

Public Company Accounting Oversight Board  
c/o Office of the Secretary  
1666 K Street, N.W.  
Washington, D.C. 20006-2803  
USA

By E-mail: [comments@pcaobus.org](mailto:comments@pcaobus.org)

December 14, 2011

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Dear Sir(s):

**Re.: PCAOB Rulemaking Docket Matter No. 37  
PCAOB Release No. 2011-006  
Concept Release on Auditor Independence and Audit Firm  
Rotation; Notice of Roundtable**

The Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany], the professional organization representing public auditors in Germany, appreciates the opportunity to comment on the above-mentioned Concept Release. We are responding to this Release both because a number of our members are registered with the PCAOB and thus would be affected directly by any new PCAOB Rule on auditor independence and audit firm rotation, and also because any action by the PCAOB in this context may have an influence on policy makers and auditor oversight authorities worldwide.

We understand the reasons stated in both the Concept Release and given by individual Board members in their individual statements thereon as to why the PCAOB has decided to address auditor independence, including mandatory rotation of audit firms, and support the PCAOB's initiative to revisit this issue at the present time. Indeed, given the fact that ongoing discussions within the European Union on external rotation seem to be primarily driven by a desire to introduce more competition within the market for audits of larger public companies, we also support the PCAOB looking at the issue primarily from the per-

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spective of audit quality and investor protection. In our view, audit quality has to be the paramount concern in this context.

We fully agree that the issue of auditor independence is critical to public confidence and trust in the auditing profession and inter alia the financial information of the companies in which they invest. Nevertheless, as we explain in more detail below as well as in our responses to the questions raised by the PCAOB in the appendices to this letter **the IDW does not believe that the benefits of mandatory rotation of audit firms would outweigh the disadvantages**. In addition, artificial market intervention of such nature would undoubtedly have unintended “side-effects” impacting audit quality. The PCAOB’s aim of strengthening investor protection further needs to be balanced with appropriate consideration of the potential impact on audit quality, as well as to bear in mind that the audit is one part of a system of corporate governance and cannot be considered in isolation. Indeed, as we discuss below, there may be other more appropriate actions the PCAOB could undertake to further strengthen audit quality. Accordingly, **the IDW does not support the proposal to introduce a rule providing that a registered public accounting firm is not independent of its audit client if it has provided an opinion on the client’s financial statements for a certain number of consecutive years**, nor do we believe there is sufficient justification for the introduction of such a rule.

In the appendices to this letter we have responded to both the general and the specific questions raised in the Release. Below we discuss matters of a general nature, relevant issues not addressed in the Release, and provide our views on certain potential alternative courses of action.

## **General Matters**

### *Need for further analysis underlying issues affecting audit quality*

We note that page 6 of the Release states: “The Board does not suggest that all of the audit failures or other audit deficiencies its inspections staff has detected necessarily resulted from a lack of objectivity or professional skepticism. Audit failures can also reflect a lack of technical competence or experience, which may be exacerbated by staffing pressures or some other problem. And, as the Board’s inspections are not random, the Board may be looking at the most error-prone situations. The root causes of audit failures are complex and vary in nature...”

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We also note that concerns have been expressed by several PCAOB Board Members in their individual statements on the Release as to the need for further analysis of PCAOB inspection results before any decisions can be made as to the best way to address remaining shortcomings. We share these concerns.

In our view, if the Board is to address audit failures appropriately, identification of the underlying cause or causes has to be the first step. In this we support the comments of those Board members who have raised this issue in their respective statements.

Inspection findings that appear to indicate a lack of professional skepticism in relation to e.g., estimates within fair value measurements could derive from a number of different shortcomings. Indeed, the example of estimates within fair value measurements is an area in which different audit skills need to be used to traditional verification procedures, and an area which the PCAOB SAG is currently considering. In cases such as these, it would be inappropriate to conclude that the issue is simply a case of the auditor being unwilling to challenge management because of a lack of independence that could be mitigated by mandatory audit firm rotation. It may well be that other measures would be more appropriate in this particular case, depending on what the underlying reasons for such shortcomings are. For example, a revision of the Board's interim standard AU Section 328: Auditing Fair Value Measurements and Disclosures might be part of an appropriate solution.

