I appreciate the opportunity to provide comments on the PCAOB’s Concept Release on Auditor Independence and Audit Firm Rotation.

During my career, I’ve been an audit partner with one of the major firms, a Professional Accounting Fellow at the SEC, CFO of several public companies, an executive with two startup entities, a financial consultant, and an investor. As a result, I’ve been in the role of auditor, regulator, preparer and user of financial statements. I had the opportunity to sit in on the recent Standing Advisory Group (SAG) meeting and, while listening to the dialogue among the members of the SAG, decided to provide my perspective on this Concept Release.

First, let me commend the Board for taking up the many important issues on its docket. Many of these issues have been discussed over a long period of time yet still remain unresolved. We would all agree that auditor independence, objectivity and professional skepticism are essential to audit quality, financial reporting and the effective functioning of the capital markets. We also know that the investor community is looking for more from the auditor and that some changes are necessary. The issue posed by the Board is whether audit quality would be improved by requiring auditor rotation and, if so, how such a requirement should be implemented.

Overview

While listening to the comments at the SAG meeting and reading through many of the comment letters on this Release, it’s clear that the views on this issue are divided: auditors, management and audit committee members seem universally opposed to mandatory rotation while investor groups are in favor of it. As expected, those against this change point to increased costs and audit risk as reasons not to go forward while also pointing out additional areas in which the communication with, and by, audit committees should be enhanced. As with any proposed change, those against point out all the negatives and those in favor see nothing but positives. The reality always lays somewhere in between and, in this case, it’s up to the Board to decide whether the positives outweigh the negatives before moving forward.
The unknown here is whether mandatory rotation will improve auditor independence, objectivity and professional skepticism and therefore improve the quality of financial reporting. In the Release, the Board wasn’t able to quantitatively build a case in support of the change by evidencing a correlation between auditor tenure and audit failure based on its inspections to date as it pointed out:

“Preliminary analysis of that data appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports. It is difficult, however, to extrapolate to an environment in which the engagement term would be fixed and assumed by the auditor and client from the outset of every engagement.”

When this issue has been addressed in the past by other bodies as described in the Release, mandatory rotation was deferred pending further study. So we need to decide whether further study is still needed before moving forward with this change and others or whether the time has come to take action. As we consider that, we should keep in mind that since this issue was last considered, we’ve seen a number of audit failures and an erosion of investor confidence in the role of the auditor and value of audit reports. As a CPA, and someone who has spent a large part of his career as an audit professional, this troubles me greatly. I’ve also been frustrated that the audit profession as a whole has been generally reluctant to step up to the issues raised by investors and to enact meaningful changes. No doubt that’s in part because we’re conservative people who don’t embrace change readily, and no doubt legal concerns have played a part, as they tend to do. But I think we need to start being more proactive in areas where there is a perceived issue and start enacting meaningful changes. It’s clear to me that something has to be done to reduce the number of instances where we see corporate failures following a clean bill of health from the auditors in their opinion on the financial statements and/or on the company’s system of accounting controls over financial reporting.

It’s also clear to me that something has to be done specifically with respect to the auditor’s role in our system of financial reporting. I share many of the respondents’ comments regarding the role of the audit committee, but I see those improvements as supplemental to the changes that should be considered with respect to the role of the auditor. Investors have been clear that they want more meaningful communication directly from the auditor and there have been way too many instances where companies have failed without any advance warning from the auditor. Granted, these situations are the exception but the erosion in public confidence is very real and so I think we should be open to changes that might have a positive impact. At the very least, taking action shows the investor community, and Congress, that we’re being proactive and trying to find fixes, while recognizing that there’s no crystal ball regarding what will work and to what extent. Sometimes you just have to act on your gut feel or “informed judgment”, as the SEC put it when addressing the issue of whether providing non-audit services will adversely affect audit quality:

“Indeed, it is precisely because of the inherent difficulty in isolating a link between a questionable influence and a compromised audit that any resolution of this issue must rest on our informed judgment rather than a mathematical certainty.”

As a former CFO and future audit committee member, I fully understand the reluctance to being required to change auditors every X number of years, particularly if I was very satisfied with the work being done by the existing firm. And as a former audit partner, I fully understand the
reluctance to being required to give up a good audit client. But I also fully understand how an investor might be concerned that the audit firm is not providing the objective, independent, “fresh perspective” audit for a company that’s been their client for 20+ years or in some cases 100+ years. And it’s this perception of a lack of independence that we need to address.

