Statement of

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To the

# Public Company Accounting Oversight Board

Regarding

# Auditor Independence and Audit Firm Rotation

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Chairman Doty, Commissioners and Staff of the PCAOB:

It is an honor for me to participate in the Public Company Oversight Board's public meeting to discuss proposals to enhance ***auditor independence, objectivity and professional skepticism***, including the potential of imposing rules setting a maximum term limit for audit relationships. Having served together with Chairman Doty during my time as Chairman at the SEC, it is immensely gratifying to see the PCAOB under his most thoughtful leadership. Just as important is the outstanding group of Commissioners and superb staff that has been assembled at the PCAOB. Although I would defer to Steve Harris on this point, from my perspective the PCAOB has already exceeded the hopes of those who helped create the agency, and yet I am also sure the best is yet to come.

It is also an honor to be able to participate with my co-panelists Paul Volcker and Chuck Bowsher. They both have extraordinary credentials on today's subjects, and more importantly they bring exceptional wisdom, perspective and judgment to these topics.

Sadly, many people in official Washington seem prepared to jettison the interests of investors without reason as would occur in the proposed JOBS legislation, which as currently written would unnecessarily savage important barriers against fraud and manipulation of markets. We should never be afraid to experiment with opportunities for reducing unnecessary regulatory costs, particularly for smaller companies. At the same time, we shouldn't let anyone's financial agenda be a pretext for allowing the unscrupulous a free rein to abuse savers and investors. In its current form this legislation has too many elements that are simply fantasies, such as that a company with $1 billion in revenue is a "small business", when that is 10-20X too high a threshold.

When Jim Doty and I were at the SEC, the Commission created an entire set of registration statements and '34 Act filings (eg, Form 10-KSB) geared for small companies to lower their costs in raising capital or being public companies. Companies could elect the simpler forms if they wished, although they might pay a market penalty for providing less information. We allowed things like requiring two years of audited financials rather than 3 years, and three years rather than five years of selected financial data. We simplified disclosure requirements for smaller firms with less than $25mm in revenue (about $41mm in today's dollars), but nobody got a free pass for fraud and there was still transparency for investors in current results.

It is simply absurd to characterize companies with $1 billion in annual revenue as small businesses that need exemptions from either primary offering rules or secondary market disclosures. "Crowd funding" and "on-ramps" are catchy phrases, but we don't need to help

create paths for pumping up interest in stocks with false information, or to give people an extended holiday from publishing accurate financial statements or telling the truth. That can only lead to outsized losses for investors, which will discredit offerings for smaller companies and ultimately reduce opportunities for IPOs and other financings in the markets. Public policy should encourage individuals to save and invest, not drive them away from the markets.

Even now, if leaders in Congress and the Administration were willing to make an effort to do so, Congress could develop more balanced legislation that would include many of the good ideas and positive objectives of the JOBS legislation without opening up gaping holes in protections against fraud and deceit. It is hard to believe that preventing unnecessary frauds on investors and depletion of their savings isn't worth time and effort, and a modicum of judgment, from all involved.

## Potential Mandatory Rotation of Audit Firms

I do not have a specific yes or no answer on the issue of mandatory rotation of audit firms. After carefully reviewing all the public comments, I have confidence that the PCAOB will put forward a balanced proposal to improve the status quo. Rather than either supporting or opposing mandatory rotation, I would like to offer a few observations that may be helpful in considering the issues of auditor independence, objectivity and professional skepticism.

When the subject of mandatory rotation was considered during the legislative process that led to Sarbanes-Oxley, I was not sure that rotation should be made mandatory. Though I generally think term limits are almost always a healthy thing, I felt then that some rotations would serve investor interests, and some would not. In that circumstance, I could not persuade myself that it made sense to create such a legal requirement, even though it would undoubtedly be a positive some of the time.