Indeed, as the Board continues to require the application of interim standards taken from the "pre-clarity" era AICPA standards in many areas, we would foremost encourage the Board to assess the need to update its suite of Standards in line with the ISAs. In our view this is a necessary step for the PCAOB in securing quality audit work be performed.

We therefore welcome the intention of the Board to "deepen its understanding of the root causes in upcoming inspections seasons", and would strongly urge to the Board to await such results before considering further whether to introduce a measure as far-reaching as mandatory audit firm rotation.

*Past discussion and continuing contention relating to mandatory audit firm rotation*

As noted in the Release, mandatory audit firm rotation has been subject to contentious discussions over the last 30 years or more. The issue was debated in detail in 2002 in the U.S. and in 2006 in the E.U. In both cases, the arguments against meant that this measure was not taken further. This fact alone would

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seem to underline the seriousness of concerns as to the appropriateness of mandatory audit firm rotation as an optimum and feasible safeguard to auditor independence. Indeed, in a number of jurisdictions mandatory audit firm rotation introduced in the past has not been retained.

The enactment of the Sarbanes Oxley Act of 2002 and measures subsequently taken by the PCAOB have already addressed a number of the issues identified in previous discussions. Taking the two main concerns that provided arguments in favor of external rotation discussed by the Cohen Commission as examples, the first one: “auditor’s incentive for resisting management pressure” has already been addressed by requiring the audit committee appoint the auditor, and the second, the “fresh viewpoint”, to some extent by engagement quality review requirements introduced in the PCAOB’s standards. In contrast, the Cohen Commission’s concerns as to increased costs remain valid, and have not been addressed.

As the Release points out, the GAO findings dating from 2003 contained some compelling arguments against external rotation. We are not convinced that there is any reason to believe the context has changed such that these findings would no longer be valid. Indeed, in our opinion, they are more likely to be exacerbated by increasing complexity in financial reporting standards, auditing standards, business models, as well as the increasing impact of globalization such as outsourcing practices, etc.

Furthermore, whilst it is undoubtedly useful to draw on past discussions, the fact that the market has changed considerably (esp. large public company market) introduces new facets for consideration. It is important to recognize that multi-national audits pose increasing and different challenges compared with those encountered in the past; a fact that, due to its very nature, may give rise to concerns in respect of investor protection. This aspect also needs to be given due consideration in the debate on mandatory audit firm rotation.

#### *Unrealistic views held*

We would question whether the views expressed by some who are calling for mandatory rotation of audit firms based upon the supposition that ending firms’ abilities to ensure long-term income streams will increase independence are well founded. In his statement on this Release the PCAOB chairman James R. Doty states that “...according to the research firm Glass Lewis, between 2003 and 2006, more than 6,500 public companies, or nearly 52 percent of all public companies, voluntarily changed their auditors.”

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If the real issue is that independence is compromised by a fear of losing a client, then logically – irrespective of how long the tenure of a particular audit firm was – setting aside income stream arguments, from a reputational viewpoint alone, no firm will wish to be dismissed within the period for mandatory audit firm rotation, and thus the introduction of mandatory rotation could result in increased pressure to hold onto an audit client rather than less.

### **Relevant issues not addressed in the Release**

In our view, the Release does not adequately discuss certain factors or alternative proposals, which we believe ought to be given due consideration in the debate on improving audit quality. We do not claim to have identified all such factors in this letter, but would like to draw attention to the following:

#### *Market concentration*

As we note above, we appreciate the fact that the PCAOB's initiative is primarily driven by concerns about audit quality rather than concerns about concentration in the audit market. Nevertheless, the possible impact on audit market concentration is a factor that the PCAOB needs to take into consideration. The IDW believes that there is a danger that mandatory audit firm rotation would increase market concentration because audit firm changes would be mainly be restricted to the larger firms, as audit committees often perceive that medium firms may lack the resources, capacity and expertise in this market segment, and that rather than facilitating access of the small and medium sized firms to more audit clients, it would also make it easier for the larger firms to encroach on their smaller company audit clients. This latter view mirrors the concerns expressed by the Cohen Commission several years ago, which we believe continue to be valid.

A further aspect of considerable concern to us is that ultimately the changes to the audit market that would likely ensue from mandatory rotation would also further reduce the audit profession's attractiveness to the individuals audit firms needs to attract in future. This development is not in the interests of the profession and thus not in the interest of the capital markets and investors.

