Concept Release on Auditor Independence and Audit Firm Rotation

RELATED INFORMATION

Event Details and Documents

DATE:	Aug. 16, 2011
SPEAKER:	Jay D. Hanson, Board Member
EVENT:	PCAOB Open Board Meeting
LOCATION:	Washington, DC

Introduction

The Board is issuing today a Concept Release to seek comment on ways that auditor independence, objectivity, and professional skepticism could be enhanced. It is appropriate now — eight years after the reforms established by the Sarbanes-Oxley Act — to consider whether more should be done to enhance auditor independence, objectivity and skepticism, and, if so, what the appropriate measures would be. Nevertheless, I believe that we should proceed cautiously along this path. The primary focus of the Concept Release is mandatory auditor rotation. Before we determine whether that is in the best interests of investors and the public, we will need to weigh carefully whether its benefits would outweigh its costs and potential unintended consequences. We also need to further analyze our inspection results and other available information to determine whether audit deficiencies are attributable to a lack of auditor objectivity and skepticism and, if so, whether those symptoms are best remedied through mandatory auditor rotation or some other measure. I look forward to what I know will be thoughtful and thorough comments in response to the Concept Release to help the Board consider all of the relevant aspects of this important issue.

The Concept Release

Section 207 of the Sarbanes-Oxley Act required the United States General Accounting Office to conduct a study and review of the potential effects of requiring the mandatory rotation of registered public accounting firms. In November 2003, the GAO issued a report that stated, among other things:

GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record, as well as the current reforms being implemented. The potential benefits

of mandatory audit firm rotation are harder to predict and quantify, though GAO is fairly certain that there will be additional costs.

Several years' experience with implementation of the Sarbanes-Oxley Act's reforms is needed, GAO believes, before the full effect of the Act's requirements can be assessed. GAO therefore believes that the most prudent course of action at this time is for the Securities and Exchange Commission and the Public Company Accounting Oversight Board to monitor and evaluate the effectiveness of existing requirements for enhancing auditor independence and audit quality.[1]

We now have several years of experience as contemplated by the GAO report. Since its creation in 2003, the Board has conducted hundreds of inspections of registered public accounting firms each year. These inspections provide the Board with a unique insight into the state of the audit profession and the conduct of public company audits. Based on this insight, the Board believes that the reforms in the Act have made a significant, positive difference in the quality of public company auditing. Indeed, any auditor, financial executive or audit committee member that was involved with public company audits prior to the enactment of the Sarbanes-Oxley Act can tell you how different the auditing profession and audit committees are today compared to ten years ago. This is due primarily to the reforms of the Act and the activities of the PCAOB.

Nevertheless, the Board's inspections continue to find audit deficiencies. Room for improvement in audit quality remains. The Board continuously strives to drive improvements in audit quality through inspections, requirements for remediation, disciplinary action, and standard setting. We consider the underlying causes for the audit deficiencies identified by PCAOB inspectors, and risks posed by an ever-changing environment, and we ask ourselves what more we can and should do to continue to improve audit quality.

Because the independence of auditors from their clients is critical to their effectiveness and credibility — perhaps more critical than any other single factor affecting audit quality — Congress, the SEC and the PCAOB have established many specific requirements relating to auditor independence. The concept release we are issuing today asks whether even more action is warranted to enhance auditor objectivity and skepticism, and, if so, what form such action should take.

Unlike other concept releases issued by the Board, such as the concept release recently issued regarding potential changes to the auditor's report,[2] I see this release more as a vehicle to gather information and spark discussion than as a step toward a Board proposal for a new or amended auditing standard. The release seeks information on a variety of important issues, including the significance of problems with auditor independence, the potential effectiveness of mandatory auditor rotation or other measures in addressing such problems, and the likely costs or unintended consequences of mandatory auditor rotation or other measures. I would like to highlight a few areas in which I believe comments would be particularly helpful:

First, although auditor rotation was specifically singled out in the

Sarbanes-Oxley Act and GAO Report and has been the subject of much debate over the years, I would encourage commenters to provide their views, and relevant factual information, relating to any potential measure to improve auditor independence, objectivity, and professional skepticism. While the Concept Release focuses on mandatory rotation as a potential remedy, we are open to other ideas, and I encourage you to include in your comments other potential measures, whether intended to supplement or replace mandatory auditor rotation.

