



June 18, 2012

Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

Re: June 28, 2012 Public Meeting on Auditor Independence and Audit Firm Rotation

Members of the Board:

I am pleased to submit this letter regarding my comments in the public meeting with the PCAOB Board regarding audit firm rotation. Given the high volume of comment letters and the amount of rhetoric devoted to the subject over the last few months, it is apparent that the subject of audit firm rotation is an extremely polarizing topic. With my time I'd like to present a point of view that I believe has been overlooked during the discussions and deliberations on auditor independence and audit firm rotation.

THINK LIKE A FRAUDSTER

I'd like to ask the Board to consider any current standards or proposed standards from the viewpoint of a fraudster. The PCAOB was created because of fraud and the billions of dollars of resulting investor losses. I believe that it is imperative to look at any PCAOB standards and proposed changes through the lens of a fraudster. So in this case, what would a fraudster say about audit firm rotation?

The answer is obvious; a fraudster would be whole-heartedly against it. You see, a fraudster has already fooled their external auditor, that is what has allowed the fraudster to already be getting away with fraud. Results from the Association of Certified Fraud Examiners show that frauds usually take place for multiple years before they are discovered – which is too late for investors who have already invested in the company. If I were a fraudster I'd have written the PCAOB not just one comment letter against audit firm rotation, I'd have written 4 letters using four different company names and letterheads since anyone can copy and paste legitimate company logos using the Internet.

FOUR INTERESTED PARTIES

The PCAOB has four sets of parties that I see commenting on audit firm rotation: External Auditors, Honest Issuers, Fraudster Issuers, and Investors. Each of the first three parties is adamantly opposed to firm rotation and understandably so. Collectively they are also doing their best to convince the Investors to take the same position. Let's look at the positions of each of the first three groups.

External Auditors claim that higher costs and lower quality audits will result in the first few years after a firm change. We've heard testimony from companies like TIAA-CREF whose actual experience showed lower costs and what they perceived has heightened audit quality due to new thinking by the new auditors. But if what the external auditors say is true about higher costs and lower quality after a new



firm takes over as the auditor, how do they ever get new business? As they market their audit services do they tell prospective customers that their costs will go up and that they don't have the expertise and background to audit that company's particular industry?

Actual experience has shown that costs are typically reduced and in truth there are so few companies who are so unique that a global audit firm wouldn't have the talent and experience to audit any company in any industry. In fact, isn't it a typical prerequisite for Senior Managers to get new business before they make Partner?

Honest Issuers also don't want to change external auditors. Change always creates a heightened level of anxiety and changing external audit firms is no exception. Company's know that the new auditors will likely ask different questions, look in different areas, view things from a different point of view, and poke and prod new territory which the prior firm did not – which is actually the point. People are creatures of habit and like what is familiar to them. It's understandable that Honest Issuers take comfort in having a relationship with the audit team members, knowing their hobbies, where their children go to school, and also knowing the areas the auditors are going to look into and what the auditor's hot buttons are.

However, Fraudulent Issuers also rely on that familiarity and also oppose audit firm rotation. Fraudsters try their best to befriend the auditors because for them to pull off the fraud successfully fraudsters have to know where the auditors are going to look, what auditor procedures they are going to perform, how they do their inventory counts, and how they perform the confirmation process. Without this knowledge the fraudster could never fool the auditors into signing off on the audit report. Being forced to hire a new audit firm is unthinkable for a fraudster because it creates a heighten level of uncertainty for them which produces a more likely chance that the fraud would be uncovered.

[MISSING THE FORREST FOR THE TREES](#)

A look at recent short seller reports from companies like Muddy Waters illustrates that as a profession, we may be missing the forest for the trees – as was the case with Sino-Forest and many others. We need to look at how and why the external auditors, with much greater insight and access to the company, management and detailed financial information, can miss frauds that short sellers are able to identify using only publicly available information.



