



The Association for
Accountants and
Financial Professionals
in Business

December 22, 2011

Office of the Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C.

Re: Rulemaking Docket Matter No. 37: Concept Release on Auditor Independence

Dear Board Members and Staff:

We write on behalf of the Financial Reporting Committee and the Small Business Financial and Regulatory Affairs Committee of the Institute of Management Accountants. The Committees are pleased to comment on the Concept Release on auditor independence.

The Committees include preparers of financial statements for large and smaller companies, representatives from large and smaller accounting firms, valuation experts, accounting consultants, academics and analysts. They review and respond to research studies, statements, pronouncements, pending legislation, proposals and other documents issued by domestic and international agencies and organizations. You can find information on both Committees at www.imanet.org.

In summary:

1. The PCAOB is right to evaluate auditor independence, objectivity, and skepticism (independence), and consider ways to bolster them. Auditors add value in large part because of their independence from the companies they audit. However, the company-pay model challenges independence, requiring a wide range of safeguards to protect it. Ensuring auditor independence is one of the most important activities the PCAOB undertakes.
2. We perceive no burning platform of problems in financial reporting by US public corporations requiring radical or urgent measures. Rather, we believe that the relevance and reliability of financial reporting has improved significantly over the past decade. We attribute these developments to the unprecedented investment in the infrastructure supporting quality financial reporting, with improvements in reporting standards, internal control, audit committees, auditor oversight, and audit quality. We reject the assertion that weak auditing caused or significantly exacerbated the credit crisis.
3. We encourage the PCAOB to work within the current framework to drive further improvement in auditor independence and audit quality. Below, we suggest six measures to bolster auditor independence and audit quality.

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4. Radical changes to auditing or governance to bolster independence are unwarranted. These changes include: required rotation of audit firms; dual audit firms; audit only firms; replacing company-payor models with a system of financial statement insurance; stricter auditor liability; random auditor selection by a third party; and mandatory tendering of audit services. Each of these ideas would impose known high costs for highly uncertain benefits, and in some cases, would undermine the overall quality of financial reporting and auditing. To overcome the obvious harm of high costs and disruption, there should be compelling, not just reasonable, arguments for change.
5. In particular, we are concerned about the consequences of mandatory rotation of audit firms. We outline below twelve reasons why mandatory rotation would be imprudent.
6. Facts about the nature and frequency of lapses in independence and how those lapses affect audit quality appear to be in short supply. Further, available facts appear contradictory. We encourage the Board to gather additional facts about audit quality and the costs and consequences of alternatives to bolster independence. Seeking public comment is an important step, although unlikely to yield robust quantitative data needed to inform the Board's debate.

We discuss each of these points in the following sections.

The PCAOB is right to be vigilant about auditor independence

The PCAOB is right to evaluate auditor independence and consider ways to bolster it. Auditors add value in large part because of their independence from the companies they audit. However, the company-pay model challenges independence, requiring a wide range of safeguards to protect it. Ensuring auditor independence is one of the most important activities the Board undertakes.

The Board's findings in certain inspections of audit firm work are obviously concerning. While the results may not be representative and the Board may not have identified the root cause, the possibility that independence could be eroding is well worth pursuing. Soliciting public comment is a logical step forward.

While we applaud the Board's consideration of auditor independence, we were surprised with the Concept Release's focus on audit firm rotation. At the concept stage, it is useful to solicit facts and comments on the wide range of issues and remedies affecting auditor independence. Unfortunately, premature focus on firm rotation causes constituents to comment mostly on that issue, possibly depriving the Board of a broader perspective.

US reporting is high quality – we see no burning platform

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attribute these developments to the unprecedented investment in the infrastructure supporting quality financial reporting, with improvements in reporting standards, internal control, audit committees, auditor oversight, and audit quality.

Examples include:

- Creating the PCAOB, with broad power to improve independence standards, inspect audit work, and discipline auditors and their firms.
- Improving standards governing auditor independence, including more frequent rotation of audit personnel, and second partner review of audit work.
- Strengthening audit committees, and expanding their responsibilities.
- Investing in people and processes that are the backbone of internal control over financial reporting and audits of internal control.
- Increasing penalties against those who violate standards.

Taken together, these actions have significantly improved the environment for auditor independence. In addition, PCAOB inspection activities have increased auditor focus on meeting audit standards and bolstered auditor independence. Audit committees have greatly stepped up their oversight of financial reporting and auditor conduct, including auditor independence. Audit firms have improved their systems of control and oversight of their audit partners. Improvement in internal control has encouraged audit committees and management to be more respectful of auditors' duty to be independent.

The frequency and importance of restatements for errors has fallen significantly in recent years, particularly for large companies, also suggesting improvements in the environment. To be sure, the goal is zero errors. But, the trend is positive.

Critics have asserted that lapses in financial reporting and weak auditing caused or significantly exacerbated the credit crisis. We reject that assertion. Poor business decisions, not weak auditing, caused the crisis. Further, we do not blame auditors for failing to predict events that management, market participants, regulators, and government officials all failed to see.