Second, I am particularly interested in comments about the role of the audit committee in ensuring auditor independence, including through voluntary auditor rotation, and in the real-life experiences of audit committees that have considered or implemented auditor rotation. The GAO Report pointed out that

. . . audit committees with their increased responsibilities under the Sarbanes-Oxley Act can play a very important role in enhancing auditor independence and audit quality. In that respect, the Conference Board Commission on Public Trust and Private Enterprise stated in its January 9, 2003, report that auditor rotation is a useful tool for building shareholder confidence in the integrity of the audit and of the company's financial statements. The commission advocated that audit committees should consider rotating audit firms when there are circumstances that could call into question the audit firm's independence from management. These circumstances included when (1) significant non-audit services are provided by the auditor of record to the company (even if approved by the audit committee), (2) one or more former partners or managers of the audit firm are employed by the company, or (3) lengthy tenure of the auditor of record, such as over 10 years—which our survey results show is prevalent at many Fortune 1000 public companies. We believe audit committees that encounter these circumstances, at a minimum, need to be especially vigilant in the oversight of the auditor and in considering whether a "fresh look" (e.g., new auditor) is needed. We also believe that if audit committees regularly evaluated whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure auditor independence and audit quality, many of the benefits of audit firm rotation could be realized at the initiative of the audit committees rather than through a mandatory rotation requirement.[3]

I would be interested in comments from audit committee members, investors, issuers, auditors and others about whether the framework contemplated by the GAO report in 2003 has been effective. Do audit committees in fact consider auditor tenure in evaluating their auditor's independence? For those audit committees that have considered rotating their auditor based on tenure, did you ultimately decide to implement term limits for your auditor? What factors did you consider in your decision? Do investors believe that audit committees are living up to the expectations of the GAO report, or should the decision to rotate auditors based on tenure be taken out of the hands of audit committees through the establishment of mandatory rotation?

Finally, I would be interested in views about the timing of the Board's consideration of measures to improve auditor independence. On page 18,

the release poses the following question: "Should the Board simply defer consideration of any proposals to enhance auditor independence, objectivity and professional skepticism?" While posed in the context of Board priorities, I believe this question also should be considered in light of the current state of audit regulation. The Board has issued a number of important auditing standards recently and continues to work on several others. All are designed to improve audit quality or transparency. For example, in August 2010, the Board adopted a suite of eight auditing standards related to the auditor's assessment of, and response to, risk in an audit. In July 2009, the Board adopted the Engagement Quality Review Standard. The Board also has issued a number of Staff Practice Alerts and has proposed amendments to communications with audit committees, a new standard on confirmations, and concept releases related to the auditor's report and to firms' obligations to supervise their associated persons. Many of these new requirements bear directly or indirectly on auditor objectivity and professional skepticism, but their effects have not yet been reflected in audits we have inspected. One approach, therefore, would be for the Board not to act on further measures to enhance auditor independence until some of these new requirements have been fully implemented and subject to PCAOB inspection. I would be interested in comments on the pros and cons of that approach.

Other Board Activities

The work of the Board, however, does not stop with the issuance of this release or the review of comments received in response. The Board has at its disposal information generated inside and outside the PCAOB that is invaluable in determining the need for and potential effects of measures to enhance auditor independence.