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*Potential impact on audit fee levels*

Whilst the issue of increased costs that would likely result were mandatory audit firm rotation to be introduced is mentioned in the Release, we are concerned that a further potential impact of such a requirement on audit fee levels is not.

Certainly in Germany, and, according to our understanding, elsewhere, many of the companies that put their audit to tender on a voluntary basis expect to be able to reduce audit fee levels. We do not believe that audit clients will be willing to accept higher fees as a result of mandatory tendering; rather they will continue to seek to use a change in audit firm as an opportunity to reduce audit fees. Thus we believe that mandatory audit firm rotation would intensify this “price spiral”, which is an additional threat to audit quality.

*Potential detrimental impact of artificial market intervention*

There is considerable concern in some quarters that statutory intervention in the audit market would have detrimental effects. Firstly, it would constitute an intervention in companies’ rights to operate autonomously. Secondly, it would lead to permanent movement in the audit market, which we are concerned would ultimately detract from the value of auditing, leading to an audit being increasingly viewed as a mere commodity to be “valued” by price alone. This very supposition would intensify the price spiral referred to above and thus also undermine audit quality.

*Additional reference material*

The Release comments on the lack of recent studies in this area.

The IDW is not aware of any reliable empirical data that would suggest that mandatory audit firm rotation would enhance audit quality. Indeed several of the more recent studies<sup>1</sup> have indicated that there is a direct correlation between an auditor’s tenure and audit quality such that this may not be the case.

One relatively recent finding not mentioned in the Release can be drawn from COSO’s conclusions<sup>2</sup> that “fraud companies are twice as likely to change audi-

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1 Mandatory Audit-Partner Rotation, Audit Quality and Market Perception: Evidence from Taiwan, Linda Smith Bamber and E. Michael Bamber, (December 2008) and Auditor Tenure and Perceptions of Audit Quality. The Accounting Review, Vol. 8, No. 2. Ghosh and Moon (2005).

2 Publication: “Fraudulent Financial Reporting 1998-2007 – An Analysis of U.S. Public Companies”,

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tors as no fraud firms between the last clean financial statements and the last fraudulent financial statements...”. This backs up previous findings of a number of other studies and academic research that indicated that auditor change may provide more opportunities for companies who intend internal fraud to remain undetected.

Within Europe, the EU Commission itself, in its Summary of Responses to the green paper “Audit Policy: Lessons from the Crisis” published on February 4, 2011, noted that little support was received for mandatory audit firm rotation. A further study published in June 2011<sup>3</sup> also indicated that the chairs of audit committees as well as finance directors from five major European countries did not support mandatory audit firm rotation. Also, experiences gained in jurisdictions that had introduced mandatory audit firm rotation have generally not been positive. In countries such as Italy where mandatory audit firm rotation is still required, recent academic research indicates that the requirement has not improved audit quality<sup>4</sup>.

On this basis we do not believe there is any real justification for the introduction of mandatory audit firm rotation.

## **Potential Alternative Courses of Action**

### *Role of company management in audit quality*

The IDW has called for firmer requirements for management to substantiate and evidence information reflected in its financial statements. We draw your attention once again to the IDW Concept Paper of 17 September 2007: “Additional Issues in Relation to a Conceptual Framework for Financial Reporting“ to this effect.

We note with interest that Mr. Jay D. Hanson commented that the PCAOB’s inspections have revealed that there is a very direct correlation between the quality of a company’s processes, controls, documentation and people on the one hand and the quality of the audit on the other hand in his speech at the Compli-

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3 Exploring attitudes to audit quality and potential reforms, YouGovStone European Audit Committee Chair and CFO Poll, PwC (June 2011).

4 Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?, Working Paper, Bocconi University (Milan- Italy) and IE Business School (Madrid-Spain), Cameran, M., Prencipe, A., Trombetta, M. (2010).

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ance Week 2011 Conference in May 2011. He went on to say that the better job management does in determining and providing evidentiary support for their valuations, the better job an auditor can do. In our view this is an area that well deserves further exploration in a debate on improving audit quality.

