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What's on Your Mind?

Share and Discuss the Corporate Governance Issues Impacting Your Business

Audit Committee Roundtable — PCAOB Gone Wild

Thursday, November 17, 2011
12:30 p.m. – 1:45 p.m.

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Audit Committee Roundtable – PCAOB Gone Wild

November 17, 2011

Audit Committee Roundtable – PCAOB Gone Wild

Moderator:

- *Mark T. Plichta* – Partner, Foley & Lardner LLP

Panelists:

- *Ken Best* – Vice President and Corporate Controller, Fiserv, Inc.
- *Patrick J. (P.J.) DiStefano* – Partner, Deloitte & Touche LLP
- *Isaac Kaufman* – Senior Vice President and Chief Financial Officer, Advanced Medical Management, Inc.
- *Aldo J. Pagliari* – Senior Vice President – Finance and Chief Financial Officer, Snap-on Incorporated

An Activist PCAOB

- Chairman Doty's first seven months:
  - Tough talk
  - Solving the "foreign problem"
  - Exploring major, lasting change
- Potential for significant change:
  - **Audit report and the role of the auditor**
    Concept release issued June 21, 2011
  - **Auditor independence and audit firm rotation**
    Concept release issued August 16, 2011

Concept Release on Auditor's Report — An Overview

Objective: To re-evaluate the auditor's reporting model with a view toward increasing transparency and relevance to financial statement users.

Concept Release Issued → June 22, 2011

PCAOB Public Roundtable → September 15, 2011

Comments Due to PCAOB → September 30, 2011

Proposed Standard Expected → First Quarter 2012

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PCAOB's Alternatives Presented

- Inclusion of an Auditor's Discussion and Analysis (AD&A) section
- Required and expanded use of "emphasis of matter" paragraphs in the auditor's report
- Reporting on information outside the financial statements
- Clarification of certain language in the auditor's report

Do you think this will have a positive impact on the users of your company's report?

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Potential Implications of Auditor's Discussion and Analysis

- Possible dueling disclosures
- Primacy of management's responsibility for financial reporting threatened
- Undermining the role of the audit committee
- Confidentiality and effectiveness of audit committee discussions
- Severe timing problems at year-end
- Effect on audit quality, audit and regulatory costs, and current filing timing

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Concept Release on Auditor Independence/Rotation — An Overview

- The objective is to enhance auditor objectivity, independence, and professional skepticism.
  - Including through the possibility of mandatory audit firm rotation
- The PCAOB wants data and analysis through a comment process.
  - Deeper analysis, including other proposals responsive to improving auditor objectivity and professional skepticism

"One cannot talk about audit quality without discussing independence, skepticism and objectivity. Any serious discussion of these qualities must take into account the fundamental conflict of the audit client paying the auditor. That leads to consideration of firm rotation as a counterweight to that conflict."

– PCAOB Chairman James Doty

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As Board Members, What Can You Do?

- Discuss the concept release with senior management and other audit committee members.
- Consider writing a comment letter from the audit committee (or encourage senior management to do so):
  - Express your views on your experience with auditors and their objectivity
  - Are there alternatives to firm rotation you would support?
  - Consider adding data about the cost of rotation to your company
  - If you oppose mandatory rotation, state your views clearly.
- Submit your comments by December 14, 2011.

Messages from corporate America will resonate better than the views of the firms on this issue. Letters from audit committees will resonate the most with the PCAOB.

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When Commenting, is it Necessary to Address All of the Questions in the Concept Release?

- No. When writing a comment letter to the PCAOB it is not necessary to answer all of the questions posed in the Concept Release. Some commenters, when writing letters to the PCAOB, choose to address their views in a narrative format without any reference to or thought about the questions posed by the PCAOB. Other commenters choose to answer some or all of the questions and structure their letter so that it tracks the questions posed by the PCAOB. Either format is acceptable.

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How Can Comments on the Concept Release be Submitted, and When Are Comments Due to the PCAOB?

- Comments can be sent to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C. 20006-2803.
- Comments also may be submitted via email to **comments@pcaob.org** or through the PCAOB's Web site at **www.pcaob.org**.
- All comments should refer to PCAOB Rulemaking Docket Matter No. 73 in the subject or reference line and should be received by the PCAOB no later than 5:00 p.m. EDT on December 14, 2011.
- These instructions for submitting comments appear on the first page of the Concept Release.