**Conclusion**

I believe we all should acknowledge that long-tenured auditor relationships undermine the confidence the investor community has with the audit process. There is a perceived lack of independence when the same audit firm has been issuing audit opinions on a registrant for an extended period of time. Required rotation is clearly one way to address this perception.

While I believe the benefits of bringing in a new audit firm outweigh the costs, I’m not comfortable with a rule that requires companies to change at the end of some arbitrary period. I believe the company and its audit committee should be allowed to make the decision regarding auditor retention based on their informed evaluation of all relevant factors. However, I do believe this is a real issue and it should be given greater visibility in a company’s communications with its shareholders.

Therefore, I would recommend that the Board consider working with the SEC to impose a requirement that a company put its audit out to bid after some defined period, say 10 or 15 years, and that the audit committee must communicate the details of this process and the basis for its final decision to the company’s shareholders. That way, there’s an expectation that the Company will be making periodic changes in its audit firm and if it decides to retain the existing firm, it will need to provide the reasons for that decision in written communication to shareholders. And, as part of this communication, it should be required to disclose how long the audit firm has been its auditors.

I believe this approach would go a long way towards addressing both the issue of whether long-tenured audit relationships impact the auditor’s independence, objectivity and professional skepticism in fact, as well the perceived independence impairment that such relationships convey to the financial markets. The Board could then re-evaluate this approach down the road and might decide to move to mandatory rotation if it concludes that the greater visibility and communication approach I’ve suggested has not accomplished the desired outcomes.

I would also recommend that the Board take some action at this time rather than deferring to some future date. It’s an important issue and I believe we need to reach a conclusion that requires some changes to the status quo – I don’t think it would reflect well on us if, after issuing this Release, the topic is dropped without any action. However, I believe that any decision on this topic must be made in the context of the Board’s other projects that, when taken together, will significantly improve financial reporting.

Given that, and with the recognition that the Board doesn’t have authority over audit committees, I would recommend the Board add a project to its agenda regarding the role of the audit committee and the required communication between the auditor, the audit committee, and the shareholders. I think there are substantial enhancements that could be made in that area that would improve the audit committee’s ability to provide the necessary oversight, which in turn would improve the audit process and financial reporting. And the Board is in a unique position to
initiate such a project and to drive substantive changes in that area. Later in this letter I mention several recommendations for this project.

**Additional Commentary**

The Board has raised a number of important issues in this Release and, while I prefer a mandatory bid process and expanded shareholder communication to mandatory rotation, the Board may choose to go in a different direction. So, I thought it might be helpful to share some other thoughts if the Board decides to move forward with mandatory rotation:

- Auditor rotation is not a new concept – it happens on a regular basis. And when it happens, the audit firm and the company ensure that the transition occurs without any decrease in audit quality and without any increase in costs. I think it’s fair to say that no auditor changes would be occurring if the company and/or the auditor believed that the potential for increased costs or increased audit risks could not be appropriately managed. In fact, the Board could look at new engagement proposal letters from the audit firms to see how the audit firms have addressed the audit risk concern. Regarding fees, often the change results in, and is often motivated by, a goal of decreasing audit fees. Granted the audit firm expects to keep the new engagement long enough to make up for the lower fees in the early years but I’m confident that under a mandatory rotation system the two parties would find a fee structure that’s acceptable to each;

- But having said that, I’m concerned that so many audit firms and preparers point out the substantial risk of audit failures in the first few years after an auditor change. Because of that, the Board may want to identify the best practices currently in place to mitigate those risks and consider codifying those best practices. It should also consider an immediate expansion of their inspection procedures to ensure they select new engagements for review and then inquire about specific procedures performed by the company, the audit committee, and the audit firm to address the added risks, consistent with its described approach:
  - The Board does not select an audit for inspection at random. Rather, it selects the audits that it believes present the highest risks and reviews the areas within each audit that are the most complex and challenging.

