



PCAOB Rulemaking Docket Matter No. 37

I am pleased to have this opportunity to comment on the PCAOB's comment release on audit firm rotation. My career background includes years as an auditor at a Big-Four accounting firm; in financial reporting at a major SEC registrant; on the staff of the Enforcement Division and Office of Chief Accountant at the Securities and Exchange Commission; and as a director and member of the audit committee for 42 mutual fund registrants. In my primary role, as an accounting and auditing professor, I frequently connect with partners and professionals including former students at nearly all the Big-Four and national accounting firms. Throughout my career, I have considered questions of audit quality from many perspectives.

Like the PCAOB and accountants themselves, I concur that reliable audits are critical to the effective functioning of our capital markets, and that an audit is worthless without independence of thought and professional skepticism on the part of the auditor. In Release No. 2011-006, the PCAOB discusses the results of inspections, citing repeated comments that suggest insufficient auditor skepticism and an increasing number of engagements with reported audit deficiencies. It suggests that rotation of audit firms will increase skepticism, and therefore, audit quality. My experiences indicate differently, as discussed below.

FINANCIAL INCENTIVES ADEQUATELY SUPPORT SKEPTICISM

The concept release states that the rotation requirement would alleviate the auditor's ability to turn an engagement into a long-term income stream, and thus aim directly at the basic conflict that "too often proves difficult for auditors to overcome." The concept release thus suggests that the financial lure of repeated fees causes auditors to fail to exercise professional skepticism.

I would argue that present financial incentives absolutely promote professional skepticism. An audit firm that fails to find a material misstatement is typically sued. The cost of defense and damage to the firm's reputation is huge; the time that an individual must spend in defense is huge; and the negative impact on an individual career of being associated with an audit failure is huge.

THE CURRENT SYSTEM PROVIDES FOR SIGNIFICANT REVIEW

A number of the comments in the concept release suggest that audit firm rotation and the knowledge that outside auditors would review their work would cause audit partners to do a better job. However, under the current system, audit partner performance is judged within a firm continuously: by concurring partners; by any consulted partners; and potentially by internal quality reviewers. Furthermore,

partners know that there is a possibility that their engagements will be selected for external review, and if they are found wanting, they will likely face significant financial and career penalties.

INDUSTRY KNOWLEDGE AND CLIENT EXPERIENCE ASSISTS A QUALITY AUDIT

With audit partner rotation, it is not unusual for directors and financial management of key clients to interview potential new partners from across the country, to find a partner with the most relevant experience and expertise. The “winner” will often move to the client’s city for a five-year period—a huge investment by the partner, his or her family, and the audit firm. Will partners and audit firms be willing to make that investment when there is no prospect of an enduring relationship?

A typical key-client audit engagement might have up to 500 audit professionals assigned in possibly 30 countries. There is an immense amount that the new lead partner has to learn in the first year of involvement in an audit. Firms reduce the potential for audit deficiencies following a partner rotation by continuing other staff during that year. If all staff on a key client engagement changed at the same time, the learning curve would be daunting indeed.

Does firm rotation increase the likelihood of having all the right skill-sets and knowledge in place to find misstatements at the largest companies? I think not.

USURPING THE ROLE OF THE AUDIT COMMITTEE

The Cohen Commission in years past recommended against mandatory audit firm rotation, concluding that the audit committee is in the best position to determine whether rotation is appropriate. I concur. As a member of an audit committee, I can confirm that we take our responsibility to hire the auditor, and to monitor auditor performance, very seriously. We discuss audit risks, whether management was cooperative and forthcoming, and key audit findings with the auditors. We certainly discuss inspection findings when the PCAOB makes them public.

The role of managing the audit relationship is appropriately assigned to the audit committee, which has knowledge about specific client personnel, issues and audit results.

THE PCAOB DOES NOT REQUIRE NEW TOOLS TO INFLUENCE THE AUDIT PROCESS

Despite the cost in time and money, inspection has the potential to positively impact audit practice. The inspection process, assuming frank and positive interaction between auditors and the inspectors, has the potential to influence development of “best practices” in auditing.

The prospect of public disclosure of audit inadequacies and the difficulty of explaining these to management and audit committees at current clients, as well as potential future clients, is a strong incentive for auditors to take the process and findings extremely seriously.

THE IMPACT OF REGULATOR OVERLOAD ON THE PRACTICE OF AUDITING

On the accounting front, we are moving to a less legalistic approach to rule-making. We will have standards that focus more on principles than bright-line rules. The thought is that judgment will lead to recording transactions in accordance with their substance.

In contrast, on the auditing front, PCAOB actions seem to be promoting a much more legalistic, “check the box” approach to auditing. In several recent conversations with audit professionals, from several firms, about how their firms have responded to PCAOB actions and inspection findings, there were frequent references to newly-developed “checklists.” In my opinion, defensive and “check the box” auditing is unlikely to lead to better results. If auditors are inordinately worried about avoiding PCAOB inspection comments, and thus are focused on completing checklists that address the risks and problems of the past, how will they identify and appropriately address emerging risks and financial reporting problems?

I recently read an opinion article in the Wall Street Journal decrying the detailed nature of government regulations over concerns as different as day-care centers (is it truly crucial to state the required number of building block toys?) and worker safety (isn't it obvious that stairwells should be lit?). “Regulation is deliberately designed to avoid human discretion—to create a regulatory code that is self-executing. By making rules as precise as possible, we hope to avoid bad judgment. The unfortunate side effect has been to preclude good judgment.” The author advocates a radical regulatory overhaul—not wholesale deregulation, but instead, results-based regulation. (Philip K. Howard, Wall Street Journal, 12/2/11)

No matter what path regulators take, there will be audit failures in the future. The test for new regulation should be: does this change make it more likely that auditors identify emerging risks and assure proper accounting and disclosure for these items? Due to the potential negative impact on auditor qualifications and performance, I strongly believe that audit firm rotation does not meet this test; as a result, implementation of auditor rotation might well increase, not diminish, the likelihood of the next audit failure.

Thank you for this opportunity to contribute to the rulemaking process.

Laurel Bond Mitchell, Ph.D.
Director, Accounting Program
University of Redlands