NDI Audit Committee Panel
Questions for Discussion

<u>Changes to Auditors' Reports</u>

Auditor's Discussion and Analysis

- How would an Auditor's Discussion and Analysis (ADA) section be useful to investors? Could or would an ADA include information specific enough that investors could adjust their models based on the ADA, or would an ADA real function be to raise red flags on accounting, auditing or independence matters and separate between companies that are conservative or aggressive in their approach?

- Because of the subjective and judgmental nature of an ADA, would this perhaps raise those most significant liability concerns for auditors among the various proposals? Do steps need to be taken to protect auditors in this regard? Should auditors be provided some sort of "safe harbor" protection for any statements or assessments, such as those afforded to forward-looking statements of management?

- Is it likely that ADAs would devolve into boilerplate? If nothing else, would the disclosure for a particular company likely roll forward from year to year?

- Would a shift from GAAP to more "principles-based" IFRS make a required ADA more or less problematic to U.S. companies and auditors?

- Ultimately, who is the better arbiter of the "right" accounting for a company – management, which better understands the business, or the auditor, who is independent? If the ADA would highlight differences between the views of management and the auditor, would a company be wise (forced?) to revise its accounting or financial reporting to eliminate the difference before the annual report if filed? Could the audit committee, in effect, be put in the position of choosing between two positions that are both GAAP compliant? Would it still be fair to say that the financial statements are ultimately the responsibility of management?

- If an ADA discloses an aggressive approach by management or a difference between the company and the auditor, would that increase the company's (and directors') risk of liability (by highlighting the risk) or reduce that risk (because the approach or difference is disclosed to investors in the annual report)?

- Assuming ADAs are not just boilerplate, how would this impact the timing of audits? Would it require significant additional partner and manager time in particular, especially in the first year? Should audit firms be compensated for the additional risk associated with ADAs, even if they don't need to spend significant time on the ADA after the first year or first few years?

Emphasis Paragraphs

- Is most of the information that would be included in additional emphasis paragraphs typically included in the first footnote of the financial statements and in the Critical Accounting Policies section of the MD&A? To the extent that is not the case, would a better solution be for companies to include the "missing" information in footnote 1 and the MD&A? How would additional emphasis paragraphs add value to investors?
- Would the additional emphasis paragraphs likely devolve into boilerplate over time?
- Would additional emphasis paragraphs raise any liability issues for companies or auditors?
- Would there be any significant cost or timing issues associated with required and expanded emphasis paragraphs?

Reporting on Information Outside the Financial Statements

- Does the PCAOB release contemplate that the auditors would opine on only information derived in or derived from the financial statements, or might auditors be opining on other statistical and operational information included in the MD&A or press releases? To what extent do the alternatives require auditors to possess skills in analyzing business, operational and strategic risks?
- Is it appropriate for auditors to provide assessments regarding information not included in or derived from the financial statements or general ledger? Assuming these assessments add value to the audit, is there another profession or body better suited to make these kinds of assessments? Does the audit profession have, or could it acquire on a timely basis, the knowledge necessary to make such assessments?
- If auditors must opine on information outside of the financial statements, would that increase their liability exposure? On the other hand, since directors may rely on the opinions of experts under Section 11 of the Securities Act, could that actually reduce directors' exposure?
- If auditors have to opine on information in earnings releases, might that materially delay such releases?
- Would reporting on information in the MD&A require significant new procedures by the auditors, or are they already tying out most or all of the MD&A anyway before the Form 10-K is filed?
- Would there be any other significant cost or timing issues associated with required and expanded emphasis paragraphs?

Clarification of Standard Auditor's Report

- It would seem that clarifying language would enhance investors' understanding of the respective roles and responsibilities of management and the auditor. Is there any cost or other downside to this proposal?

Mandatory Audit Firm Rotation

- Do long-term engagements affect the independence of auditors? Is this issue already addressed by the current requirement that managing partners on engagements must rotate after a certain number of years and the natural turnover among audit firm staff?

- If enacted, should mandatory firm rotation be limited to a certain size of issuer? What factors should be taken into account when setting a term of service before mandatory rotation is required?

- Are the main risks associated with mandatory firm rotation – additional financial costs and loss of institutional knowledge – only short-term problems to which public companies will adjust? Are they prohibitive?

