December 12, 2011

Public Company Accounting Oversight Board
1666 K Street
Washington, D.C. 20006

Dear Board Members,

Regarding PCAOB Release No. 2011-006, Docket Matter 37, I would like to make the following comments.

Audit Prep Services, LLC is an enterprise devoted solely to helping companies prepare for their financial statement audits and quarterly reviews. We do this for approximately thirty companies each year, and are typically working with seven to ten audit firms simultaneously, ranging from the Big 4 to ten-person firms. Consequently, like the PCAOB we have a unique perspective on auditor independence as we observe different audit firms at the same time. However, unlike the PCAOB, we observe the audit firms real time during the audit, from the preparers’ side.

Root Cause

In my experience, when you ask an auditor about independence, their focus is on financial interests in the issuer. In fact, this is what their client acceptance checklists and various audit programs ask. And many state ethics courses are similarly oriented. The institutionalized idea of independence is not focused on the crux of the issue identified in your concept release, which is the independent mindset necessary to audit the issuers’ positions. In my view, this lack of focus on the issue is the root cause of any perceived independence problem today. And in fact, financial interests in the issuer are a symptom, not the cause of a lack of independence.

Sarbanes-Oxley went a considerable distance in awakening auditors to the need for thinking and acting independent from management as it relates to preparation of financial statements, as well as the technical positions and support underlying such financial statements. Some would argue auditors initially went too far, refusing to simply give the clients the answer to a technical question (a position I do not share). But regardless of where we’ve been, the pendulum has swung back toward the past and I now see increasing willingness by auditors to perform original work, as opposed to auditing it.
Size Matters

Regarding how and where to apply any rulemaking in this area, I have a contrary view to that posited by your concept release. In my experience, firms from national to local, not the Big 4, are far more likely to get involved in preparing client financial statements and the support that goes into them, thereby evading the goal of independence. This may be caused by the constant scrutiny of Big 4 firms by the PCAOB. I understand there is less capital at risk in non-Fortune 500 companies. However, there is still significant capital invested in middle market companies that are audited by non-Big 4 firms. I would therefore contradict the notion of applying a rule for companies in excess of a certain size.

Auditor Rotation

Regarding whether auditor rotation would be effective in addressing the root cause of the issue, I believe it would not. First, I dismiss the notion that auditors would somehow do a better audit if they knew someone else was going to be on the assignment in the following year. While generalizing, in my experience auditors are conscientious and do the best job they can, regardless of circumstances.

Furthermore, a forced auditor rotation would necessarily make the marketplace more competitive because revenue would be transient. This has the potential of driving auditors to make concessions to get new clients and keep their revenue at a sufficient level. So they might be incentivized to provide more, not less concessions to clients. As there are fewer competitors in the Big 4 environment, I believe this would be far more prevalent in the non-Big 4 environment.

Another Solution

Rather, to get at the root cause, one needs to focus the auditor on auditing, and the independent mindset necessary to perform an audit.

One way to do this is to develop a second level of signoff. The airline industry requires mechanics to sign off before the pilot flies the plane. The pilot is ultimately responsible, but the FAA requires the mechanic to sign off before leaving the gate.

There would basically be a set of required steps that issuers would need to complete prior to the auditor getting involved. For well known seasoned issuers, with large technically competent accounting departments, the company might handle the signoffs internally, or maybe they too would outsource this task. But for small and middle market issuers, there may be a requirement for someone at another accounting firm to come in and perform and/or certify that the company
had performed the initial work. It would not be an opinion. Rather it would simply state the company performed the initial analysis and reached a certain conclusion. This would allow the auditor to audit, not prepare, the financial statement and underlying positions and support.

The model I envision is similar to the Sarbanes-Oxley Rule 404 model, whereby one firm performs the internal control engagement on behalf of the issuer, and then the audit firm audits the result of that engagement. For example, Ernst & Young might be engaged to do the 404 work and testing on behalf of the client; then KPMG would audit it. We would apply that model to financial reporting.

The result of this type of structure would be that auditors would be having discussions with another accounting firm, each of which would provide a check and balance on the other one.

**Financial Impact**

From a microeconomic standpoint, this structure has the potential to save the issuers money because the auditors would receive a complete set of work papers upon commencement of the audit. This would serve to make the audit far more efficient and less costly. Additionally, as the preparation work is prepared by another firm that is not forming an opinion the hourly rate would be lower due to a reduced level of risk inherent in the engagement. So the companies come out ahead.¹

Regarding the impact on audit firms, the billable hours for the audit would decrease, but the realization would increase to the point that audit firms would potentially be more profitable. And the firms would introduce another service line in audit preparation, making up for the reduction in billable hours. However this service line would be differently staffed, and billed at a lower rate.

From a macroeconomic standpoint, the cost wrung out of the system would benefit both the issuer and the auditor through a reduction of each party's cost. What's driving the cost reduction is a re-focus of talent to the lower-risk, and lower cost activity of audit preparation, thereby causing gains in efficiency.

¹ We have done an informal survey and found that companies engaging a separate audit preparation firm to prepare for the audit save approximately 30% when comparing (a) the cost of the audit without the audit preparation firm to (b) the combined cost of the preparation and the audit with the audit preparation firm.
Auditor Independence

The PCAOB fills a necessary role in overseeing auditors of public companies. And the inspections it performs have no doubt improved the controls at subject audit firms. But there remain a large number of audit failures detected by the PCAOB in those inspections.

Part of the problem is that the PCAOB comes in after the fact, when the audit is complete and the financial statements have been filed. There no longer exists the opportunity to correct any problems before issuance.

The model contemplated herein would provide more investor protection insofar as there would be another level of scrutiny up front, as the audit was happening. I believe this structure would accomplish the objective stated in Release 2011-06, which is to improve auditor independence and objectivity.

Of course I would be pleased to discuss this model further if you would like further clarification.

Sincerely,

Michael T. Psomas CPA
President