3 December 2011

Office of the Secretary
PCAOB
1666 K Street, N.W.

Subject: Concept Release on Auditor Independence and Auditor Firm Rotation; PCAOB Rulemaking Docket Matter No. 37

Dear Secretary

I have read the concept release on the above identified topic. At this moment, it appears that the release fails to provide convincing support for considering positively the introduction of audit firm rotation. (One participant at the last SAG meeting expressed the same failure as I have noted.) Therefore, all my comments relate to some of the interesting questions you raise on page 18.

Question 1: Should the Board focus on enhancing auditor independence, objectivity, and professional skepticism?

A simple answer: Absolutely. There is a basic question: Why is there failure to adhere to these fundamental requirements. (more comment later)

Question 2: Would audit firm rotation enhance auditor independence, objectivity and professional skepticism?

A simple answer: It is difficult to believe that such an administrative change would influence behavior positively.

Question 3: What are the advantages and disadvantages of mandatory audit firm rotation?

I have no response to this question.

Question 4: Because there appears to be little or no relevant empirical data directly on mandatory rotation available, should the Board conduct a pilot program so that mandatory rotation of registered public accounting firms could be further studied before the Board determines whether to consider developing a more permanent requirement?
Comments: I find Question 4's reference to "little or . . no empirical data" unbelievable. I was surprised that there was no discussion of what was actually learned from almost 8 years of inspections. I realize that the inspection follows a supervisory approach and there is no basis for conclusions about the quality of audits of a single registered firm or a group of such firms since, so it appears, from reading inspections there may be modification in procedures followed during the course of an inspection.

I read and reread about 40 inspections of the annually inspected registered firms. In that review I found not a single reference to deficiencies in the initial planning stage that indicated that there was auditor failure to describe how a continuing client was reconsidered in the determination of the year's strategy for the audit.

What information were inspectors seeking for continuing audits? Why were there seemingly no deficiencies of insufficient information related to updating what was known about the issuer? What is the reader to conclude? Possibly, the reader determines that there was sufficient documentation of a serious reconsideration of factors critical for any audit, including a continuing audit by the registered firm. Yet, the Proposal indicates there is no empirical evidence.

Some simple suggestions:

1. In rereading PCAOB auditing standards, Nos. 3, 8, 9, 11, and 12 I find no explicit reference to what should be done on a continuing audit. I expected to find some reference to the nature and scope of planning for a continuing audit. Actually careful auditors do wise, thoughtful planning for continuing audits. For example, the following is what we teach in our auditing classes, based on experiences in public accounting and the interpretation of the standards set by the ASB:

   The planning stage is of critical importance. The judgments made during this stage, of course, are perceived open to modification throughout the audit engagement. A continuing audit engagement must be viewed in planning as though it were a new audit engagement -- consideration of industry developments, activities that were new during the past year, economic circumstances that developed that could impact what is reported in financial statements. Information from prior audits of the same client is valuable, but it is never accepted without reconsideration of its relevance and timeliness.

   The audit team understands that just accepting "that we know this client well and we can dismiss the need for analytics and research in relation to the industry and the issuer" does not reflect the nature of planning we support.

   Reconsideration is common in many instances. One illustration used is the theatrical rehearsals of long running plays. While directors and participants in a theatrical production are thrilled with intensive popularity, they realize that the 8 performances (typical in New York City's Broadway theatres) per week for 5, 10, 15, 20 years will not retain the enthusiasm and passion of initial performances.
Just recently, a radio moderator spoke with the director of The Phantom of the Opera, the production in New York that is celebrating its 23rd year! The director said we have four rehearsals each year... where all the participants assume we are just beginning this production... we realize that this refreshing experience is required to maintain the quality of performance we think is warranted. All those on stage – and those in production jobs – are grateful for such review.

Therefore, would it be worthwhile to be more explicit about what is needed for a continuing audit in relevant standards? Good partners are very careful about a sufficient reconsideration of a continuing client. The guidance, therefore, should be more explicit.

2. I just read the Strategy plan issued a few days ago. Among the strengths identified was this one for the Division of Research and Analysis:

**Unique Data and Analysis:** We possess unique data and analysis related to audits based on eight years of inspections and enforcement experience, as well as a sophisticated research and analysis function.