- Is mandatory firm rotation practical with only four "Final Four" firms, plus independence rules regarding non-audit services? If a company requires or demands a "Final Four" firm, might that give one or two of those firms great leverage when they are bidding to replace another "Final Four" firm?

- Are there other ways an Audit Committee can enhance auditor independence?

- How does mandatory rotation affect the economics of audit firms? Should firms be forced to lose large clients every number of years?

- How would billing arrangements be affected by a firm rotation requirement? Are there any incentives for audit firms that would make this requirement more attractive?

- Some suggest that rotation should be mandatory only when certain circumstances are present rather than after a set amount of time. For example, firms should be rotated when a certain number of former audit partners or managers now work for the client, or the audit firm provides a certain percentage of services outside of the audit. Do you think this might be a practical and meaningful alternative to a time-based standard?

- Do Audit Committees typically consider firm tenure when considering an auditor's independence? What other factors may or may not weigh more heavily in this evaluation?

Deloitte.

Heads Up

June 28, 2011
Volume 18, Issue 18

In This Issue:

In developing this concept release, the PCAOB conducted extensive outreach, consulting investors, preparers, auditors, audit committee members, regulators, standard setters, and academics.

PCAOB Issues Concept Release on Potential Alternatives Related to the Content and Form of the Auditor's Report

by Jennifer Burns, Deloitte LLP; John Fogarty, Deloitte & Touche LLP; and Danielle Gallagher, Deloitte LLP

On June 21, 2011, the PCAOB issued a concept release[1] to solicit public comment on potential changes to the auditor's reporting model. The concept release seeks direction on a possible standard-setting project that could result in amendments to PCAOB AU Section 508[2] and Auditing Standard 1[3] or in "the development of a new auditing standard that would supersede or amend the Board's current standards on auditors' reports." Comments on the concept release are due by September 30, 2011. The PCAOB will also convene a public roundtable meeting during the third quarter of 2011 to discuss the concept release and related issues.

We encourage all financial statement stakeholders, including audit committees, company management, investor groups, and others, to study the concept release and submit comments to the PCAOB.

Background

The PCAOB is evaluating the current auditor's reporting model in response to investors' and other financial statement users' concerns about the information provided in the auditor's report in light of:

- Increasing complexity in preparing and auditing financial statements.
- Ongoing dialogue both in the United States and in Europe on the role of the auditor and the form of the auditor's report.

In developing this concept release, the PCAOB conducted extensive outreach (from October 2010 through March 2011), consulting investors, preparers, auditors, audit committee members, regulators, standard setters, and academics. The PCAOB staff gave an overview of its outreach efforts, including a summary of its findings, at its March 22, 2011, open Board meeting and at the March 24, 2011, PCAOB Standing Advisory Group (SAG) meeting. For more information, see Deloitte's April 5, 2011, *Heads Up*.

[1] PCAOB Release No. 2011-003, *Concept Release on Possible Revisions to PCAOB Standards Related to Reports on Audited Financial Statements.*

[2] PCAOB AU Section 508, *Reports on Audited Financial Statements.*

[3] PCAOB Auditing Standard No. 1, *References in Auditors' Reports to the Standards of the Public Company Accounting Oversight Board.*

Objective and Overview of Presented Alternatives

The concept release's objective is to discuss several alternatives for supplementing the current pass/fail auditor's report and to "increase its transparency and relevance to financial statement users." These alternatives, discussed in greater detail below, include:

- Inclusion of an Auditor's Discussion and Analysis (AD&A) section in a supplement to the auditor's report.
- "[R]equired and expanded use of emphasis paragraphs."
- "[A]uditor reporting on information outside the financial statements."
- "[C]larification of certain language in the [current standard] auditor's report."

As indicated in the concept release, these potential supplements are not mutually exclusive and a revised auditor's reporting model "could include one or a combination of these alternatives or elements of these alternatives." In addition, the PCAOB may, on the basis of the comments received, consider other ideas that are not addressed in the concept release.

Inclusion of an Auditor's Discussion and Analysis

An AD&A would be a supplemental narrative report that is intended to provide a view of the audit and financial statements "through the auditor's eyes." According to the concept release, this narrative could include information about audit risks identified, audit procedures and results, and independence. Such information could help investors understand a company's financial statements and related MD&A.