BIG FIRM CONCENTRATION

As for audit firm concentration, while we have gone from the Big 8 to the Big 4, I think that if mandatory firm rotation is put in practice that the current concentration of just four big firms will become less of an issue. There are at least four to five additional firms that are global organizations with the ability and talent to audit global companies and market needs will create a market reaction to meet the needs in the market place if we need to shift back to a Big 6 or Big 8.

REQUIRED RFP'S, AFFIRMATIVE VOTES AND "CHANGE OR EXPLAIN"

Required rebidding of the audit will not stop fraud and will fall short of the PCAOB's primary objective of protecting the investor. Would the executives of a company who are committing fraud which personally benefits them to the tune of hundreds of thousands, millions, or tens of millions of dollars a year actually switch audit firms because the audit fee is a million or two lower? It's impractical to assume so. In fact, even the offer of a free audit to the fraudsters would be turned down because the risk of being found out by the new auditors is too great. In fact, fraudsters will go to great lengths to keep the same audit firm and same audit team members if they have been pulling off a fraud for multiple years. Case in point is Parmalat. Italy had mandatory auditor rotation and when Parmalat had to change auditors it went through an expensive and time consuming process to set up a wholly owned subsidiary and transfer all the fraudulent activities to the subsidiary so that their old auditors could continue sending a bank confirmation to the wrong location. As we know, this fraud lasted for about 10 years and was never caught by either of the audit firms – the auditors of the subsidiary or the auditors of the parent company – and the investors lost billions of dollars. This points out that if audit firm rotation is required that the old firm should have no part in auditing any portion of the company.

Similarly, requiring a periodic affirmative vote on the audit firm or having a clause that allows a company to forgo changing auditors if the company simply documents the reasons why they aren't changing, won't stop or deter fraud either. A fraudulent company will keep their auditors indefinitely and give every plausible reason why they do so because it is in their own personal best interest not to change firms.

AUDIT COMMITTEES & MANAGEMENT RESPONSIBILITY

Sharing inspection reports with Boards and Audit Committees is a great idea, and will serve to enhance the audit quality of honest companies. However, for a fraudster it doesn't matter how bad his or her auditors are, unless the fraudster is forced to do so there is no way they will change audit firms.

It has been suggested that the PCAOB should consider enhancing the representation letters that management signs or consider creating new documents for management to sign. This will accomplish little as an honest executive will have no problem signing any document the auditor provides, while unfortunately the fraudster will also sign any document the auditor provides. By the time the investors



have lost their money the document signed by the fraudster will be worthless. It is a folly to believe that a dishonest person would not sign an untruthful statement. If we think otherwise and believe that fraud can be uncovered by having an executive sign a document saying that they've told the truth and that the financial statements are correct, then one has to wonder why we perform any substantive procedures at all, and don't simply just ask management if everything is accurate and truthful and then sign the audit report.

TIME FOR ACTION

While there is much debate about what we shouldn't do, it is obvious that what we are currently doing isn't stopping the frauds. More time, research and analysis won't give us any better answers than we have now but will in fact cost investors millions and billions more in losses while our profession is seen as waiting for more research.

We have enough facts and it's time to take action. I believe that there are several options that should be considered if the PCAOB's intent is to reduce the occurrence of fraud and have more instances where the external auditors identify and catch fraud.

SET TIME AND CONTRACT

When an audit firm feels it can be fired at any point there is an inherent conflict of interest that exists at least at some level. In order to fully remove that conflict of interest the PCAOB should consider requiring multi-year contracts with predetermined lengths and fees. For example, if the PCAOB requires auditor firm rotation after 7 years, then the company and auditing firm would sign a 7 year agreement that spells out the audit firm's fees for each year and does not allow the audited company to change audit firms during that 7 year period. This would allow the audit firm to price the full 7 year engagement with enough revenue to perform a proper audit for all 7 years and would eliminate any possible fears the audit firm might have that they could be fired if they disagree too strongly with the company or decide to look in new places or perform certain audit procedures that the company would prefer the audit firm not do.