#### *Strengthening the cooperation between the auditor and the Audit Committee*

The IDW believes there is significant potential for increasing the value of the audit for users by intensifying the cooperation between auditors, and the audit committee (and external oversight authorities for regulated industries).

The auditor should be able to respond in line with the differing informational needs of the various stakeholders, both internal and external to the company. In addition to the short-form auditor's report (addressed to the shareholders and the general public), the auditor could prepare a long-form audit report directed towards the entity's audit committee or supervisory board, containing the auditor's comments on the entity's accounting policies, where necessary, explaining them in more detail, giving the auditor's own viewpoint. This would assist the audit committee in making its own evaluation of these measures and also indicate any areas where they should place a specific focus in their own supervisory activities.

The auditor could also inform the audit committee when an accounting decision, which, although in line with the applicable financial reporting framework, is nevertheless at the border of being permitted by the applicable rules. In particular, this should include a statement by the auditor on grooming transactions (e.g., sale-and-buy-back transactions) that have a material effect on the recognition and measurement of assets and liabilities in the annual financial statements. In Germany there is already a legal requirement to include this type of information in the long-form audit report.

Enhanced two-way communication between auditors and audit committees would also have a positive impact on the quality of the audit, particularly if the auditor were required to give more consideration in future to the impact of the entity's business model on its economical development than is presently the case.



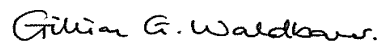
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We hope that our comments are useful for the Board's further deliberations. Should you have any questions about our comments, we would be pleased to be of assistance.

Yours very truly,



Klaus-Peter Feld  
Executive Director



Gillian G. Waldbauer  
Technical Manager

## APPENDIX 1

### Views on the following more general issues (Pages 18 and 19 of the Release)

- *Should the Board focus on enhancing auditor independence, objectivity and professional skepticism? How significant are the problems in those areas relative to problems in other areas on which the Board might focus? Should the Board simply defer consideration of any proposals to enhance auditor independence, objectivity and professional skepticism?*

We support measures designed toward optimizing audit quality, which include, but are not limited to, enhancing auditor independence, objectivity and professional skepticism. As we have commented in the attached letter, we would urge the PCAOB to analyze its inspection findings as to “root causes” and to then take action appropriate to addressing any issues so identified. Depending on the results of such analysis, such action could include revision of auditing standards, auditor qualification and CPD requirements, quality control requirements, etc.

In the absence of such analysis having been undertaken, we believe that the “over” emphasis on external rotation potentially implied in the Release is not justified, particularly as significant changes such as the introduction of engagement partner rotation have been made recently in this area.

We would also encourage the PCAOB to consider particularly problematical areas of financial reporting that pose specific challenges to auditors in terms of their verifiability and whether they may need to be addressed by enhanced audit approaches i.e., revision of specific auditing standards. The areas which the SAG is currently looking at (meeting of November 9 and 10, 2011) should also be taken into account in the context of enhancing audit quality.

- *Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?*

In practical terms, we doubt that mandatory audit firm rotation would lead to a real sharpening of auditor independence, objectivity and professional skepticism. The pressures on audit firms to retain audit clients will not disappear; merely the period will be shortened and pressure intensified. Adding to this, the

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drawbacks of initial audits discussed in the Release would mean that audit quality would be reduced on two folds. In our opinion, the reading of a predecessors audit files, however detailed, in the initial years of an audit could not adequately give auditors the depth of understanding of the client that can be gained by inquiry and observation over time. In conclusion, whilst mandatory firm rotation may influence public perception, any benefits would not be outweighed by the ensuing increase in costs.

- *What are the advantages and disadvantages of mandatory audit firm rotation? If there are potential disadvantages or unintended consequences, are there ways a rotation requirement could be structured to avoid or minimize them?*

The potential advantages and disadvantages are discussed in the Release quite comprehensively.

We do not support mandatory audit firm rotation. Artificial market intervention of this nature would undoubtedly have unintended “side-effects”, in addition to the disadvantages pointed out in the Release.

In the accompanying letter we draw attention to certain matters not addressed in the Release, and refer to these in this context.

As we have explained, we are concerned that some of the perceived advantages may not be achievable in practice.