The concept release's objective is to discuss several alternatives for supplementing the current pass/fail auditor's report and to "increase its transparency and relevance to financial statement users."

The concept release states that the "AD&A would likely be among the most expansive form of reporting of the alternatives presented since it would provide auditor commentary on significant matters to the users of the financial statements." If this alternative is adopted, the "PCAOB, in collaboration with the SEC, would likely need to develop new auditing standards to provide standard, objective criteria to the auditor regarding the appropriate content and level of detail to be reported in an AD&A."

Required and Expanded Use of Emphasis Paragraphs

Under the current PCAOB standards, emphasis paragraphs are not required but may be added at the discretion of the auditor. This alternative "would mandate the use of emphasis paragraphs in all audit reports." Such paragraphs would "highlight the most significant matters in the financial statements and . . . identify where these matters are disclosed in the financial statements." The concept release further states that "emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates," areas of significant uncertainty, and other areas the auditor deems important to emphasize for a more thorough understanding of the financial statement presentation.

Auditor Reporting on Information Outside the Financial Statements

This alternative could be used to provide assurance on information outside the financial statements (e.g., MD&A, or portions thereof, such as critical accounting estimates). Such assurance may give investors and other financial statement users more confidence in the information provided by management and presented outside the financial statements. The concept release indicates that providing such assurance "would increase the scope of the auditor's responsibilities, require the development of new auditing standards, and might result in projects separate from the auditor's reporting model project."

Clarification of Certain Language in the Auditor's Report

Although this alternative "would not significantly expand the content of the auditor's report, it could provide additional explanation about what an audit represents and the related auditor responsibilities." As described in the concept release, possible language that could be added to the report includes:

- The meaning of reasonable assurance, which is defined in the auditing standards as "a high level of assurance, but not absolute assurance."
- An explanation of the auditor's responsibility for fraud.
- Explicit reference to the auditor's responsibility for financial statement disclosures.
- Management's responsibility for the fair preparation of the financial statements.
- Discussion of the auditor's responsibility for information outside the financial statements.
- A statement in the report that the auditor has a responsibility to be independent of the company and has complied with applicable independence requirements of the PCAOB and SEC.

Considerations

During the PCAOB staff's outreach efforts, various participants suggested that certain practical challenges and unintended consequences could result from additional auditor reporting. On the basis of the questions in the concept release, the PCAOB is interested in hearing views on the following:

During the PCAOB staff's outreach efforts, various participants suggested that certain practical challenges and unintended consequences could result from additional auditor reporting.

- General considerations related to changing the auditor's report.
  - Retention of the current pass/fail model.
  - Need for expansion of the information provided by the auditor and what new information should be included.
  - Potential benefits and shortcomings of each presented alternative.
  - Whether a combination of the alternatives or certain elements of the alternatives would more effectively improve the auditor's reporting model.
  - Feasibility of avoiding boilerplate language under the suggested alternatives.
  - Potential direction of and need for related standard-setting projects under the suggested alternatives.
  - Liability considerations.
  - Additional considerations/alternatives that the PCAOB should contemplate in making changes to the current auditor's reporting model.
- Potential implications for the audit, including scope.
  - Implications for the scope of the audit or the auditor's responsibilities.
  - Effect on audit quality.
  - Effect on the auditor's relationships with management and the audit committee.
  - Other practical challenges.
- Effects on issuers.
  - Impacts on meeting current filing deadlines.
  - Effects on audit committee governance.
  - Confidentiality considerations.
  - Concerns regarding potential costs associated with the suggested alternatives.
  - Appropriateness of the auditor's being the direct provider of additional information about the company's financial statements.

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PCAOB Issues Concept Release Seeking Input on Possible Changes to Auditors' Reports

PCAOB Issues Concept Release Seeking Input on Possible Changes to Auditors' Reports

On June 21, 2011, the Public Company Accounting Oversight Board (PCAOB) issued a concept release seeking input on possible changes to auditors' reports. These changes, if adopted, have the potential to increase both the cost of required audit services and the legal liability faced by both companies and their auditors.

