Regarding the proposed rule requiring rotation of Audit firms every five years, the outcry from most experts and colleagues sounds much like the complaints surrounding the retention rule.

As a former regulator with a federal bank regulatory agency, I have always believed in the need for “thoughtful” regulation. That is, rules designed to preserve/protect or support safety and soundness, but which allow for a competitive free market to adjust and continue to operate.

Many argue that supporting this rule based on anecdotal evidence rather than hard facts underscores the needlessness of the rule. That long tenured firms and partners, over time, lose objectivity is unproven hearsay. Citing the economic impacts of having to change firms every five years, they argue that the costs associated represent an undue hardship on companies and audit firms. I have to disagree on both counts.

In my recent experience, I am witness to a long term partner losing objectivity in administering his responsibilities to a client firm. This partner failed to adequately prepare the client for the advent of Sarbanes Oxley and resulted in material weaknesses for two years despite the efforts of his own firm to address after removing him as engagement partner. He had gotten too cozy with management after more than five years, comfortable with the environment and less than diligent, becoming a personal friend and advisor rather than an objective overseer. As the newly hired director of audit and Sox for the firm, the brunt of trying to bring into compliance an operation bereft of policy and procedure and an effective control environment became mine.

The cost to the firm of having a "disengaged" engagement partner was over $3 million each year it had material weaknesses in attempts to mitigate them. This in addition to reputation lost, lost access to capital markets, etc. proved much more costly than if they had switched firms after five years or at least switched partners every five years. These costs may have been reduced had someone with fresh eyes new to an engagement been in place. The concept continues to
be a common sense approach to sound business practice even 30 years since I first began to hear about it.

I recall back in my early years as an examiner during the 80’s, the notion of changing auditors every five years was not new. In fact, it was often verbally discussed during exit meetings with boards and management, but never documented in reports. Intuitively, it just made sense, even though it did not have the weight of written regulation.

Like the retention rule, which will go a long way to reestablishing safe and sound investor markets with assurances that everyone responsible for loan origination will have skin in the game despite the hue and cry about the costs, so too will this common sense rule promote confidence in the market place.

Sometimes, not unlike castor oil, the “kids” just don’t know what is good for them so you have to make them take it.

Unsigned