In the 20 years since I left the SEC, and the 10 years since considering this issue at the time of Sarbanes-Oxley, I have had quite a few practical experiences that bear on my thinking about the dynamics of audit firms and their performance of professional responsibilities. These practical experiences include:

- Serving from 2005-2009 as the corporate monitor of KPMG on behalf of the U.S. Department of Justice under the Deferred Prosecution Agreement entered into by KPMG relating to the sale of fraudulent tax shelter instruments;
- Serving as a senior partner of Coopers & Lybrand from 1993-1996, before its merger into what is now PwC;
- Overseeing the restatement of WorldCom's financial statements prior to its exit from bankruptcy, which I believe is still the largest financial restatement ever done. We had to

restate financial results covering the better part of $100 billion in revenues covering something like 70 trillion transactions, as well as restating the results of more than 50 M&A transactions and eliminating more than $14 billion in phony income;

- Serving as a director of more than a dozen companies in the U.S. and Europe, and in many cases either chairing or serving on the audit committee. Several companies where I was a director have switched audit firms for one reason or another, so I have been through multiple audit firm transitions in both small and large companies;
- Living through the application of independence rules at several companies including H&R Block, Inc., where lack of independence forced a transition from KPMG to Deloitte while I was Chairman of the Board;
- Investing billions of dollars in more than 65 companies in the U.S. and Europe over the past six years, and evaluating financial statements prepared under both US GAAP and IFRS;
- Helping numerous companies unravel potentially illegal or improper conduct through internal investigations or "forensic" audits, sometimes with the incumbent auditor, and sometimes with a new audit firm;
- Going through numerous IPOs, as well as several financial restatements; and
- Experiencing the consequences of inadequate auditor vigilance as both an investor and a director.

These and other experiences have given me better insights into some of the practical realities that bear on the issue of auditor rotation. However, I still believe that rotation would benefit some companies, and harm others, and I don't know what the actual proportions would be. Let me highlight a few practical concerns:

Concentration and Lack of Choice. Over the years the "Big Eight" became the "Big Six", the "Big Five", and now the "Big Four". If we hadn't succeeded in preventing the collapse of KPMG due to the deferred prosecution of its tax shelter frauds, we would have had the intolerable situation of a "Big Three". I believe that for many reasons it was a huge failure of public policy to allow the current level of audit firm concentration.

For companies and their audit committees, the lack of competitors significantly limits practical choices. For many reasons, large companies may be reluctant to have the same audit firm as their principal competitor -- Ford may not want to have the same auditor as GM, or possibly Volkswagen. That theoretically leaves two potential new audit firms, unless there are three major firms in the industry. However, one or more of the non-incumbent firms might audit a potentially hostile acquirer, or a company developing a rival technology or which is performing litigation analytics on the other side of a massive litigation. There may be many reasons, including lack of industry depth or geographic presence, that make one or more of the

non-incumbent firms unattractive as a business matter. Therefore, for many large companies, there may at worst be no viable alternative to the incumbent auditor, and at most only one or two viable alternatives.

The level of concentration of audit firms limits the practical choices of all audit committees, and means that rotation now would be much more difficult than it might have been 20 years ago. No director would want to be forced to appoint an audit firm that they believe has a material conflict with the company and its interests. And, if there are only two viable competitors, you will think long and hard before burning your bridges with the incumbent firm due to the risk that the new firm might develop an independence problem or otherwise not work out, which would prejudice the entire company.

I agree with Chuck Bowsher's suggestion that if mandatory rotation is to be implemented, it ought to be tried first among the very largest audit engagements. However, that is the group where finding a capable and conflict-free alternative firm would be the most difficult. Thus the benefits of rotation in enhancing professional objectivity may well be offset by increased conflicts, loss of an important non-audit service provider or other adverse impacts. Since it will be different for every company, that is a difficult cost benefit analysis to make.

<u>Economics and Independence.</u> The Concept Release notes "Yet, auditor independence remains subject to a significant inherent risk. The accounting firm is a for-profit enterprise that is paid by the company being audited to provide a service." That is a considerable understatement, particularly when considering the largest audit clients.

For a very large global company, it is not impossible for the audit fee to be tens of millions of dollars. Putting aside any ancillary non-audit services, a $25 million audit fee continued in perpetuity would have a present value at a discount rate of 5% of $500 million. Thus, the ten or so largest audit relationships of any of the Big 4 could have an aggregate present value of something north of several ***billion*** dollars assuming continued incumbency. That is an immense sum for any professional firm, and it helps explain why the issue of auditors trying to please the largest clients continues to arise notwithstanding how many inspections the PCAOB performs. The largest audits support the audit firm's core existence, and literally pay the pensions of the partners. That is something that every audit partner understands.

