



October 19, 2011

Office of the Secretary
Public Company Accounting Oversight Board
166 K Street, NW
Washington, D.C. 20006-2803

Subject: Docket 037: Concept Release on Auditor Independence and Audit Firm Rotation

Dear Board Members and Staff of the PCAOB:

Thank you for providing the Aerospace Industries Association ("AIA") with the opportunity to share our view on the Concept Release on Auditor Independence and Audit Firm Rotation ("the Concept Release"), issued by the Public Company Accounting Oversight Board ("the Board") on August 16, 2011. AIA represents the nation's major manufacturers of commercial, military and business products such as aircraft, helicopters, aircraft engines, missiles, spacecraft, and related components and equipment.

We are supportive of the Board's efforts to address the financial reporting concerns of investors and other users of financial statements, especially in light of the recent global financial crisis; however, we are strongly opposed to a draft audit standard being issued on mandatory audit firm rotation for the following reasons:

- **Decreased audit quality:** If mandatory audit firm rotation were to be put in place, overall audit quality would decrease, especially in the first or second year after a required change. Auditors need sufficient knowledge and understanding of a company, its processes and controls, the industry and unique risks in order to effectively deal with complex accounting and auditing issues. Gaining this knowledge takes time and becomes more important when auditing specialized industries (*e.g.*, aerospace) and when dealing with companies with global operations. We are concerned that qualified auditors with applicable aerospace industry experience will not always be available at the requisite locations worldwide when a mandatory rotation is required. This clearly would have a negative impact on audit quality. Audit engagements have normal staff turnover and, on a smaller scale, our member companies have witnessed the learning curve faced by these new auditors and how it often takes a considerable period of time until they appear to fully understand the area they are auditing. As a result, we believe the "fresh look" desired from mandatory audit firm rotation, is not necessarily a "better look."
- **Increased audit costs:** We strongly agree with the Concept Release that the risk of increased costs merits particular focus during a period of economic weakness and heightened global competition. We expect the audit cost will increase if mandatory audit firm rotation is implemented. The total cost incurred by companies will be a combination of the expected increased audit fees, in addition to increased selection

and audit support costs. The selection costs include the time spent by management and other personnel in preparing a request for proposal as well as time spent by management and audit committees in evaluating the alternatives. More significant will be the support costs that will be incurred by company personnel in helping the auditor understand each company's operations, applicable IT systems, and financial reporting practices and controls. We expect audit fees to increase since the audit firms will be incurring and passing on the additional marketing costs, as well as the start-up costs required to understand the company. The November 2003 GAO report on the potential effects of mandatory audit firm rotation summarized the survey results received from the largest public accounting firms and Fortune 1000 public companies. The report stated "...we estimate that following a change in auditor under mandatory audit firm rotation, the possible additional first year audit-related costs [inclusive of increased audit fees, company selection and support costs] could range from 43 percent to 128 percent higher than the likely recurring audit costs had there been no change in auditor."

- **Significant risks of failure are unknown:** While we believe audit quality would decrease while costs increase, the reality is that the ultimate impact of mandatory audit firm rotation on quality and costs is unknown. For example, the impact to the audit firms and their related compensation and competitive structures is largely unknown. What if it had the opposite effect and turned the audit into a severely competitive commodity? What if it dramatically decreased what the firms and their partners make because of the need for price competition? This could impact the firms' ability to attract, retain and reward top talent. It could also make the best people in the firm become fully focused on winning new work and not providing the necessary focus on existing audits. What happens in smaller markets when a large public company audit would be ending? The audit firm rolling off a large engagement in a small market would likely need to significantly downsize their staff and perhaps even close an office. What would happen to the new firm taking over the audit? Could this create a "win-or-die" mentality at the firms? Would they be willing to pull their top talent off engagements in the final years to place them on new engagements causing risk in the final years? What are the full cost and fee and quality implications? What would the impact of mandatory firm rotation be on mergers, acquisitions and financings? We believe these questions need to be fully studied before the Board moves forward with a proposal requiring mandatory audit firm rotation. Research should also seek to determine whether audit firm tenure is a notable cause of audit failures since it is clear that a number of factors could affect the auditor's ability to detect financial reporting issues that may indicate material misstatements, including education, training, and experience; knowledge of GAAP and GAAS; experience with the company's industry; appropriate audit team staffing; effective risk assessment process for determining client acceptance; and knowledge of the client's operations, systems, and financial reporting practices.
- **Significant Improvements have been made to audit quality:** The Sarbanes-Oxley Act ("SOX") put in place the following reforms to enhance auditor independence and audit quality:

- established the PCAOB, as an independent nongovernmental entity, to oversee the audit of public companies that are subject to the securities laws;
- made the PCAOB responsible for (1) establishing auditing and related attestation, quality control, ethics, and independence standards applicable to audits of public companies, (2) conducting inspections, investigations, and disciplinary proceedings of public accounting firms registered with the PCAOB, and (3) imposing appropriate sanctions;
- made the public company's audit committee responsible for the appointment, compensation, and oversight of the registered public accounting firm;
- required management and auditors' reports on internal control over financial reporting;
- prohibited the registered public accounting firm from providing certain nonaudit services to a public company if the auditor is also providing audit services;
- required the audit committee to preapprove all audit and nonaudit services not otherwise prohibited;
- required mandatory rotation of lead and reviewing audit partners after they have provided audit services to a particular public company for 5 consecutive years; and
- prohibited the public accounting firm from providing audit services if the public company's chief financial officer, chief accounting officer, or any person serving in an equivalent position was employed by the firm and participated in the audit of the public company during the 1-year period preceding the date of starting the audit.

The Concept Release has some discussion on the environment prior to the passage of SOX (*e.g.*, citing testimony related to Enron on page 12 and how Arthur Andersen might have behaved differently knowing that Peat Marwick would be reviewing their work in following years). Given this was prior to the formation of the PCAOB and any of their inspection reviews, it does not take into account the fact that the audit firms now have that enhanced incentive for diligence that mandatory audit firm rotation would bring. Audit firms are clearly focused on addressing issues identified by the PCAOB reviews and understand that any public filing engagement can be selected by the PCAOB. This has driven the audit firms to give much more focus on compliance and audit quality internally. Partners who now do not pass peer reviews, internal reviews or PCAOB reviews often face serious consequences up to and including termination. Another notable change implemented under SOX was the required mandatory rotation of lead and reviewing audit partners after they have provided audit services to a particular public company for 5 consecutive years. We believe that additional time needs to pass prior to concluding that mandatory rotation of lead and reviewing audit partners was ineffective and needs to be replaced with mandatory audit firm rotation. In fact, we believe the data supports that the reforms

are working. According to study conducted by Audit Analytics, the impact of an average restatement had on the net income of companies traded on one of the three major American stock exchanges (Amex, NASDAQ, and NYSE) decreased 93 percent^l in 2010 compared to 2002.

- **Audit committee oversight has improved under SOX:** Although the concept release discusses that audit firms are paid by the companies they audit, it does not fully take into account the role an effective audit committee plays in overseeing the auditor's engagement and related fees. Audit committees are charged with hiring and firing the auditor, and reviewing and approving the auditor's audit plan and related compensation. A recent study in the journal of accountancy stated, "In the pre-SOX study, most audit committees were deemed passive and ineffective. However, in the current study, 86 percent of respondents indicated that the audit committee was now a serious group fulfilling an important role in monitoring the functioning of internal controls."ⁱⁱ By requiring mandatory audit firm rotation, the PCAOB would effectively take away the oversight power of the audit committee in determining to keep auditors because they were deemed to be performing effectively. We believe this choice and responsibility (required by SOX) should continue to rest with audit committees.
- **Limited viable rotation alternatives exist:** Given that there are only four large international firms (who according to the 2003 GAO study, audited 99 percent of public company sales), it would be difficult to have a viable mandatory rotation plan. The issues that contribute to this include:
 - Some firms possess specialized industry experience (e.g., years of experience serving a specific industry, specialists in auditing certain industry specific issues, proper security clearances, etc.) which would be hard for other firms to replicate in the short term
 - Some firms have unique local or regional area strength and size that other firms can't easily replicate
 - Partners who already rotate on large accounts would be forced to rotate even more frequently since partner rotation and firm rotation may not coincide causing inefficiency
 - Audit quality would be deteriorated in early years as the audit team gets up to speed on a new client
 - Given prohibition on non-audit services, it would be difficult to find viable choices without causing serious disruption to other services (e.g. existing tax and consulting engagements)
- **A fresh look would have limited benefit:** We feel the firms already get the benefit of a fresh look through the audit partner rotation, second partner / concurring partner reviews, internal peer reviews, external peer reviews and PCAOB reviews and

therefore there would be limited incremental benefit from this fresh look. In addition, the learning and improvement that takes place over time in the individual audits and the quality of the individual audit would be lost upon rotation. Even the PCAOB's own specific observations on how a firm could improve on an individual audit would be lost upon rotation since the new audit firm would presumably not have the benefit of the PCAOB's prior comments and insights. As Board member Goelzer pointed out, "the real possibility that any public company engagement may become the subject of a rigorous PCAOB inspection, performed by experienced professionals with a deep commitment to the public interest, is an important counter-weight to the pressures that can undermine independence and professional skepticism".

