PCAOB Panel on Auditor Independence
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Good Morning

Thank you for the invitation to speak today.

Frankly my friends will tell you that asking me to speak for 5 minutes is a challenge. I tend to over explain.

Today, on this very complex topic, I am going to be pretty flat-footed in stating my opinions without much in the way of explanation.

Independence, Skepticism and Objectivity are, without any doubt, the most important issues the PCAOB can address.

The cultural evolution from an accounting profession to the business of accounting began in the 70's and reached its apparent peak in the 90's when the public accounting firms became the largest retail consulting organizations in the world and the audit became only one product in a multi-product line.

The management emphasis fails to give primacy to the idea that the investor is the audit client and any management related benefits, a by-product. Audits are a public good.

Throughout this transition the leadership of the firms believed they could manage any independence conflicts arising out of the management client-service business model.

I believe they consistently underrate the impact of the culture they have created.

SOX put a temporary hold on the dominance of the management client-service model with a forced refocus on the audit for third-party investors.

Unfortunately, I believe the paying management client-service model is reasserting itself.

Today the paying management client-service model is tightly coupled with an industry that shares the market among a small number of participants, an oligopoly, where company audits are held for long periods, in some cases for so long as to appear to be in perpetuity, and when client-auditor changes that do occur are traded within that small tight knit group of four firms that are now too big to fail.

I am not the first to note that this combination might not bode well for investors.

Therefore, independence proposals that may, as a by-product, initiate discussions about future structural changes should be given extra points. We may be considering one such proposal today.

First, a few words on issues that invariably arise any time significant proposals are made bearing on independence issues.

Cost: Audits are a public good. Therefore, cost should not be measured solely or even primarily by the fee paid for a specific company audit, but rather on the likely costs that will be imposed on investors by large and small audit failures. Even on a company audited basis, audits are cheap.

Management Pays: A payment scheme where the professional is paid, not by the client, but by the management of the company under audit, introduces independence problems. I am not aware of a good alternative to this model and this simply means we need to be that much more vigilant.

Expertise and Transitions: No doubt firms have developed specialties and have shared the market based on these specialties. Nevertheless, I find it interesting that we will entertain the idea that firms as large and talent laden as those in question and that pride themselves on advising managements on complex strategic and operational issues, cannot develop the necessary methods to manage the required transitions in operations and expertise to do any audit.

More research, more studies and pilot programs: As an academic, I am sympathetic to this position. However, as with many decisions positing future behaviors, research today has its limits. Waiting for more research and studies, including pilot programs fraught with their own independence issues, will not likely provide the comfort we seek, but will certainly mean taking no substantive action now or in the near future.

The Proposals:

Tendering with a refutable presumption of firm rotation –

Put most simply, I do not believe this proposal will work whatever its appeal as a compromise position.

Implementation will require rule-making concerning the criteria on which the rotation can be refuted. This process will be an invitation for delay, dilution and ultimately, litigation. Both the audit firms and management will have a common incentive to lobby this matter and failing in this effort will have a strong incentive to make common cause as each rotation cycle approaches.

Mandatory firm rotation –

This is a simpler requirement, more difficult to avoid.

I will not repeat the pros and cons of mandatory rotation here.

I believe that mandatory firm rotation can stand on its own as a means of enhancing auditor independence, skepticism and objectivity.

The implementation of mandatory rotation will have to be staged and will take enough time to allow us to work on the problems that will arise.

It is, in my opinion, it will be worth the effort required.

--The proposal has the distinct advantage of being a significant break with the past where we tinkered with the existing independence rule structure with little success other than to emphasize the rules game itself.

More importantly, and here I step off a cliff, I sense that mandatory firm rotation may initiate a discussion by the various stakeholders about more fundamental changes to the structure of the auditing business and possibly a return of the professional auditor.

This seems possible to me if we think not only about auditor incentives, but also about management's participation in this partnership.

A management that knows the joint auditor/manager endowments have limited life may rethink its relationship to the audit, the auditor and consultants.

I must admit that I have only a sense of this issue and not a complete story to tell.

However, what is clear is that management must be convinced that failure to protect their current and future auditors' independence will incur costs for them and that their responsibility for those costs will be transparent in the marketplace.

Is there going to be room for larger consulting firms that do not have the audit as an entry point?

Will there be an incentive to support the growth of a larger number of multi-service public accounting firms?

Will breaking up the existing firms become more attractive to both managements and the existing multi-service public accounting firms?

Could it even open the option for audit-only firms? The existence of audit-only firms would substantially reduce the potential for conflicting consulting service issues and enhance the professional culture of auditing.

In conclusion, I support a move to mandatory firm rotation and believe it will enhance auditor independence and increase the probability that appropriate levels of skepticism and objectivity will exercised during the audit.