As noted in the Release, the Board's inspection activities have resulted in findings that include situations we define as audit failures. PCAOB inspections are designed to focus on high risk audits and audit issues. They are designed to identify and focus on weaknesses and deficiencies, and our reports are not intended to serve as balanced public report cards or overall rating tools. Thus, our findings may not constitute a representative sample for purposes of drawing conclusions about actual trends. However, in order to determine whether, and how, such failures can be prevented by enhancing auditor independence, we need to take a close look at the audit failures to determine what the trends are. Is audit quality is improving or declining? Is the significance of audit failures increasing or decreasing? How significant were the audit failures? How many of the failures resulted in a restatement, and how many restatements were related to Fortune 500 companies, systemically important banks, banks that received TARP funds, or companies that ultimately filed for bankruptcy or were provided a bail-out. Were investors harmed? Most importantly, what are the "root causes" for our findings: Are they the result of a lack of technical competence? Which findings are related to complex areas that everyone struggles to get right, and which were mistakes in basic "blocking and tackling" that no auditor should make? Were any findings due to time pressures associated with tight filing deadlines or the result of pressure to reduce fees? And — the most important question for today — which findings likely were caused, at least in part, by a lack of objectivity or professional skepticism? The same questions should be asked in the context of our remediation

determinations and enforcement actions: Do our findings in those contexts reflect concerns about auditor objectivity and skepticism? We are working on analyzing our data to answer some of these questions. In most cases, we believe the answers will not reflect one cause, but, rather, a combination of factors. We are also asking firms to conduct their own analyses, and we would welcome firms sharing their conclusions with us in their comments to the Concept Release.

It is also important to understand how wide-spread the relevant issues are. The Concept Release includes one example from a 2010 inspection of a firm whose proposals to potential audit clients included statements suggesting the firm's actions would be guided by management's wishes. This is a troubling finding, but our inspectors have not seen such assertions by other firms. In the meantime, I would be interested in commenters' views about how common statements or actions like those described in the Release are, as well as other experiences that may reflect a lack of auditor objectivity and skepticism. Do commenters believe that the problems they have encountered would be eliminated or reduced by mandatory auditor rotation? If not, what other measures may be more effective?

Finally, we should continue to monitor and consider the activities and experiences of others as they relate to auditor independence. For example, as noted in the Concept Release, the European Commission earlier this year issued a Green Paper that recommends consideration of, among other things, mandatory auditor rotation. In response to the EC's Green Paper, audit firms and preparers generally opposed mandatory rotation because they believed it would increase costs without improving audit quality. Public authorities had mixed reactions, with some suggesting mandatory rotation may have a positive effect on auditor independence, while others expressed concerns about cost and audit quality.[4] The discussion on this issue continues. We are also continuing to analyze academic studies relevant to the question of auditor independence and auditor rotation. As pointed out in the Concept Release, some academic studies conclude that audit quality tends to increase with auditor tenure, including one study focusing on mandatory auditor rotation in Italy (see footnote 80). Likewise, the Concept Release points out that, in Spain, mandatory auditor rotation was abandoned after seven years due to the increased costs incurred by issuers in connection with auditor rotation. The Board will continue to monitor developments and discussions in these and other jurisdictions in order to inform its own views.

I look forward to receiving what I know will be thoughtful, thorough and balanced comments in response to the Concept Release. I hope we hear from a wide range of stakeholders. I urge firms to talk with their clients' audit committees and investors. Use this opportunity to demonstrate that you put their interests first. Encourage them to respond to the Concept Release.

As always, I would like to thank the staff who worked on this project, particularly Martin Baumann and Michael Gurbutt in the Office of the Chief Accountant, Gordon Seymour and Jake Lesser in the Office of General Counsel, and Helen Munter and Santina Rocca in the Division of

Registration and Inspections.

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[1] U.S. General Accounting Office, Required Study on the Potential Effects of Mandatory Audit Firm Rotation — “Highlights Page” (2003).

[2] Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements and Related Amendments to PCAOB Standards, PCAOB Release No. 2011-003 (June 21, 2011).

[3] U.S. General Accounting Office, Required Study on the Potential Effects of Mandatory Audit Firm Rotation 9 (2003) ("GAO Report").

[4] European Commission, Summary of Responses to Green Paper — Audit Policy: Lessons from the Crisis 28 (2011).