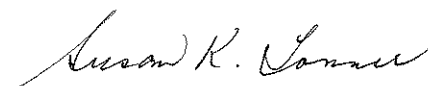
- **The risk and magnitude of the change would be too dramatic a solution for the size of the problem:** The Concept Release itself states on page 5 the following: "the Board's inspectors have reviewed portions of more than 2,800 engagements of such firms and discovered and analyzed several hundred cases involving what they determined to be audit failures." If one infers several hundred to be 200-300, this would indicate that there is a 7-10 percent failure rate in audits the PCAOB reviews cited. We recognize that audits can fail for many reasons other than not having mandatory audit firm rotation, but even if a majority of the problem was from not rotating audit firms (which it is not), we feel that causing the companies with the 90 percent+ of the auditors who are doing sufficient audits to switch is not an appropriate or reasonable response given the lack objective data to demonstrate the practice would be effective. In addition, the actual overall audit failure rate is likely to be less than the 7-10 percent mentioned above since the Board's inspections are not random but risked-based. As discussed in the Concept Release, the inspection target audits that are believed to present the highest risks and reviews are performed on the areas within each audit that are the most complex and challenging. Prior to a proposed audit standard on mandatory audit firm rotation being issued, there should be a demonstrated correlation between audit failings and long audit firm tenure. Furthermore, audit failures should be analyzed in the context of the size of the company since in 2010, 79 percentⁱⁱⁱ of financial statement restatements were made by non-accelerated filers. Without the proper data available to arrive at an informed judgment, significant cost and effort could be expended on mandatory audit firm rotation without the desired benefits being achieved in the most efficient manner.
- **Current structure could work better if audit committees are given additional and more timely information:** We feel the PCAOB should be focused, as it is today, on determining the reasons for the audit failure and focusing on ways to lower that number. One fundamental missing element to the PCAOB review process is that the company's audit committee, who has oversight responsibility of the auditor, does not get a direct copy of the specific results of the PCAOB's review of that company's auditor. Audit committees play a very important role in enhancing auditor independence and audit quality and we believe that if they were provided the report on the detail findings of the PCAOB review for their auditor, they could better monitor the firms' corrective actions on their engagement and also better decide if they should take action in changing audit firms. We feel that this reporting should be made as timely as possible to allow the audit committees to take swift action, if

required. Audit committees currently have this responsibility related to internal controls and management by monitoring the corrective actions from internal audit reports and reports of significant deficiencies and material weakness. It makes sense they would do an effective job ensuring their audit firm fixed any deficiencies the PCAOB identified, if they were made aware of them. Another alternative could be for the PCAOB to require a change in the auditor of record as an enforcement action if conditions warranted such a measure.

In summary, we believe the establishment of the PCAOB and reforms implemented by SOX, have significantly improved audit quality and auditor independence. We think the PCAOB should keep its efforts focused on identifying and further reducing the relatively small number of engagements that have audit failures. To this end, rather than requiring mandatory firm rotation of 90 percent+ of the engagements that appear to be effective, the PCAOB should share, as early as possible, the results of their individual engagement reviews with impacted audit committees. As representative of the shareholders, the independent board members who make up the audit committees would then be empowered to make more informed decisions on the quality of the audit they are receiving and decide if they should hire a new audit firm. We believe, like the 2003 GAO report cited in the concept release on page 14, that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality..." and as the GAO report goes on to state it "...is not a panacea that totally removes pressures on the auditor in appropriately resolving financial reporting issues that may materially affect the public companies' financial statements." Available information needs to be studied to determine if long audit firm tenure actually contributes to audit failures in a meaningful way, prior to a draft audit standard being issued on mandatory audit firm rotation.

Thank you for taking the time to consider our response.

Sincerely,



Susan K. Tonner
Assistant Vice President, Acquisition Policy

ⁱ 2010 Financial Restatements: A Ten Year Comparison; Audit Analytics (May 2011). Average cumulative impact on net income per restatement in 2002 was a negative adjustment of over \$82.8 million dollars compared with a negative adjustment of over \$5.9 million dollars in 2010 (page 14).

ⁱⁱ September 2011 Journal of Accountancy Article titled "Highlights of Corporate Governance Research" by Cynthia E. Bolt-Lee, CPA; David B. Farber, Ph.D.; and Stephen R Moehrle, CPA, ph.D.

ⁱⁱⁱ 2010 Financial Restatements: A Ten Year Comparison; Audit Analytics (May 2011). Non-accelerated filers accounted for 551 of the 699 restatements in 2010 (page 17).