audit procedures that should be required to mitigate any risks posed by rotation?

One of the beneficial effects of mandatory audit firm rotation is that the audit firm knows that its engagement is limited, and that its audits will be reviewed and challenged by the replacement auditor. In order to support and promote this concept, I would strongly suggest

² As quoted on page 20 of the Concept Release.

that the replacement auditor should be equally liable for any unreported audit failures of the prior auditor, should the replacement auditor not discover them during its review, as long as the replacement auditor would reasonably be expected to have uncovered the failures during its review of the prior audits. This should ensure that the replacement auditor would diligently carry out the review of prior audits, and that the prior auditor would expect this and consequently always produce audits of the highest quality.

20. If the Board moved forward with development of a rotation proposal, should consideration be given to the recommendation for a cause restriction on the company's ability to remove an auditor before the end of a fixed term? Would such a provision be useful? Would there be unintended consequences of such a requirement? Should the Board work with the SEC on implementation of this recommendation? Are there other matters on which the Board should coordinate with the SEC?

I suggest that further consideration should be given to a proposal that audit committees should be prohibited from removing the auditor without good cause prior to the end of the fixed term. I would also suggest that the audit firm should only be allowed to withdraw before the end of the fixed term in specific circumstances, especially in the case that it would not have the resources or capacities to continue with audits due to an unexpected change in audit scope.

21. What other transition issues might arise in the first year of a rotation requirement? How should the Board address these issues?

I cannot think of any other transition issues that would require regulatory action.

Yours faithfully

C.R.B.

Chris Barnard