AUDITS FOR IPO'S

Typically with newly issued public companies where the public invests and then within a few years it is determined that a fraud was occurring the whole time, even though the investment banks are required to perform their own financial due diligence, they typically turnaround and say that they didn't have the same expertise or responsibility as did the external auditors and therefore the investment bankers, like the investors, simply blame the external auditors. One idea here would be to require the investment bankers to be the ones who hire the auditing firms and require the investment bankers to pay upfront the auditor's fees for a set number of years. This would better align the parties in an IPO as the



investment bankers would be responsible for the financial statements as they should be today, and the auditors would be beholden to the investment bankers and the public instead of the company.

AUDIT RATING SCALE

I believe it is time to reconsider an audit ratings scale for companies, similar to the debt ratings that companies receive. What exists today is essentially a “Pass-Fail” model which gives no leeway to the auditors to provide better, more accurate information to the public. We’ve seen too often where auditors provide an Unqualified Opinion to a company only to see it fall into bankruptcy the very next year, and the public investors blame the auditors for not telling them of the potential impending doom right around the corner. The real issue is this, companies know that they must have an Unqualified Opinion or they risk a mass exodus from their stock by the market. This creates a huge strain on the auditor-company relationship and creates a perception risk to investors. With any “Pass-Fail” model, the party involved is not rewarded for going above and beyond a minimum threshold and therefore looks to achieve only so much as is required to pass. A ratings system would allow the auditors to recognize the companies who are well above a failing grade – a AAA rating – and would inform the public of which companies are doing just enough to pass or are on the verge of failing – a C rating. This would allow auditors to even raise or lower the audit rating at quarterly intervals based on quarterly audit work, again providing more clarity into the financial statements for the investing public upon which they make an investment decision.

SHAREHOLDER VOTE ON AUDIT FIRM ROTATION

An alternative to mandatory audit firm rotation would be a requirement to allow the shareholders to determine when they want to change auditing firms. So that minority shareholders aren’t held hostage by groups with large voting blocks, I’d propose a decreasing scale of shareholder approval needed to force a change in audit firms. For example, a simple majority could be required for each of the first two years, then 45% in year 3, 40% in year 4, with the threshold continuing to decline in successive years until a predetermined minimum threshold is reached. This would allow management, the Board and the audit committee to present their reasons for wanting to stay with the same audit firm year after year, but would give the shareholders – who are the reason why the auditors even audit – the ability to change audit firms if they choose to while not allowing large shareholders to block that decision indefinitely.

AUDIT TEAM MEMBER ROTATION

Another alternative to mandatory audit firm rotation would be to limit any single audit team member from working on the same client for more than a certain number of years. While today we have mandatory audit partner rotation, we all know that it is the audit team members who perform the audit procedures, make the sample size selections, determine which locations to visit, which warehouses to count inventory in, etc. In the case of Satyam, where Satyam hid its fraudulent revenues by



manipulating the audit firm's confirmation process, we saw the audit Partner and Senior Manager lose their jobs and go to jail even though the audit confirmations are performed by the interns or staff and are overseen by the Seniors. Rotating the partner would most likely not have helped catch the Satyam fraud, nor does it seem to have had a material impact on catching fraud at U.S. listed companies since it was put into practice.

CONCLUSION

I want to again thank the Board for allowing me to speak at this public panel and to ask the Board to spend part of its deliberations "thinking like a fraudster." Doing so will provide the Board with an interesting perspective on any proposed changes or current standards that I believe will allow the Board to see the world as the fraudster sees it which should provide clarity as to the direction the Board should go with the changes it is considering. If you have a need for me to assist in the process or would like to talk with me further about my comments, I'd be glad to do so. I believe in the value our profession provides to investors and I believe it can be strengthened. And on a purely personal note, I'd really like to see more fraudsters go to jail and fewer families lose significant portions of their life savings. Thank you again for this opportunity to speak with you.

Sincerely,

C. Brian Fox, CPA
Founder
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