In my experience, the vast bulk of audit personnel are hardworking and conscientious professionals who strive to complete their work in accordance with high standards of competence and integrity. For the most part, audit personnel are attracted to the profession because they believe in doing the right thing. However, auditors also have children who need to go to college, mortgages that need to be paid, and all the other concerns of financial security both as individuals and as members of a firm. As a practical matter, holding onto the "gorilla"

engagements is a critical concern for each of the incumbent firms, and I don't know any successful professionals who wouldn't fight hard to hang onto their best clients.

To some, the inherent economic conflicts are a reason to force rotation, in hopes that throughout the engagement the audit professionals would feel less pressure to accept management's wishes in an uncritical manner because they know they are going to lose the client no matter what they do. This would be an attempt to try to improve objectivity by creating a certainty that the annuity stream of fees would end.

For various reasons, I am not sure that improved objectivity would be the result. If the mandatory rotation period was reasonably long, such as 10 or 12 years, then the partners of the incumbent firm would still be afraid of losing the client throughout the early years of the engagement. Even as the time for rotation grew closer, the incumbent firm would be preoccupied with preparing to compete for replacement clients that other firms were losing. They would want management of the firm they were losing to sing their praises to other companies being forced to rotate, and therefore might still feel a strong pressure to defer to management.

Ultimately, rotation would replace one set of somewhat conflicted partners with another set of partners with the exact same issue. One group of people would lose their relationship, while another group would step into their shoes and have the identical potential conflict. Theoretically the new firm would also know it would eventually lose the client, but again it would be 6 or 7 years before they would worry about that rather than keeping the client satisfied. Thus, we would have a degree of musical chairs among audit firms, and I really doubt that objectivity levels would rise that much overall.

Indeed, I don't want to be too philosophical, but I am not convinced that there is such a thing as true "objectivity". I think my children are just cuter than other children, whether or not there is any objective evidence for that. People who work closely with other people are often somewhat blinded to their faults due to loyalty, friendship or other factors. The working relationships between auditors and the management team at the company are often very close, with daily detailed discussions of issues and problems. This will probably always produce a willingness to give your clients the benefit of the doubt, with or without rotation somewhere many years down the road. Thus true objectivity may be a mirage, and mandatory rotation simply may not change the field auditor's mindset all that much.

Ideally the audit firms themselves, with PCAOB prodding, would work hard to make sure that any "benefit of the doubt" is not given uncritically, or without backup and substantiation. Ronald Reagan's immortal dictum of "trust, but verify" is a very good principle to help auditors appreciate the need for a continuous level of healthy professional skepticism.

The Value of PCAOB Inspections. My experience monitoring KPMG convinced me that the inspection teams of the PCAOB do a terrific job identifying problems, particularly a lack of objectivity or evidence of serious risks to audit integrity. Unfortunately, the restrictions on disclosure of inspection reports reduce the potential benefits of the inspections considerably. . Nonetheless, I believe that greater emphasis could be placed on positive inspection results as a threshold for continuing incumbency beyond some period of time. It would be particularly beneficial if audit committees were able to meet with PCAOB inspection teams and discuss concerns confidentially. If audit firms knew adverse inspection reports would be seen and discussed by audit committees of their clients, they would have to work harder to reduce the incidence of weak inspection results.

Costs of Switching Audit Firms. There is quite a bit of discussion of higher costs if rotation were implemented. Whenever I have been involved with a company that is considering a change in audit firm voluntarily, it has almost always been the case that the proposals from firms trying to win the business are usually the same or lower than the budgeted hours and fees of the at-risk incumbent. Even if rotation is mandatory, the three firms vying to succeed the rotating firm will have enormous incentives to keep proposed fees low, at least in the initial phase, in order to win the selection. Thus, the increased direct costs of the audit that some predict may well be avoided due to competition and enhanced productivity.