This is an impressive strength. What has the Division of Research and Analysis done about continuing audits of issuers? I am guessing that most of these long term audits relate to the firms that are inspected yearly. There have been several business stories about the number of issuers who have used the same audit firm for long terms. (I recall imagining what we would learn about actual audits once PCAOB was underway; auditing researchers were generally unsuccessful in gaining audit engagement evidence from public accounting firms. My, this new organization could provide information without revealing the auditor and we would learn much more about the quality of audits, so I believed in late 2002.)

It should not be difficult to identify a random sample of 50 to 60 issuers (or, if the population isn’t too large, why not use the total population in the survey?) that have used the same auditor for decades and develop criteria for intensive and comprehensive review of the quality of such audits related to this group of issuers. (Inasmuch as there have been mergers, there may be more than one firm involved, such as PricewaterhouseCoopers and Coopers and Lybrand...)

The PCAOB has the resources for valuable empirical studies of this topic.

Why are such proposals as changing the reporting model and requiring audit firm rotation made as means of enhancing audit quality? Are opinions sufficient for new rules? Why doesn’t the PCAOB strive to deal directly with audit quality through serious inspections that do provide an assessment of audit quality?
3. Why isn't the inspection process based on criteria related to audit quality? The inspection process, as it continues to be implemented, seems insufficient to encourage improvement in audit quality. Isn't it time to change the model?

The gentle, supervisory approach doesn't seem to have enhanced audit quality. Why isn't the inspection similar to a compliance audit? Why have deficiencies not declined (as noted by the Chairman at the last SAG meeting)? (However, given the nature of the inspection, an opinion based on number of deficiencies is no basis for a generalization.

The ad hoc, supervisory/consulting approach is appealing to many. There is support for this inadequate activity. There was great support for the Public Oversight Board, too. That Body persisted for more than two decades with no serious, objective assessment of its effectiveness.

Developing criteria that are both relevant and reliable is not an easy task, but given the power of PCAOB in the performance of inspections, there is at hand a way of establishing criteria (based on review of results of inspections to date) that could be effective. That means that conclusions, possibly for as long as five years, would be shared with the registered firm inspected but would not be disclosed publicly. (It is likely that for the first two years, no one but the appropriate persons in inspections and research and analyses at the PCAOB would know and study the conclusions.)

4. Is the assumption of the PCAOB that public accounting is no longer a field with professional status?

In 1977, in the first Federal assessment of public accounting, the title of the report was The Accounting Establishment. The term Profession was considered inappropriate after the thorough review of public accountants' behavior.

In April 2003, the Interim Chairman of the PCAOB noted in an interview with the editor of The CPA Journal:

The accounting profession has been unable to discipline itself on standards of professional conduct. The board will bring to the environment the rigorous discipline and enforcement of professional and ethical standards that the accounting profession needs when confronting financial statement fraud. Most accountants want to do the right thing, and they understand that those individuals who do not live up to the standards of the profession hurt the entire profession when they are not disciplined.

On December 1, 2011 the chairman of the PCAOB in a speech stated:

The first challenge is to find the solution to the bias of the payment model: the auditor is hired and fired by the company itself. This creates perverse incentives for the auditor not to call the fouls.
With the acceptance of responsibility for auditing standards, the PCAOB Board stripped the public accounting profession of all factors considered critical for professional status.

Is the Chairman of the PCAOB reflecting the need for change because of the present lack of professionalism among public accountants who perform audits? Is there is no basis for expecting adherence to a professional code of conduct?

The early auditors seem to have been highly influenced by Flexner's brilliant identification of factors that reflected a profession. The first group of commissioners at the SEC in 1934 decided to rely on the "profession" for rules and self regulation.

All self-regulation of public accountants who audit issuers ended with the April meeting in 2003 of the PCAOB. And now in 2011, the Chairman indicates a serious problem that presents a challenge.

I am not a historian of public accounting, but I am guessing that the client who sought an audit provided payment to the auditor even in the early years of professional auditing in the United States. I am guessing that U. S. Steel and J. C. Penny in the early years of the last century paid for their audits. That system of payment seemed to be effective in the early years of public accounting. Now that method is being challenged by the PCAOB.

The perception of public accounting by the PCAOB needs to be made explicit. Is public accounting just another commercial activity that requires strict monitoring and controls to be sure the goal is met? Will the PCAOB soon have a separate body that pays for audits? Or???

Sincerely

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