In responding to the question of whether there are ways a rotation requirement could be structured to avoid or minimize potential disadvantages or unintended consequences, we would like to make the following points:

Any assumption that disadvantages such as client disruption can be avoided or significantly minimized are misplaced. Attempts to minimize extra costs of both audit firm staff and client staff will impact audit quality. To illustrate this we would like to point out that the PCAOB’s new risk standards require the auditor to obtain an understanding of the company and its environment (“understanding of the company”) to understand the events, conditions, and company activities that might reasonably be expected to have a significant effect on the risks of material misstatement. We would question the suggestion made by proponents of mandatory audit firm rotation that access to a predecessor’s audit files would address the risk that a new auditor may, without increasing audit costs significantly, be unable to obtain a sufficiently deep understanding in initial years. Reading of files, however well written, cannot replace the interaction with an au-

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dit client in terms of inquiry and observation by which the auditor is required to obtain this understanding. Disruption to the company's staff due to an entirely new audit team having to ask questions afresh is also a factor that should not be underestimated.

The impact on a company's corporate governance of taking away a company's own ability to act i.e., the audit committee's freedom in auditor appointment, is potentially a factor to consider, as it could have a negative impact on the effectiveness of the audit committee's work and its relationship with the audit firm.

- *Because there appears to be little or no relevant empirical data directly on mandatory rotation available, should the Board conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the Board determines whether to consider developing a more permanent requirement? How could such a program be structured?*

We do not believe a pilot program is appropriate at this stage. As mentioned in the accompanying letter, we believe it is essential for the Board to analyze the reasons behind its inspection findings before taking further steps.

Depending on the nature of identified deficits mandatory audit firm rotation may not be the right solution, as certain deficits will not be rectified but just moved to another client. Indeed, for example if competence or inexperience of auditors in certain areas of financial reporting were found to be an issue, mandatory audit firm rotation would be detrimental to audit quality.

- *According to the 2003 GAO Report, large firms estimated that a rotation requirement would increase initial year audit costs by more than 20 percent. What effect would a rotation requirement have on audit costs? Are there other costs the Board should consider, such as the potential time and disruption impact on company financial reporting staff as a result of a change in auditors? Are there implementation steps that could be taken to mitigate costs? The Board is particularly interested in any relevant empirical data commenters can provide in this area.*

Our members confirm that initial audits inevitably require increased audit resources in practice. This inevitably increases costs of the audit. By requiring a company to change its auditor at regular intervals mandatory audit firm rotation would force such costs on the whole public company market - not just on those

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companies voluntarily seeking a new audit firm (who may expect the incoming audit firm to absorb the “extra” costs in its fee projections).

In respect of the potential time and disruption impact on company financial reporting staff as a result of a change in auditors, we also refer to our response to the third question above. The potential detrimental impact on audit quality of any steps that could be envisaged as mitigating costs ought to be of primary concern.

- *A 2003 report by the Conference Board Commission on Public Trust and Private Enterprise recommended that audit committees consider rotation when, among other factors, "the audit firm has been employed by the company for a substantial period of time— e.g., over 10 years." To what extent have audit committees considered implementing a policy of audit firm rotation? If audit committees have not considered implementing such a policy, why not? What have been the experiences of any audit committees that have implemented a policy of rotation?*

In our experience, tendering does occur regularly in the audit market, but often the impact is to introduce artificial pressure on audit fees. In the long term, this is detrimental to audit quality.

As the IDW does not represent audit committees, we are unable to respond to this question from the viewpoint of an audit committee.

- *Are there alternatives to mandatory rotation that the Board should consider that would meaningfully enhance auditor independence, objectivity and professional skepticism? For example, should broader alternatives be considered that relate to a company's requirement to obtain an audit, such as joint audits or a requirement for the audit committee to solicit bids on the audit after a certain number of years with the same auditor? Could audit committee oversight of the engagement be otherwise enhanced in a way that meaningfully improves auditor independence?*

The audit committee ought to be primarily interested in getting best audit service to assist it in its own role. To function effectively the audit committee needs to have an appropriate degree of autonomy. Whether the audit committee has both the power and the means to obtain the best audit service is an issue worth further consideration. For example, management is often responsible for setting a budget and audit committees may need to be given more say in this respect so

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that they are better able to select the audit firm they believe best suited to the audit, rather than being constrained by management-determined cost limits in tendering.