While not perfect, we perceive that reporting by US companies has improved in response to major investment and reforms over the last decade, and is now of solid quality. The trend remains positive. Thus, we see no need for additional radical reform. Rather, we should promote further progress through incremental, evolutionary improvement.

Bolster independence within the current structure for financial reporting

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Regulators can bolster auditor independence through substantive improvement within the existing framework. Six ideas for doing so are:

- a. *PCAOB should report or discuss troubling inspection findings directly with the applicable audit committees on a timely basis, when major findings warrant direct communication.* Doing so would avoid undermining audit committee oversight (which would occur were the PCAOB to mandate firm rotation). Yet, direct PCAOB reporting would inform audit committees of problems from the Board's unique perspective.
- b. *Develop and market PCAOB recommendations on best practices for audit committees to promote auditor independence.* Given the importance of audit committees in setting a tone and environment that promotes auditor independence, we suggest that the PCAOB expand its advocacy for audit committee best practices. After working with the private sector to identify best practices, the PCAOB should share these practices with audit committees through director conferences, education materials, speeches and articles. It should also ask COSO to incorporate those practices in its internal control framework.
- c. *Enhance the qualifications of audit committee members by strengthening the definition of "financial expert."* Rules defining financial experts include people who have general management oversight over finance functions, which could qualify a CEO or COO, even if they have little background in accounting or auditing. In contrast, we believe the concept of financial expert should require education, certification and background in accounting or auditing. While we believe that audit committees generally provide effective oversight, strengthening the definition of financial expert could enhance audit committee scrutiny and oversight, thereby improving auditor independence.
We recognize that the PCAOB has no direct authority to enhance the concept of financial expert. However, we suggest the Board recommend that enhancement to the SEC and stock exchanges.
- d. *Address lapses in independence and weak inspection findings with targeted and, where necessary, aggressive enforcement actions against specific auditors and firms.* As argued above, severe reforms in the earlier part of this decade bolstered auditor independence. Today, we suspect lapses in independence are not systemic, but are a function of specific people and circumstances. Fortunately, the Board has broad powers to get facts and impose remedial action and discipline. We encourage the Board to use the full range of its power whenever it perceives lapses in independence. In contrast, radical changes to address independence concerns, such as required rotation of audit firms, are a blunt instrument – they unnecessarily impose large costs and significant risks across the financial reporting system.



- e. *Intensify PCAOB inspections in the first years of a change in auditors.* As the Concept Release notes, evidence suggests that audit problems are more likely to occur in the early years following a change in auditors. Inspections targeting these cases could provide insight into the root causes of audit problems and inform the debate about independence and the consequences of mandatory rotation of audit firms.

- f. *Expand inspections to provide the PCAOB with a basis to conclude on the overall quality of an audit firm’s public company audits.* We understand that the PCAOB targets its inspections toward higher risk engagements and audit areas, an approach we support. Unfortunately, that approach leaves the Board unable to conclude on the overall quality of a firm’s audit practice, as the results of high-risk areas may not apply elsewhere. Expanding inspections to provide the Board with a representative perspective would inform the Board’s view on independence, and provide a better basis to assess firm leadership.

In addition, the PCAOB has implemented important new audit standards which would also help audit quality. The Board should give them a chance to work.

Radical changes are not prudent at this time

Radical changes to auditing or governance to bolster independence are unnecessary. These changes include: required rotation of audit firms; dual audit firms; audit only firms; replacing company-payor models with a system of financial statement insurance; stricter auditor liability; random auditor selection by a third party; and mandatory tendering of audit services.

Each of these ideas would impose known high costs for highly uncertain benefits, and in some cases, undermine overall quality of financial reporting and auditing. The following summarizes our concerns about each approach.

Area	Problem
Required rotation of audit firms	Would undermine audit quality, undermine audit committee oversight of the audit relationship, and impose high costs (see discussion in next section)
Dual audit firms	Risks missing key audit issues if cooperation between firms is lacking; inspires competition between joint auditors that may undermine audit quality. Imposes redundant costs.
Audit only firms	May undermine a firm’s ability to attract highly qualified people; could deprive a firm of the wide range of expertise needed for high-quality audit work.
Insurance companies hire	Insurance companies may prefer mediocre but cheap



auditors when they write financial statement insurance	audit work as they spread risks of financial statement error across a large group of companies; insurance company auditors could be motivated to reduce insurance company risks rather than ensure quality financial reporting. Cost of premiums may greatly exceed the cost of audit work today, particularly for companies in inherently risky businesses.
Stricter auditor liability	Auditors are already highly sensitive to litigation risk. Higher liability would undermine the ability of firms to attract qualified personnel, and impose greater costs throughout the reporting system.
Random audit selection by a third party	Undermines audit committee control of the audit relationship and triggers many of the problems of mandatory firm rotation.
Mandatory tendering of audit services	Increases firm focus on marketing, potentially distracting firm from audit quality. Could encourage low cost audits, undermining quality. Fails to alter the incentives of the incumbent auditor. Expensive for companies and firms.