- Regarding increased costs, the Board would need to decide if that’s reason enough not to proceed. Congress went forward with Sarbanes-Oxley despite the substantial additional costs of compliance, including the extensive efforts around documenting, testing and then auditing the accounting controls over financial reporting, and the additional costs of establishing the PCAOB to audit the auditors that now has a 2012 operating budget approaching $230 million. I believe we have a better chance to manage the costs if we act on our own than if we wait for Congress to mandate something – and the House Financial Services Committee has a hearing on the accounting and auditing profession on Dec 15;

- I would suggest a mandatory rotation period that is not less than 10 years; 15 years may be even better. I really don’t think we’d be improving things by requiring more frequent rotations and we’d probably be making things worse;

- I think the argument has merit that with mandatory rotation there should be a guaranteed tenure such that the firm can’t be terminated before the end of the term unless for good
cause. But the Board may want to get more information regarding how that would affect the fee arrangements and may find that it has to address that issue in any final rule;

- When I started in the profession there was a “Big 8” – we’re now down to a “Final 4”, thus reducing the number of firms that can be selected. These four firms are substantially larger than the next tier of three firms and they audit essentially all of the Fortune 500 companies. So, it’s likely that any mandatory rotation would simply be moving these companies around from one of these four firms to the other. Plus, these same firms do substantial non-audit work for these companies that would preclude them from doing the audit. And it’s not uncommon for a company to have 2 or 3 of them involved in various aspects of their business at the same time. Thus, if the Board requires mandatory rotation, it will need to ensure that such a requirement doesn’t mean the company has to engage a less qualified firm because it’s the only firm that meets the independence requirements;

- Further, mandatory rotation suggests that companies have their choice of a number of firms that could adequately meet the audit challenges of each company. But that is not the case and companies in certain industries, particularly those that are highly regulated, may find themselves with even fewer choices or none at all when factoring in the independence issues;

- The Board might want to consider changing its terminology from “audit failures” to “audit deficiencies” when describing situations where evidence was lacking that the auditor had obtained reasonable assurance. I think many people would conclude that an “audit failure” means the audit failed to detect a material misstatement and the financials cannot be relied on;

- The Board should also consider making it clear that the client of the audit firm is not the company but the shareholders of the Company.

### Potential New Project on Audit Committees

While considering mandatory auditor rotation as a possible solution to improve auditor independence, objectivity, and professional skepticism, the Board also asked for other possible solutions. This leads many of us to consider the role of the audit committee, how it has progressed and improved as a result of Sarbanes-Oxley, and ways that we believe would improve their role even further.

Shareholders rely on the audit committee to be their eyes and ears through their close oversight of the Company’s accounting, controls, and financial reporting as well as the work being done by the auditors. Given that significant and important role, and with the understanding that the PCAOB doesn’t have authority over audit committees, I would recommend that the Board work with the SEC to investigate ways to strengthen audit committees as part of its efforts to improve financial reporting, such as:

- Strengthening the requirements for meeting the Audit Committee Financial Expert (ACFE) designation to include being a CPA with substantial audit experience due to the significance that audit knowledge has to effectively overseeing the work of the audit firm;
• Requiring that all audit committee members meet certain education requirements. The major firms are all offering excellent sessions for audit committee members to keep them abreast of the current issues and best practices and the NACD has a number of outstanding conferences and seminars;

• Enhancing the written communication between the audit committee and the shareholders to something far more substantive than the current boilerplate. Such communication should include substantive discussions regarding the procedures employed by the audit committee in evaluating critical accounting policies, management’s estimates, risks to the business, the audit approach agreed with the auditors, additional non-audit services performed by the audit firm, fee discussions, etc., – as mentioned earlier, this communication should also include a discussion of auditor tenure and the audit committee’s plans to solicit bids from other firms;

• Moving the audit committee communication from the Proxy into the Forms 10K and 10Qs because I believe more frequent communication would be beneficial and it should include a discussion of what the audit committee did prior to the earnings release and in preparing the 1934 Act filings;

• I believe that the PCAOB inspections have had a significant impact on the quality of audits and will continue to do so. But I also believe that the auditors should fully communicate the PCAOB findings to the audit committee to help it carry out its oversight duties by better understanding the issues identified by the PCAOB, and so they’re better able to work with the auditors in developing the necessary changes to audit procedures;

• I also think it’s important for the audit committee to meet with other key members of the audit team that may have been consulted with respect to various judgment issues, specialized industry matters, technical accounting or auditing matters, reviewing the work of third party experts, etc.;

• I would encourage the Board to institute procedures where the inspection team meets with the audit committee chair, or perhaps the full committee, at least once during the course of its inspection of that company’s audit. This will help the audit committee better understand any issues that the inspection teams identify and to better carry out their oversight responsibilities;

• For that matter, it would be very helpful to audit committees if the PCAOB were to publish reports that summarize the types of issues it’s finding on all inspections to help audit committees focus on the key issues.

Once again, I appreciate the opportunity to provide comments on this Release.

Sincerely,

Jack C Parsons