The IDW believes there is considerable merit in strengthening the relationship between the audit committee and the auditor. As noted in the accompanying letter we do not favor market intervention. However, requirements for audit committees to justify audit firm retention might be a step worth considering.

Whilst such measures are not within the remit of the PCAOB itself, if they were to be the best course of action, the PCAOB should pursue them with the SEC rather than taking action on mandatory audit firm rotation for the sake of taking action.

We refer to our comments and suggestions outlined in the accompanying letter in this regard.

- *Should the Board continue to seek to address its concerns about independence, objectivity and professional skepticism through its current inspection program? Is there some enhanced or improved form of inspection that could better address the Board's concerns? If mandatory rotation were in place, could an enhanced inspection, perhaps focused particularly on professional skepticism, serve as a substitute in cases in which it would be unusually costly, disruptive or otherwise impracticable to rotate auditors?*

Inspections have a significant role to play in enhancing audit quality. As we have explained in the accompanying letter, we welcome the intention of the Board to “deepen its understanding of the root causes in upcoming inspections seasons”, and would urge to the Board to await such results before considering further whether to introduce a measure as far-reaching as mandatory audit firm rotation.

In addition, where such analysis reveals that an auditor has not exercised sufficient professional skepticism, the Board already has the power to reprimand that individual, even including deregistration.

## APPENDIX 2

### Possible Approaches to Rulemaking

Given the measures already in place to address auditor independence and the disadvantages of mandatory audit firm rotation, we do not support the proposal made on page 19 of the Release to introduce a rule providing that a registered public accounting firm is not independent of its audit client if it has provided an opinion on the client's financial statements for a certain number of consecutive years.

### Responses to specific questions in the Release

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

We do not support mandatory rotation across the board. Any term length would be arbitrary, and, as we have commented elsewhere, the pressures on audit firms to retain audit clients will not disappear, as an audit firm would not wish to lose any audit client before the period of mandatory rotation had expired. Adding to this, the drawbacks of initial audits (depth of understanding of the client needs to be gained over time) would mean that audit quality would be reduced on two folds.

- 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?*

We do not support mandatory rotation across the board. In general, we do not support different treatment according to kind of engagement, as we subscribe to the premise that "an audit is an audit" and audit quality should be of a consistently high level.

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We have also commented that the Board needs to give careful consideration of the root causes of audit failures identified in its inspections before deciding whether perhaps mandatory audit firm rotation might make sense.

In this context we would also like to point out that companies of systemic relevance risk are likely to be large and have complex businesses. The drawback to selecting only such companies for mandatory audit firm rotation would be that fewer audit firms would possess the specialized expertise and experience to carry out the audit in a cost efficient and qualitative way efficiently. Thus, the Board would need to balance these factors appropriately.

*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?*

Potentially yes. As the Release points out, several studies have indicated that the initial years of an audit are likely to be more costly and can be less effective than later years. This is because an effective audit requires the auditor to possess an appropriate understanding of the audit client. Without sufficient understanding there is a danger that the focus of the audit may be inappropriate. This may occur, for example, when audit risks are either identified or assessed incorrectly, or when risks fail to be identified and assessed. This level of understanding cannot generally be gained in the initial years of an audit without considerable application of resources (more experienced staff, etc.), since the auditor has no information from past audits upon which to draw. It would not be feasible to expect that reading a predecessor audit firm's audit files could compensate for this, quite apart from the fact that reliance on the work of another previous auditor would have to involve additional work to evaluate the reliability thereof.

The exact learning curve would vary with factors such as complexity and nature of the client's business and audit firm experience in the particular field, and resources in terms of staff, etc.

*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*



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*or less diligent towards the end of their term? Does the answer depend on the length of the term?*

Diminishing diligence with audit tenure duration is not the issue in question. Auditors in general, as well as individual audit firms, also have a reputational interest, which means they need to meet public expectations.

Given the various measures that have been introduced relatively recently in terms of quality control within audit firms, including engagement quality review and external inspections, we do not believe that audit firms would set out to become less diligent with tenure. We therefore do not believe that the question as to whether the answer depends on the length of the term is relevant.

A replacement audit firm should not be viewed as a check on a predecessor firm.

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

Any period would be arbitrary. Were such period too long, the returning auditor would have either little or no relevant understanding of the client. A too short period would make the measure counterproductive.