The auditor's report is the primary means by which an auditor communicates information regarding the audit of the financial statements to investors and other financial statement users. The concept release presents several alternatives for changing the auditor's report and the PCAOB is seeking specific comment on those or other alternatives that could provide investors with increased audit process transparency and insight into the company's financial statements and other information outside the financial statements. Alternatives discussed in the concept release are:

- An auditor's discussion and analysis
- Required and expanded use of emphasis paragraphs
- Auditor assurance on other information outside the financial statements
- Clarification of language in the standard auditor's report

As a result of the performance of required audit procedures, auditors often have significant information regarding how a company's financial statements were prepared that might be useful to investors and other financial statement users. It is believed that discussion in the auditor's report of this information could lead to more efficient markets and improved allocations of capital. According to PCAOB Chair James R. Doty, the concept release "represents a significant step for investor protection in response to the financial crisis, and a first step toward a holistic consideration of reforms designed to foster the relevance, transparency and reliability of the audit process." Mr. Doty also stated that the alternatives discussed in the concept release "are intended to spur debate over how to change auditing, from a culture that emphasizes client service to a culture that emphasizes public service."

Background

The current standard auditor's report, largely unchanged since its adoption almost six decades ago, identifies the financial statements that were audited, describes the nature of the audit, and presents the auditor's opinion as to whether the financial statements present fairly, in all material respects, the financial position, results of operations, and cash flows of the company in conformity with the applicable financial reporting framework. The current auditor's report is commonly described as being pass/fail because the auditor opines on whether the financial statements are fairly presented (pass) or not (fail).

In 2010, the PCAOB began evaluating its auditing standards for reporting on audited financial statements in response to investors' and other financial statement users' historical concerns, including recent concerns highlighted by the financial crisis related to preparing and auditing financial statements for complex global businesses, as well as the active international debate in this area.

The staff found that the pass/fail model and the standardized language of the auditor's report provides investors with consistency, comparability, and clarity. However, investors also told the PCAOB staff that the standard auditor's report is too "boilerplate" and does not convey the significant judgments made by the auditor in forming the audit opinion. Accordingly, there was support for retaining the pass/fail form but supplementing the auditor's report with discussion by the auditor about the audit and the company's financial statements. This would allow the auditor to issue an unqualified opinion while also adding commentary on significant matters. Investors also suggested that clarification of some of the language in the standard auditor's report could be helpful. Investors indicated that they are looking to the auditor for more information, rather than management or the audit committee, because the auditor is a third party.

Alternatives

All of the alternatives presented in the concept release would retain the pass/fail opinion of the standard auditor's report. The PCAOB emphasized that the alternatives are not intended to in any way alter the auditor's ultimate responsibility to obtain sufficient appropriate audit evidence to support the audit opinion. Nor are the alternatives intended to qualify or piecemeal the auditor's opinion or to shift the requirement to assess the risk of material misstatement of the financial statements from the auditor to investors or other users of financial statements.

The alternatives presented below are not mutually exclusive. A revised auditor's report could include one or a combination of the alternatives, elements within the alternatives, or alternatives not currently presented in the concept release.

Auditor's Discussion and Analysis

This alternative would require that an auditor provide an Auditor's Discussion and Analysis (AD&A) along with the auditor's report. The AD&A would be a supplemental narrative report that would provide the auditor with the ability to discuss his or her views regarding significant matters. The AD&A could include information about the audit, such as audit risks identified in the audit, audit procedures and results, and auditor independence. It also could include a discussion of the auditor's views regarding the company's financial statements, such as management's judgments and estimates, accounting policies and practices, and difficult or contentious issues, including "close calls."

The AD&A would not be intended to provide separate assurance on individual balances, disclosures, transactions, or any other matters discussed. Rather, the AD&A would be intended to facilitate an understanding of the auditor's opinion on the financial statements taken as a whole.

The AD&A would likely be among the most expansive form of reporting of the alternatives presented in the concept release and could require the auditor to communicate some of the same information that the auditor currently communicates to the audit committee. However, the AD&A may give the auditor greater leverage to effect change and enhance management disclosure in the financial statements, thus increasing transparency to investors. On the other hand, auditor communication with management and the audit committee may suffer if the auditor is required to disclose additional information about the company.

Required and Expanded Use of Emphasis Paragraphs

This alternative would require an auditor to include an expanded emphasis paragraph in all audit reports, highlighting the most significant matters in the financial statements and identifying where such matters are disclosed in the financial statements. Currently, emphasis paragraphs are not required, but may be added at the auditor's discretion to emphasize a financial statement matter.

