Statement of

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PCAOB Roundtable

Auditor Independence and Audit Firm Rotation

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My name is Gaylen R. Hansen. I am Chair-Elect of the National Association of State Boards of Accounting (NASBA), and an audit partner and director of quality assurance at Ehrhardt Keefe Steiner & Hottman (EKS&H) in Denver, Colorado. EKS&H is the largest accounting firm in Colorado with approximately 350 professionals. We audit both issuers and non-issuers; our issuer component approximates ten percent of firm revenues and includes accelerated and non-accelerated filers. I am a member of the PCAOB's Standing Advisory Group and have served on the AICPA's Professional Ethics Executive Committee (PEEC), the U.S. Treasury's Advisory Committee on the Auditing Profession (ACAP), and the Colorado State Board of Accountancy. Currently, I am also a member of both IFAC's Consultative Advisory Group for auditing and ethics standards boards (the IAASB and IESBA, respectively).[1]

NASBA's mission is to enhance the effectiveness of licensing authorities of CPAs and their firms in the U.S. and its territories. Boards of Accountancy take seriously their responsibilities to protect the public interest. They understand the importance of the public's confidence and the importance of reliable capital markets. In that spirit and on behalf of NASBA, I wish to convey our appreciation for the opportunity to express some thoughts on auditor independence, objectivity and professional skepticism.

Kudos goes to the Board for its leadership in putting this critical topic on its agenda. It is not only appropriate and well within the scope of its mandate, but courageous. True independence requires professional skepticism and an inquisitive mind. Your determination to enhance independence, objectivity and professional skepticism, thereby elevating audit quality is laudable.

Perceptions about independence are as important as the reality of independence in fact or in mind, and are a critical factor in achieving public confidence in our capital markets. Decades-long tenures of auditors with their clients are risky business for investors relying on independent audits. Excessive tenure will always leave people wondering if over-familiarity or self-interest has shaded objective judgment.

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[1] The views herein are my own and do not necessarily reflect those of any of the organizations mentioned.

Mandatory Firm Rotation (MFR) has been suggested as one possible counterweight to the consequence of long tenures, and is now being considered by regulators worldwide. The difficulty is assessing at what point MFR is warranted, and at what cost.

A decision to adopt MFR must unmistakably correlate with significant improvement in audit quality, and balance any benefit achieved with the incremental costs required. While your series of public meetings and concept release are highly educational, clearly there is still a crying need for more unbiased research on this matter. And while public input is always welcome, there is no question but that auditors and their firms, as well as issuers, audit committees, and management, each have a conflict of interest regarding MFR. Their input should be weighed accordingly.[2] I hope the Board continues to be open to ongoing MFR research, possible pilot testing, and continued analysis of proposals and experience in other jurisdictions.

In addition to MFR, there is some talk of mandatory tendering, a time consuming and costly exercise, but informative. While an option, tendering should not be viewed as a substitute for MFR. Please consider a hybrid combination of the two approaches. For example, a requirement to tender every five years with disclosure, followed by MFR with a very long tail, say 25 years (as recently proposed in the EU), might be a more balanced approach to address investor concerns. I do worry whether mandatory tendering might overemphasize fees. Related to an undue focus on fees but with an opposite effect, is the question of the tenure period: if too short, and if there is an inability to increase fees, a firm might be inclined to walk away. This might be particularly more prevalent with smaller issuer audits.

The comply-or-explain tendering approach proposed in the UK by the Financial Reporting Council also has merit and should be explored. Although issuer disclosures are not governed by the PCAOB, the "explain" part of this solution should be considered, irrespective of whether a MFR or tendering standard is adopted.

Canada is looking at a slightly different approach, a "mandatory comprehensive review" by audit committees. The existing firm would ordinarily retain the engagement, unless the audit committee has determined that the firm has not met audit quality expectations, or if institutional familiarity threats are present. Part of the process would look at the length of service of the auditor and their senior members. It would also require the firm to affirmatively demonstrate to the audit committee how it had exercised professional skepticism.[3] This solution should also be considered.

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[2] A recent study by Protiviti surprisingly finds nearly half of all issuers agree that rotation might improve audits; *2012 Sarbanes-Oxley Compliance Survey, Where U.S.-Listed Companies Stand: Reviewing Cost, Time, Effort and Processes*, May 2012; http://www.protiviti.com.au/en-US/Documents/Surveys/2012-SOX-Compliance-Survey-Protiviti.pdf.