*6. Should the Board consider requiring rotation for all issuer audits or just for some subset, such as audits of large issuers?90/ 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?*

We question the arguments discussed at the bottom of page 21 of the Release, which mirror certain discussion in the EU. Specialist knowledge and sufficient capacity are needed for certain of the larger and more complex audits. Suggesting that in the event that the largest audit firms would be displaced periodically would mean that “more firms might develop additional capacity and expertise” appears well meaning but unlikely, certainly in the short term. As audit committees look for the best firm for the job, it is likely that only a few firms will come into the reckoning – i.e., generally the larger firms will continue to be chosen, which will further increase market concentration.

As mentioned in the accompanying letter there could be a number of unintended consequences potentially compromising audit quality.

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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?*

A rotation requirement would constitute regulatory intervention in the audit market, and in a company's powers to act for itself.

In our view, the expectation that mandatory audit firm rotation might generate dynamism into audit market is not realistic. Indeed, as explained above in our response to q. 6, as well as in the accompanying letter, we are concerned that it could have the reverse effect and lead to further market concentration.

Given the specialist nature of certain industries, combined with prohibition on the provision of audit together with certain specialized consulting services, we believe it is very likely that a rotation requirement would present particular difficulties in identifying an auditor with the necessary skills and expertise in specific industries or regions.

Smaller firms are likely to be the losers anyway, since in practice audit clients forced to reselect their auditor do not tend to go to smaller audit firms but look for firms they perceive to be best able, in terms of specialization, experience and staffing capacity, to provide quality services for a competitive fee, which often means larger audit firms.

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?*

As we do not support the introduction of mandatory audit firm rotation, we do not believe that artificial measure that would essentially force companies to cancel non-audit services in order to have sufficient choice of audit firms as a viable proposition. We also view the proposed introduction of a rule, which would then itself need to be modified with various exceptions, as highly problematical. We therefore do not believe that workable steps that could be taken to address any limitation on auditor choice. Combined with existing independence rules, artificial interference in the audit market, such as mandatory rotation, would also affect a company's ability to obtain non-audit services. In practice such a situation

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would force audit firms to choose to tender for either a non-audit service or an audit service to a particular company, but not both. This will impact on the company's choice of audit firm, potentially forcing the company to accept a firm other than the preferred firm for the audit which is unlikely to be in investors' interests.

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 is some debate as to whether it is practicable or illusory to anticipate that smaller and medium-sized firms could and would develop the necessary capacity to provide audits to larger and more complex companies, certainly in the short term.

Many smaller and medium-sized audit firms will not currently have the staff resources needed to perform new audit engagements, particularly those relating to larger companies. Existing independence requirements on internal rotation that restrict the number of years key audit team members can serve on a particular audit is a factor that would preclude such firms from "poaching" the most suitable staff from outgoing audit firms. Development of increased capacity with adequate experience without recourse to such measures would take time, and in many cases is likely unachievable in the short term. This means that relatively few such firms would be able to provide audit services to new larger clients, were mandatory audit firm rotation introduced.

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?*

An across the board rotation requirement would severely impact the audit market. All companies would be affected on a regular recurring basis. For multinational companies the impact would be even more complex, taking account of independence rules relating to network firms etc., to name but one aspect.

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 ro-*

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*tation requirement pose fewer or more implementation issues for small firms than for large ones?*

In our accompanying letter, we have already mentioned the likely impact on the auditor's ability to obtain the necessary understanding of an audit client's business. It is likely that all audits would be affected, although the extent of disruption may vary. The more complex the business and the less experience a new audit firm has within the particular industry, the more costly it will be for new audit teams to get to grips with key issues, and thus the greater the risk that in initial years the audit quality may be less than in later years.

*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?*

We are concerned that audit clients will be reluctant to bear the extra costs associated with a rotation requirement.

One could guess the extent and manner in which individual firms may seek to address this problem. In this context however, as alluded to in the accompanying letter, we are concerned that fee pressure already experienced in some markets may be intensified.

It is conceivable that some firms might exit the audit market. Increasing fee pressure and perceptions of overregulation might well be factors in such decisions.

The impact of both these factors on audit quality would be unfavorable.

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

In our opinion mandatory rotation would impact the market for non-audit services, in a way which, as we explain below, would not be beneficial to investors.