From one perspective, this might reduce the cost disadvantages of mandatory rotation. However, to me the greater costs will be at the audited firms. Mandatory rotation will almost certainly force management to learn to do things differently in working with a new audit firm. There will be IT costs, process costs, training costs and losses of efficiency as the two teams first start to interact. Allowing smaller firms to avoid these types of costs is a good reason to consider limiting any mandatory rotation to the largest companies.

Benefits from Switching Firms. I have certainly seen many cases where a new auditor brings significant benefits to the company. If the prior incumbent was in place for a long period, there may be issues such as accounting interpretations that have not been revisited for a very long time. When a new auditor comes in, a fresh perspective is gained on many topics, as every issue has to be reevaluated. I have seen a new firm spot and resolve potential problems on many occasions. I have also seen companies benefit significantly when a new audit firm is accompanied by a new team of tax advisors.

Often a new team will spot opportunities to reduce effective tax rates that the prior incumbents didn't see. Thus, it seems to me that rotation will sometimes increase costs, and sometimes may result in savings. Unfortunately, absent convincing empirical evidence that costs will not rise, one has to be highly sensitive to the risks that costs will exceed the offsetting

benefits. Unnecessary or excessive regulatory costs always harm shareholder interests, and that harm can be significant.

Frequency of Reproposals. I believe that companies should repropose their audit engagement at least once every five or six years. That is a sufficiently long interval since the selection of the incumbent firm that it should be a worthwhile investment of time to consider new alternatives. Of course many times a company seeks proposals but ultimately elects to stay with the incumbent. If a company goes ten years without a reproposal, that to me is cause for concern regarding the quality of the audit committee.

In theory, shareholders can vote against reappointment of the same auditors if they have been in place for 20 or 50 or 100 years. However, the current system of having shareholders vote to approve retention of the auditor every year makes this a matter that is so frequent and so routine that it doesn't get a careful look. If auditors were selected and approved for longer terms, such as three years, it might prompt shareholders to get more involved in reviewing the length of incumbency and any issues of possible prejudice to investors.

## A Possible Middle Ground

In closing I would like to suggest a possible middle ground to the issue of rotation. Ultimately I believe the number of poor inspection results found by the PCAOB suggests that the status quo can be improved by having somewhat greater consequences for receiving a poor inspection. At the same time, however, there is a great deal to be said for allowing audit committees the flexibility to do what they think will be most beneficial for the company and its shareholders. That would include evaluating all the potential disadvantages to changing firms, along with the possible benefits.

Instead of a mandatory rotation at the end of ten years, for example, the PCAOB could establish a time frame of ten years for a rebuttable presumption of loss of independence. Instead of requiring rotation, the decision could be left to the audit committee to "comply or explain" why it chose not to appoint a new audit firm after the presumptive loss of independence.

Around year 7 of any incumbency (assuming a presumptive loss of independence ten years after the initial appointment), the PCAOB should conduct an inspection of the audit if the company is among the X largest companies (eg 50 largest audits). If the inspection report showed serious issues with objectivity and independence, then a rotation should be required. If, however, the inspection report showed very good results, then the audit committee should have the right to elect to continue the incumbent firm for some additional maximum period (such as five years) so long as it had conducted a reproposal and obtained shareholder

ratification of the choice. At the end of the maximum renewal period, the entire "comply or explain" process would be repeated.

The system of "comply or explain" is used in many applications of corporate governance in the UK and other countries. Here it would allow the PCAOB to set a rebuttable presumption of loss of independence after an extended incumbency. That is something audit committees would be likely to take quite seriously. At the same time, if the incumbent firm had good inspection results, the audit committee would be free to decide to retain the incumbent after conducting a reproposal. This would create a far more flexible system in which the audit committees are free to exercise discretion. Because weak inspection results would cause the incumbent firm to lose the opportunity for reappointment, there would be a powerful incentive for firms to take active steps to prevent loss of independence and objectivity as an engagement progresses.

My suggestion of a rebuttable presumption of loss of independence is not likely to satisfy those who believe mandatory rotation is the best course. However, in practice such an approach would avoid unnecessary rules and related costs, while still encouraging audit firms and boards to take the risks of loss of independence and objectivity more seriously. This might be enough to improve the status quo without forcing an outcome that simply won't always be in shareholder interests.

Thank you for allowing me to participate in this timely and important discussion.