[3] Canadian Public Accountability Board and Chartered Accountants of Canada; *Enhancing Audit Quality: Canadian Perspectives – Auditor Independence*, September 2012; http://www.cica.ca/enhancing-audit-quality-canadian-perspective/item68293.pdf.

While SOx has resulted in a significant net improvement of the audit, management and unfortunately NOT the audit committee, typically still drive the auditor hire or fire decision, at least more so with smaller issuers. In some respects these audit committees have very little involvement in auditor oversight other than a briefing before the audit begins and again prior to filing. Often these meetings are merely quick conference calls and usually include significant management participation. In many cases, the focus continues to be driven primarily by a desire to control or reduce fees instead of improve audit quality. In summary, in many instances audit committees continue to exist solely as an alter ego of management. The role of the audit committee still needs to be strengthened, and especially to remove management from the hire or fire decision. Even though oversight of the audit committee is not that of the PCAOB, this matter should be communicated to the SEC and exchanges.

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The Board has requested feedback on the following discussion questions. My responses are in the boxed areas below each question.

1. Steps audit firms might take to reinforce professional skepticism (e.g., related to tone-at-the-top, client acceptance procedures, staffing models, training, etc.)

Culture within an audit firm is a key driver of audit quality. PCAOB inspection teams could do the following to get a better fix on firm culture:

- Scrutinize evidence of leadership tone, client acceptance procedures, staffing models, and training beyond the current routine quality control interview.
- Spend more time looking at marketing philosophy, plans and specific proposals.
- Scrutinize the partner compensation model:
  - technical competence should be a required component of compensation decisions;
  - the expectation and assessment of technical competence and linkage with compensation should be a documented part of the quality control system; and,
  - hone in on alignment of incentives. Partners must have the ability to walk away from engagements without adverse career consequences, i.e., is there an environment where they can always say, "No, not on my watch!"?

2. Steps audit firms take to manage any risks associated with new engagements. Views on the need for enhanced auditing standards in this area even in the absence of a rotation requirement.

An area needing attention is predecessor and successor communications following a change of auditors. There is an increasing unwillingness of predecessor firms to share information in transitions. In some cases a review of working papers is not allowed, contrary to the spirit of AU 315. Typically copies of work papers are not provided. This is done I am told, for legal reasons. But I believe it is done more often out of spite, an attempt to hamstring the replacement auditor, punish a departing client, or all of the foregoing. Most troubling is the struggle a successor often must go through to adequately check out opening balances. This behavior is unethical and contrary to public policy. It should not be tolerated.

3. Ways that a rotation requirement might be implemented or scaled to contain cost and disruption and views on any other transitional considerations (see, for example, the written statements of Charles Bowsher, John Bogle and John Biggs).

> If adopted, some roundtable panelists have suggested the largest audits be the first to be subject to MFR. Since these audits are the typically the most complex and often span multiple locations and large numbers of staff, this is probably not the best place to start. On the other hand, the smallest clients are not particularly a challenge but would be an unreasonable burden on small firms already being pushed out of the audit arena. I suggest a more reasonable place to start would be with mid-size engagements.
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> A performance-based approach should also be considered. Here a rotation could kick in if inspections identify substandard practice or in the event of certain restatements.

4. Views on how a rotation requirement might affect smaller firms.

> Smaller firms have always been challenged in this practice space. The additional resources required to audit public companies often are not balanced with the costs and risks involved. This has resulted in an ever-decreasing number of smaller firms willing to audit public companies. It is no secret that the investment community is not as familiar with the abilities of smaller firms or willing to learn about them. Consequently, many small firms develop practices only to see arbitrary decisions mandating rotation that unfairly discriminates against them. While MFR might provide new opportunities for small firms, it is just as likely to further erode their practices. Also see Item 3 above.

5. Views on the merits or otherwise of tenure protection.

> Regardless of whether MFR, mandatory tendering, or tenure protection is pursued, the central goal should be a significant improvement in audit quality. Tenure protection involves restrictions on the ability of an issuer to fire an auditor at will, and presumably in situations when disagreements arise between management and the auditor. It may have merit if audit engagements are lengthened, but could also result in unintended consequences, including complacency.

6. Impact of concentration in the profession on audit quality (see, for example, written statement of Thomas Gard).

> The Board's overriding objective is correctly to raise the bar on audit quality. That should be the primary focus of MFR. While other concerns such as market concentration, competition and choice are serious matters, they are public policy issues that should not be combined or confused with considerations about objectivity, independence and professional skepticism.