Emphasis paragraphs could be required in areas of critical importance to the financial statements, including significant management judgments and estimates, areas with significant measurement uncertainty and other areas that the auditor determines are important for a better understanding of the financial statement presentation. The auditor could also be required to comment on key audit procedures performed pertaining to the identified matters.

Auditor Assurance on Other Information Outside the Financial Statements

This alternative would require an auditor to provide assurance on information outside the financial statements, such as the management's discussion and analysis (MD&A), earnings releases, or non-GAAP information. This assurance could improve the quality, completeness, and reliability of such information and provide investors and other users of financial statements with a higher level of confidence in such information. Currently, auditors are not required to provide assurance on the MD&A, earnings releases, or non-GAAP information.

Clarification of the Standard Auditor's Report

This alternative would involve adding language to the auditor's report clarifying what an audit represents and the related auditor responsibilities. Possible language and concepts that could be clarified in the auditor's report include:

- Reasonable assurance
- Auditor's responsibility for fraud
- Auditor's responsibility for financial statement disclosures
- Management's responsibility for the preparation of the financial statements
- Auditor's responsibility for information outside of the financial statements
- Auditor independence

Impact

The changes being considered by the PCAOB raise a number of concerns for companies, management, audit committees, and auditors, including:

- The changes would require additional effort by auditors, management, and audit committees, increasing the costs of and time spent on audits. Some companies might find it more challenging to meet their release and filing dates.
- Because the changes would include the disclosure by the auditors of additional, and in some cases more subjective, information, the changes would raise liability risks for companies and auditors.
- Companies may be concerned about auditors discussing proprietary or highly sensitive company information in the new disclosures.
- The additional disclosures could create further questions as to whether the financial statements are truly the responsibility of management and not the auditor and call into question the oversight role of the audit committee. This issue may be further exacerbated by the movement to a more principles-based approach to accounting standards, including the proposed conversion to International Financial Reporting Standards, which may lead to more opportunities for differences of opinion and conflicts between auditors and management.

Request for Comment

The PCAOB has requested comment on a number of issues in connection with the concept release. Beyond the specific alternatives presented in the concept release, the PCAOB also is interested in receiving comments on the effect changes to the auditor's report would have on:

- Auditor time and effort, including additional costs
- The auditor's relationships with management and the audit committee
- The governance role of the audit committee
- Liability for companies and auditors
- Maintaining the confidentiality of proprietary and sensitive company information

Comments must be submitted by September 30, 2011.

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Heads Up

August 26, 2011
Volume 18, Issue 23

In This Issue:

PCAOB Issues Concept Release on Auditor Independence and Audit Firm Rotation

by Consuelo Hitchcock, Deloitte LLP

On August 16, 2011, the Public Company Accounting Oversight Board (PCAOB or the "Board") issued a concept release[1] that seeks public comment on mandatory audit firm rotation and other ways in which auditor independence, objectivity, and professional skepticism could be improved. The PCAOB announced that it will hold a public roundtable on the concept release in March 2012. Comments on the concept release are due by December 14, 2011.

Background

In an August 16, 2011, statement, PCAOB Chairman James Doty emphasized that the concept release explores ways to mitigate the "fundamental conflict of the audit client paying the auditor." While the concept release largely focuses on mandatory audit firm rotation, it also seeks comment on whether measures other than firm rotation could meaningfully enhance auditor independence, objectivity, and professional skepticism.[2]

The PCAOB announced that it will hold a public roundtable on the concept release in March 2012.

The concept release provides background on mandatory audit firm rotation and an overview of rulemaking by the Securities and Exchange Commission (SEC), PCAOB standard setting associated with auditor independence, and related reforms (e.g., audit committee oversight of auditor independence, audit partner rotation requirements, scope of service limitations) that were put in place as a result of the Sarbanes-Oxley Act of 2002. While the concept release notes that changes enacted as a result of the Sarbanes-Oxley Act have "made a significant, positive difference in the quality of public company auditing," it also says that the PCAOB inspection staff "continues to find instances in which it appears that auditors did not approach some aspect of the audit with required independence, objectivity and professional skepticism."

