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Office of the Secretary
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CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION
PCAOB Release No. 2011-006 August 16, 2011
PCAOB Rulemaking Docket Matter No. 37

The Accounting Principles and Auditing Standards Committee (“the Committee” or “We”) of the California Society of Certified Public Accountants (“CalCPA”) is grateful for the opportunity to comment on the Concept Release referenced above. The Committee is the senior technical committee of CalCPA. CalCPA has approximately 35,000 members. The Committee is comprised of 43 members, of whom 56 percent are from local or regional firms, 12 percent are sole practitioners in public practice, 9 percent are in academia and 2 percent are in an international firm.

The Committee strongly opposes any requirement to require audit firm rotation. It has been studied and rejected a number of times in the past. There is nothing in the PCAOB’s rationale that makes a convincing argument for auditor rotation. The Committee questions whether any of the benefits cited by the PCAOB are valid and believes the detriments would be substantial. The reasons for this are explained in the answers to the PCAOB’s questions.

The questions in the Concept Release (the “Release”) fail to solicit views on the basic merits of auditor rotation. Significant changes have occurred in recent years that are not considered in the Release:

- PCAOB reviews of audits provide enhanced safeguards against the effects, if any, of a continuous auditor/client relationship
- Firm policies have been strengthened in reaction to PCAOB reviews of audits
- There are increased limitations on non-audit services to audit clients
- Engagement partner rotation period has been shortened from 7 to 5 years
- Fewer firms are available and willing to perform audits of SEC issuers
- Continued litigation and regulatory enforcement actions have increased auditors’ objectivity and professional skepticism.

The PCAOB, through its inspection program over almost eight years, should be able to accumulate evidence of any links among (i) audit failures, (ii) a lack of auditor independence in mental attitude, and (iii) the auditor's tenure on the audit. The Release describes a possible link between findings of a lack of professional skepticism and objectivity when conducting audit procedures and evaluating results, but does not relate those findings to how long the auditor had been engaged and whether results varied in relationship to the auditor's tenure. Further, the Release describes (pg. 7) audit deficiencies that may be attributable to failure to exercise the required professional skepticism and objectivity, but does not demonstrate how mandatory auditor rotation might reduce or eliminate such failures.

Client payment of fees to professionals for services is well ingrained into American business, be they auditors, lawyers, engineers, or other learned fields. Each of these professionals, to varying degrees, faces constraints on their activities in the interest of protecting the public interest. None face any externally mandated limits on their tenure in providing services to a client. Should auditors now be treated differently? We believe the answer is "No."

The Committee appreciates and supports the PCAOB's interest in increasing audit quality, and a continuation of the PCAOB's existing program seems to be the best way to achieve its objective. Auditor rotation would be disruptive and there is a significant risk that it would have an adverse effect on audit quality for reasons cited by past commentators and herein. The Committee does not believe there are any demonstrable benefits, and certainly none that outweigh the risks.

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

The Board should not move forward with an auditor rotation proposal. Companies should be free to engage an auditor of their own choice and discharge the auditor if it chooses, in the same manner as it engages any other professional service vendor.

If the Board does move forward with an auditor rotation requirement, any term length less than ten years would be oppressive.

But, ten years is long enough that any benefit of firm rotation would be negligible, if any. Engagement partners, with the five year tenure limit, will have been rotated twice. Normal turnover in client executive ranks often means significant change in officers over a ten year period. So, the excessive familiarity that may be a concern does not have the opportunity to exist to any significantly greater degree for the incumbent firm than for a new firm.

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?

The Board should not move forward with an auditor rotation proposal.

If the Board does move forward with an auditor rotation requirement, there must be a cost/benefit consideration, and the costs may be relatively higher for smaller companies than for

larger companies; this would need to be studied further in evaluating different term lengths for different companies.

If the PCAOB moves forward with a proposal, an exclusion for firms with few audit clients similar to the one for audit partner rotation in Regulation S-X 2-01(c)(6)(ii) should be considered to avoid undue hardship on the firms and their clients.

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 a "learning curve" of a year or two on all but the simplest new engagements. This learning curve is exemplified by higher initial costs and often audits after the initial years become more effective as auditors gain experience with the client and overcome the initial lack of familiarity with unique aspects of the company audited. Audit firms often have absorbed the cost of the learning curve in the interest of building a long-term relationship, but would likely be less willing to do that if the term of the audit engagement is limited.

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?

This should not be an issue. In the current environment of potential litigation, PCAOB inspections and other factors, auditors are not likely to change their diligence based on the term of the engagement. Partner rotation is the best way to keep effectiveness high, not firm rotation.

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

The Board should not move forward with an auditor rotation proposal. If the PCAOB moves forward with a proposal, a required time before a rotated firm could return to an engagement should not be mandated. Companies should be free to choose their auditors, and change is sufficiently disruptive that they are not likely to want to change too frequently.

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?

No.

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

This is a significant issue because of independence considerations and availability of firms.

Many companies prefer to engage a "Big Four" firm, and frequently must in order to get adequate geographic coverage, especially outside the U.S. They will often engage a different Big Four firm for tax services of a type that will cause the firm providing tax services to be non-independent, and another firm to do foreign bookkeeping that causes that firm to be non-independent. The ability of offices of the Big Four to provide service in every location needed varies. The sum of these factors may limit the availability of alternative firms that can provide adequate services to zero or one other firm, which is clearly not desirable for a company seeking a new auditor.