Further market concentration within both the audit market and the market for certain non-audit services could prevent companies from selecting the particular firm they believe is best for the job, forcing them to engage another firm. As such, this could also impact on the quality of services a company receives for both audit and non-audit services.

Current independence requirements preclude an incoming auditor from providing certain non-audit services prior to being engaged as the auditor. This of its

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own will mean that companies would become limited in their choice of firms permitted to supply certain non-audit services. Mandatory rotation on top of this may exacerbate the problem by further causing even firms anticipating that they could be selected as auditor to reject non-audit work from a particular company in order to qualify as independent for the potential audit engagement. Such a restriction on a company's ability to obtain quality non-audit services is not in investors' interests.

In addition, if firms perceive that the regulatory burden of providing audit services outweighs any attaching benefits, some firms may choose to concentrate on non-audit services and leave the audit market altogether in the long term, which will lead to further market concentration.

*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 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?*

Yes. It is conceivable that opinion shopping might be one factor. For example, as we have noted elsewhere, reputational concerns might mean that mandatory rotation would have the undesired effect of increasing the pressure on audit firms to retain a particular audit client for the maximum period allowed under mandatory audit firm rotation. Such pressure may well foster opinion shopping. However, it is not possible to forecast whether and to what extent this might be a factor in practice.

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

If firms were forced to compete for each of their audit client at set intervals, it would be reasonable to assume that tactics might evolve. For example, losing a client would free spare capacity which firms might then, rather than have idle, choose to offer at lower prices initially or in the short term. This would encroach on markets served traditionally by other firms, increasing market concentration. Were firms to react to fee pressure by allocating less staff or less well qualified or experienced staff this would have an impact on audit quality.

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*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?*

We do not believe that quality control measures alone could compensate for the factors discussed above.

*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?*

As we have explained above, the firm's understanding of the client is key to a quality audit. Obtaining sufficient depth of understanding is not a simple matter to be addressed by added supervision. Certain factors help – for example a firm with experience in a particular specialized industry could generally be expected to be more efficient in gaining this understanding than a firm lacking such experience. In Germany there are standards governing the exercise of the profession (professional requirements) which require a firm to possess the appropriate competence, experience and resources before accepting an audit engagement.

Client acceptance procedures are just one side of the coin. Mandatory audit firm rotation requirements would impact a company's ability to select the most appropriate auditor. In extreme cases, client acceptance procedures would fail to be effective if firms became desperate to obtain new clients using strategies to outbid rival firms.

*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?*

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No. The PCAOB would need to revisit this aspect. In Germany the auditor is required to obtain the long-form audit report prepared by a predecessor auditor. This notwithstanding, as noted elsewhere, we do not believe that reading a predecessor audit firm's files can ever substitute for the enquiries and observation required of an incoming firm by current auditing standards. An incoming auditor needs to perform these procedures to obtain an understanding of a new audit client and make its own assessment of risk. Whilst information from a predecessor may be useful, firms could not rely on information supplied by a predecessor audit firm for such significant aspects as those mentioned in this question.

In addition, we note that the PCAOB has not yet updated all its interim standards taken over at its initiation. In our view an approach similar to that taken in ISA 600 in respect to the work of other auditors would be appropriate.

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

We refer to our responses above and to our accompanying letter. In our view the risks to audit quality outweigh the benefits, and cannot be adequately overcome by additional regulatory measures.

*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?*

Irrespective of whether the PCAOB were to require audit firm rotation or not, we do not believe that companies should be able to dismiss their auditors during an audit already contracted for unless there are valid reasons. Disagreements as to correct accounting treatment or similar cannot constitute valid reasons.

In Germany, the Commercial Code ("Handelsgesetzbuch") requires an auditor be appointed before the end of the business year subject to audit and also prohibits the removal of an appointed auditor without court approval (and appointment by the court of a new auditor) in all but extreme cases (e.g., auditor's continuing illness). The German Commercial Code tightly governs the initiation of

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court proceedings to replace an auditor. In addition only in certain extreme cases can an auditor resign from an ongoing audit engagement.

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

We refer to our responses above and to our accompanying letter. In our view the risks to audit quality outweigh the benefits and cannot be adequately overcome by additional regulatory measures.