To overcome the likely harm of high costs and risks of radical alternatives, there should be compelling and not just reasonable arguments for change. As discussed in earlier sections, we believe that reporting in the US is generally of high quality and there is positive momentum. Thus, we don't see a need for additional radical reform.

We note that some countries have either implemented or proposed major changes to bolster auditor independence, including the notion of audit-only firms and mandatory rotation of audit firms. We do not opine on whether those changes are needed or desirable in those countries. However, those countries have not imposed the same massive investment in financial reporting as companies, auditors and regulators have done in the US over the past decade. We believe that those changes have been largely effective, rendering more radical changes unnecessary in the US environment.

Mandatory change in audit firms is particularly risky and flawed

Surprisingly, the Concept Release focused on mandatory change in audit firms. Because it appears to be the leading concept in the minds of some Board members, we outline our concerns in detail. In short, we believe that mandatory rotation of firms would undermine audit quality while imposing high costs on the financial reporting process.

We are concerned that mandatory rotation of firms will undermine audit quality for the following reasons:



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1. *Requires auditors to climb steep learning curves on a regular basis.* Effective auditing requires not only audit skill and general business knowledge, but also detailed knowledge about a company's systems, procedures, controls, personnel, transactions, and environment. Acquiring this knowledge requires years of effort, which is why continuity of staffing on complex engagements is important. Mandatory rotation requires an entirely new audit team. The downside of a fresh perspective is ignorance and oversight, particularly in large, complex engagements, where quality auditing most matters. As the Concept Release notes, a disproportionate share of audit problems occurs early in an audit relationship. Mandatory rotation increases the risk of audit problems by increasing the incidence of auditor changes. Current and recently enhanced audit partner rotation requirements achieve the benefits of a fresh perspective, without loss of institutional knowledge.
2. *Increases risk of undetected aggressive accounting or fraud.* A new audit team that is distracted with learning about a new client may be less likely to detect circumstances where a management under pressure decides to stretch the truth.
3. *Eliminates the company's access to an auditor's unique industry or geographic skill sets that are only resident in one firm.* Audit firms are not interchangeable – each firm has unique strengths related to industries, geographic regions, and transactions. Mandatory rotation may require a company to terminate the most qualified firm. Firms without the required skills will require time to build them, increasing risk of weak audit work. Some smaller public companies already have limited access to qualified firms. Mandatory rotation would further restrict their access.
4. *Undermines the effective working relationship between the audit partner and audit committee.* Obviously, most effective working relationships require time and trust to develop. As a result, many firms overlap changes in audit partners for a year so that the audit committee and new audit partner can develop an effective working relationship by the time the previous engagement partner rotates off the engagement. Mandatory rotation forces a new relationship without the benefit of overlap, undermining effective communication at a time when the new firm is trying to get down the learning curve.
5. *Requires audit firms to devote more time and resources for marketing.* Doing so starves resources useful for audit quality and encourages the marketing mindset that PCAOB is trying to eliminate.
6. *Undermines audit committee oversight of the audit relationship.* Recent reforms in the US emphasized the critical role audit committees play in hiring, firing and compensating auditors. Mandatory rotation undermines audit committee control and oversight, relegating the most important aspects of oversight to regulatory fiat.
7. *May disguise opinion shopping by enabling companies to portray a voluntary change in auditors as obligatory.* Required auditor changes allows companies to consider potential new auditor views on accounting principles as part of the vetting process and avoiding disclosures required when opinion shopping.



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8. *Relegates auditors to commodity status.* Mandatory rotation rewards excellent audit work with a lost client. Doing so is not an incentive for quality auditing, or for attracting highly qualified personnel to audit firms.

Mandatory rotation of firms also imposes significant costs. For example, it causes:

1. *Duplication of start-up and learning time needed for an effective audit.* Some estimate that this cost alone adds 20 percent to audit fees.
2. *Puts upward pressure on audit fees because incentives change.* Currently, new firms agree to lower audit fees to gain a potential long-term client. Mandatory rotation changes this incentive causing the new firm to require more fees during a temporary relationship.
3. *Management time and distraction.* Changing audit firms requires a great deal of management time and resources to educate the new auditors. Time pressures on financial management are particularly intense, increasing expense and risks of reporting problems.
4. *Restricts companies' choice when purchasing consulting services.* Upon rotation of firms, audit committees will want to choose from among several firms. To do so, the company must restrict the purchase of consulting services from those firms for a long period before the rotation. This could deprive the company of the best consulting expertise.

We acknowledge that mandatory rotation is not without possible benefit – namely that it may reduce management pressure on the auditor, motivate the auditor to perform good work because of pending scrutiny of a new firm, and allow a fresh look at a company's reporting. However, those possible benefits are outweighed by many serious risks to audit quality and certain high costs. It would be particularly imprudent to impose such massive change at a time of generally high quality financial reporting.

Of course, we would be pleased to discuss our comments with members of the PCAOB or its staff.

Sincerely,

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