The situation is basically no different for smaller companies that more often engage non-Big Four firms. The engagement of other firms to provide services that cause them to be non-independent may not be as frequent. But among the non-Big Four firms, local choices may be limited in all but the largest cities in the U.S., either because there are too few firms willing to audit SEC registrants or because they lack expertise in the company's business.

A mandatory rotation requirement may well cause smaller accounting firms to leave the public company audit market because of over-regulation and adverse business consequences of periodic changes in its client base.

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?

The Board should not move forward with an auditor rotation proposal, and this is one more instance of how it would be disruptive. Transition out of non-audit services can often be done, but for some services, such as taxes, the transition can take years and may be disruptive. A solution may to grant dispensation from rotation provisions where there may be excessive disruption, but we question whether any such provision could be workable. In addition, smaller firms are not likely to abandon profitable non-audit services to accommodate any audit rotation requirement with a term limit on the audit.

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?

The Board should not move forward with an auditor rotation proposal. While firms would try to meet the challenge, firms, even large firms, are typically challenged to meet staffing requirements for new engagements, and rotation would severely aggravate this. Staffing numbers and skills reflect an office's client base, and a change to the client base will cause changes in staffing requirements. This would likely lead to termination of staff in some years and hiring staff in other years. Hiring may well include staff from the displaced firm, if possible, but this has its own difficulties, since audit personnel are often not fungible among firms.

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?

The Board should not move forward with an auditor rotation proposal. See question 9. The problems on multi-national engagements are the same type, only larger. Solutions have been to transfer personnel, attempt to hire locally, often from the displaced firm, assign personnel to travel to the locale (if language does not prohibit it) or retain certain offices of the displaced firm for a transition period if the successor firm cannot staff it locally. All of these make an effective and efficient audit more difficult.

Firms smaller than the Big Four often do not have the international coverage to adequately service any but the most routine needs of multinational companies, limiting alternatives available to mitigate the unique challenges if auditor rotation were required. Associations are made between the primary auditor and other firms that would need to be re-established at each rotation point. This can cause further inefficiencies and ineffectiveness as well.

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?

The Board should not move forward with an auditor rotation proposal. Yes, increased frequency of auditor changes disrupt audit firms' operations or interfere with their ability to focus on performing high quality audits. Staffing disruptions (See response to questions 9 and 10) would be an adverse effect of rotation of auditors and those would have an inevitable effect on audit quality. These would potentially impact firms of all sizes. In addition, uncertainty in each rotation year could impact individuals' careers significantly.

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?

The Board should not move forward with an auditor rotation proposal. The disruptions caused by rotation would likely require firms to devote more resources to audit quality to just maintain existing quality. While they may continue to try to improve quality of audits, rotation will likely make such improvements more difficult to achieve.

Smaller firms are likely to focus more on non-audit services and services to non-SEC registrants, in order to avoid dealing with auditor rotation issues on SEC registrants.

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

The Board should not move forward with an auditor rotation proposal. There could be some effect as providers of non-audit services cease providing those services to meet independence requirements on a newly engaged audit client. This can be disruptive for companies, and companies' aversion to this disruption could drive them to engage non-audit professionals for those services where possible. Firms that choose not to provide audit services to SEC registrants may increase their capabilities to provide non-audit services. It is hard to say whether this will be harmful or beneficial to investors.

14. Some have expressed concern that rotation would lead to "opinion shopping," or that in competing for new engagements firms would offer favorable 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 favorable 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?

We believe that existing safeguards against opinion shopping make this a non-issue.

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

The Board should not move forward with an auditor rotation proposal. Mandatory rotation could cause companies to regard an audit as a commodity if competing firms have similar capabilities; this could cause audit fees to be the most significant differentiation. How firms will deal with this in the face of high initial costs is hard to determine at this time, but we believe audit firms will not willingly compromise audit quality. If firms competing for an audit do not have similar capabilities, which may limit the number of firms who are capable of doing the audit, audit fees would be less of a competitive issue, resulting in higher fees, but audit quality would not be affected.

But, competition could decrease if some smaller firms elect to avoid the uncertainty involved in rotation and abandon the public company audit market.

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?

No. The PCAOB should not require auditor rotation.

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?

Nothing additional is required. Firms will do their own assessment of how to manage risks and necessary allocation of resources. But, there is a cost to doing this, which can be substantial, and these costs call into question whether rotation ever can be cost-beneficial.

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?

The Board should not move forward with an auditor rotation proposal. We believe existing standards relating to communications between predecessor and successor auditors are sufficient. Information required by the successor auditor would be in the predecessor auditor workpapers. Provision of additional information is not necessary and could breach confidentiality.

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

No. Auditor rotation should not be required.

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?

The Board should not move forward with an auditor rotation proposal. Companies should be free to remove an auditor whenever it chooses to. A "cause" restriction could force continuation of a bad auditor/ client relationship that might fail to meet a satisfactory "cause," and could lead to expressions of "cause" that belie the true reason for removal. Current reporting of disagreements provides adequate information to protect public interest.

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

The Board should not move forward with an auditor rotation proposal. The transition issues are no different than in any other initial audit, so there is no need to address them separately as auditor rotation issues. However, it should be borne in mind that there would be almost several thousand auditor rotations each year, and this would result in huge expense, significant disruptions at registrants and their auditors, potential delays in completing audits, and significant increases and decreases in personnel requirements at many of accounting firms, all without any proven benefit to anyone.

We would be glad to discuss our opinions with you further should you have any questions or require additional information.

Sincerely,

A handwritten signature in black ink that reads "Howard Sibelman". The signature is written in a cursive, flowing style.

Howard Sibelman
Chair
Accounting Principles and Auditing Standards Committee
California Society of Certified Public Accountants