The concept release acknowledges that not all audit deficiencies detected by the PCAOB inspection staff necessarily result from a lack of objectivity or professional skepticism; rather, such deficiencies could "reflect a lack of technical competence or experience, which may be exacerbated by staffing pressures or some other problem." In addition, the concept release notes that because the PCAOB's inspection program is risk-based, "the Board may be looking at the most error-prone situations." During the open meeting, the Board and PCAOB staff discussed the staff's ongoing research to analyze whether audit deficiencies it had identified could be tied to a lack of professional skepticism, independence, and objectivity. This discussion revealed that though the PCAOB's research thus far was inconclusive, it was also incomplete. Nevertheless, it is clear that

[1] PCAOB Release No. 2011-06, *Concept Release on Auditor Independence and Audit Firm Rotation*.

[2] Footnote 2 of the concept release states, "While the terms 'independence,' 'objectivity,' and 'professional skepticism' have slightly different connotations, they all relate to the auditor's ability to perform the audit in a disinterested manner, free from influence by the client. An independent auditor is more likely to exercise appropriate professional skepticism and make objective auditing judgments."

the PCAOB's intent is to focus on the lack of independence, objectivity, and professional skepticism as potential root causes of audit deficiencies and to consider mandatory rotation as a means of addressing these potential root causes.

The concept release points out that the notion of mandatory audit firm rotation is not new and that it has, in fact, been discussed in various forums since the 1970s. In addition, the release presents summaries of various academic and other studies of the issue, including a 2003 study by the U.S. General Accounting Office (GAO),[3] which was required by the Sarbanes-Oxley Act.[4]

The study concluded that "mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record . . . . The potential benefits of mandatory audit firm rotation are harder to predict and quantify." The GAO report also stated that "it will take at least several years for the SEC and the PCAOB to gain sufficient experience with the effectiveness of the act in order to adequately evaluate whether further enhancements or revisions, including mandatory audit firm rotation, may be needed to further protect the public interest and to restore investor confidence." Chairman Doty and other Board members cited this latter point in stating their belief that now is an apt time to revisit this issue.

The concept release states that opponents of rotation have expressed concerns about the attendant costs (especially for large multinational companies) as well as the view that audit quality may suffer in the early years of an engagement.

Overview of Release and Request for Comment

The concept release notes that proponents of rotation believe that setting a term limit on the audit relationship could mitigate the effects of client pressures and "offer an opportunity for a fresh look at the company's financial reporting." However, it also states that opponents of rotation have expressed concerns about the attendant costs (especially for large multinational companies) as well as the view that audit quality may suffer in the early years of an engagement. At its August 16, 2011, meeting, the Board emphasized that it is looking for comments that expand on these traditional arguments as well as for empirical data supporting commenters' views.

The concept release includes 21 numbered questions as well as numerous questions embedded in or implied by the text of the release. On the basis of those questions, the PCAOB seems interested in constituents' views on the following general themes:

- Whether the current model in which the auditor is paid by its audit client in fact causes an inherent conflict that is not sufficiently mitigated by existing regulatory and other safeguards.
- Whether audit firm rotation would enhance auditor independence, objectivity, and professional skepticism or whether there are other alternatives that the Board should consider.
- The advantages and disadvantages of mandatory audit firm rotation.
- The effect that a rotation requirement would have on costs to auditors and companies (direct and indirect), whether steps could be taken to mitigate such costs, and how transitions between auditors are currently conducted.
- How the recently implemented engagement partner rotation and audit committee rules and regulations should factor into the consideration of audit firm rotation.
- Whether the Board should conduct a pilot program to further study mandatory rotation and, if so, how it could be structured.
- The significance of auditor independence, objectivity, and professional skepticism in relation to the Board's other possible areas of focus.

[3] Now known as the Government Accountability Office.

[4] More recently, the consideration of mandatory rotation and related issues has been a focus outside the United States, most notably by the European Commission, which raised the issue in its October 2010 consultation paper *Audit Policy: Lessons From the Crisis*. Currently, only a few countries have a form of mandatory audit firm rotation (which, in some cases, is limited by industry), while some countries that had introduced mandatory rotation in the past reversed their position after experiencing the implementation.

In addition, in the event that the PCAOB does consider rulemaking on mandatory rotation, the Board asks for views on the following four topics:

- Possible approaches to rulemaking, such as a rule under which an auditor would not be independent "if it has provided an opinion on the client's financial statements for a certain number of consecutive years."
- Potential maximum length of audit firm term, particularly the advantages and disadvantages of rotation terms of 10 years or more.
- Scope of the potential requirement, including whether a rotation requirement should apply to all audits conducted under PCAOB standards or only, for example, to audits of the largest companies or companies in certain industries.
- Transition and implementation considerations, including whether a rotation requirement would further limit a company's choice of auditor and whether there is a higher audit risk in the early years of an engagement.

Also, as noted, the PCAOB has emphasized that it is seeking input on whether there are alternatives to mandatory rotation that could enhance independence, objectivity and professional skepticism.

We encourage all financial statement stakeholders, including audit committees, company management, investor groups, and others to study the concept release and submit comments to the PCAOB.

Opportunity for Public Comment

We encourage all financial statement stakeholders, including audit committees, company management, investor groups, and others to study the concept release and submit comments to the PCAOB. Note that a concept release is a step before official rulemaking but is a crucial stage in the PCAOB's process. If, after considering feedback on this concept release and from the March 12 roundtable, the PCAOB decides to propose a regulatory requirement, it would also have to expose that proposal for public comment.

Interested parties can send comments to the Office of the Secretary, PCAOB, 1666 K Street, N.W., Washington, D.C., 20006-2803. Comments also may be submitted via e-mail to comments@pcaobus.org or through the PCAOB's Web site at www.pcaobus.org. All comments should refer to PCAOB Rulemaking Docket Matter No. 37 in the subject or reference line and should be received by the Board no later than 5:00 p.m. EDT on December 14, 2011.

Additional Thoughts on Mandatory Firm Rotation

We agree with the PCAOB about the importance of auditor independence, objectivity, and professional skepticism. We also agree with Board member Lewis H. Ferguson, who emphasized, in his statement at the Board's August 16, 2011, meeting, that "[I]n this, as in all other instances where we consider regulatory change, we take seriously the Hippocratic maxim, that has application to anyone attempting to ameliorate anything, of 'first, do no harm'."

The concept release refers to some of the risks of mandatory audit firm rotation that have been suggested by commentators; these risks are likely to receive further consideration during the comment period. The many well-known potential detriments to a universal mandatory rotation include:

- Mandatory rotation destroys the knowledge base and understanding developed by the audit firm, which threatens audit quality and effectiveness.
- Efficiencies that were developed over time by the preceding auditor are lost upon rotation, thereby increasing the costs of maintaining the same level of audit services.
- Each time rotation occurs, management faces the disruption, expense, and time involved in changing its audit firm.
- Some may see mandatory rotation as an opportunity to leverage competition and pressure auditors to decrease their audit fees below reasonable levels.

While supporters of mandatory rotation have cited some potential benefits, these benefits are untested and we believe that they will not outweigh the potential risks in the final analysis.

- Mandatory rotation could be a disincentive for audit firms to accumulate sector/industry expertise and could jeopardize their ability to attract and maintain talent, especially in specialized industries.
- Similarly, it could be difficult for companies in specialized industries or remote locations to find successor audit firms that have the requisite expertise, staffing levels, and independence.
- Mandatory rotation may give rise to significant problems for global companies, if, for example, different national regulations require rotation after varying amounts of time.

While supporters of mandatory rotation have cited some potential benefits, these benefits are untested and we believe that they will not outweigh the potential risks in the final analysis.

Moreover, in response to the Sarbanes-Oxley Act, the SEC adopted a number of rules and regulations designed to address the PCAOB's concerns; however, the impact of these requirements has not been fully assessed. The provisions included audit committee engagement of and oversight of the independence of the auditor, five-year rotation of the lead audit partner and concurring partner, and seven-year rotation for certain other partners serving on the audit engagement team. These requirements became effective for fiscal years ending after May 31, 2003; thus, for many public companies, the end of the fiscal year 2010 audit marks the completion of the first cycle of partner rotation under these rules.

The PCAOB specifically has asked for comment on potential alternatives to mandatory rotation that could address its concerns in these areas. Because we agree with the PCAOB about the importance of auditor independence, objectivity, and professional skepticism, in the coming months we will be exploring alternatives that do not present the same level of risk as mandatory rotation and will share these alternatives with the PCAOB. We note that the PCAOB's concept release also raises fundamental questions about the role of the audit committee (and how its role was defined in the Sarbanes-Oxley Act), and we expect that members of audit committees and public companies themselves will actively participate in the comment process.

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