

December 13, 2011

Office of the Secretary  
PCAOB  
1666 K Street, N.W.  
Washington, D.C. 20006-2803

Submitted via email to: [comments@pcaobus.org](mailto:comments@pcaobus.org)

**Re: PCAOB Release No. 2011-006—Concept Release on Auditor Independence  
and Audit Firm Rotation**

**Rulemaking Docket Matter No. 37**

The New York State Society of Certified Public Accountants (NYSSCPA), representing more than 28,000 CPAs in public practice, industry, government and education, welcomes the opportunity to comment on the above captioned release.

The NYSSCPA's Auditing Standards and SEC Practice Committees deliberated the release and prepared the attached comments. If you would like additional discussion with us, please contact Jan C. Herringer, Chair of the Auditing Standards Committee at (212) 885-8133, or Ernest J. Markezin, NYSSCPA staff, at (212) 719-8303.

Sincerely,

  
Richard E. Piluso  
President

Attachment

**NEW YORK STATE SOCIETY OF  
CERTIFIED PUBLIC ACCOUNTANTS**

**COMMENTS ON  
PCAOB RELEASE NO. 2011-006—CONCEPT RELEASE ON AUDITOR  
INDEPENDENCE AND AUDIT FIRM ROTATION  
RULEMAKING DOCKET MATTER NO. 37**

**December 13, 2011**

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# New York State Society of Certified Public Accountants

## Comments on

### PCAOB Release No. 2011-006—Concept Release on Auditor Independence and Audit Firm Rotation

We appreciate the opportunity to comment on the Public Company Accounting Oversight Board’s (“PCAOB” or the “Board”) Concept Release, *Auditor Independence and Audit Firm Rotation* (the “Concept Release”). Set forth below are our comments on the issues of auditor independence and mandatory audit firm rotation.

#### **Existing Authoritative Requirements Relating to Auditor Independence, Objectivity and Professional Skepticism**

We share the PCAOB’s recognition of the importance of auditor independence, objectivity, and professional skepticism. Independence, integrity, and objectivity are bedrocks of audit quality and hallmarks of the Code of Professional Conduct of the American Institute of Certified Public Accountants (“the Code”), and these same hallmarks are found in the NYSSCPA Code of Professional Conduct. CPAs are required by the Code to comply with the standards of the PCAOB when associated with audits of financial statements of public companies.

The AICPA Code of Professional Conduct, as of June 1, 2011, in *Article III—Integrity*, states the following, as excerpted:

- Integrity is an element of character fundamental to professional recognition. [ET § 54.01]
- It is the...benchmark against which a member must ultimately test all decisions. [ET § 54.01]
- Integrity is measured in terms of what is right and just. [ET § 54.03]

*Article IV—Objectivity and Independence*, states the following, as excerpted:

- Objectivity is a...quality that lends value to a member’s services. [ET § 55.01]
- The principle of objectivity imposes the obligation to be impartial, intellectually honest, and free of conflicts of interests. [ET § 55.01]

These hallmarks guide the CPA in the performance of all services and the Code provides precepts to guard against the loss of independence in fact or appearance. The standards of the PCAOB require the auditor to maintain independence, objectivity, and professional skepticism in all matters relating to the audit.

The Concept Release emphasizes the importance of the issue as seen on Page 4, “Accountants have long recognized that independence is critical to the viability of auditing as a profession” and on Page 2 “The Sarbanes-Oxley Act included a number of significant provisions designed to bolster the auditor’s independence from the company under audit.” For listed companies, the audit committee is put in charge of the audit relationship (*i.e.*, hiring the auditor and overseeing the audit), the performance of certain non-audit services to clients is prohibited, and mandatory audit partner rotation is imposed. We believe that these provisions, relevant ethical requirements, and PCAOB auditing standards constitute strong safeguards to auditor independence, objectivity, and professional skepticism.

### **Root Causes of Identified Audit Deficiencies**

The Concept Release states on Page 5:

“When the Board’s inspectors find audit failures, they focus firms on the need for corrective action, which in some cases has resulted in issuers restating previously issued financial statements. The Board also seeks to understand any quality control defects that underlie the audit failures it finds. Through the quality control remediation process, the Board’s findings have led to numerous and significant improvements in firm audit methodologies, processes and related quality control systems.”

We believe that the PCAOB inspection process should continue to emphasize the identification of quality control deficiencies and the remediation process with respect thereto.

PCAOB Chairman, James R. Doty, pointed out the following in his comments of August 16, 2011, on the Concept Release:

- “Since the PCAOB began its work, our inspectors have identified hundreds of audit failures.
- To ascertain why those failures have occurred, we consider surrounding circumstances.
- We look for common themes.
- We try to infer root causes.”

We concur with Chairman Doty of the PCAOB. Identifying root causes of audit deficiencies and securing remediation agreements from inspected firms should receive particular emphasis in the Board’s inspection process and be incorporated by design into each inspection that the Board conducts.

Despite the PCAOB’s finding as stated on Page 5 that, “Based on its inspections and other oversight activities, auditors still, at times, fail to display the necessary independence in mental attitude,” the Concept Release does not provide any correlation between audit deficiencies and a lack of independence in mental attitude. Indeed, it acknowledges on Page 6 that “Audit failures can reflect a lack of technical competence or experience, which may be exacerbated by staffing pressures or some other problem” and

do not necessarily result from a lack of objectivity or professional skepticism. Nevertheless, on Page 7, the Board provides five examples from inspection reports of audit deficiencies that may have been attributable to a failure to exercise the required professional skepticism and objectivity.

From the standpoint of causation, these examples do not make a convincing argument given that audits involve a multitude of decisions applied to a set of often complex financial statements subject to numerous standards, principles, and regulatory rules of multiple standard and rule-setting bodies. We believe that it would be presumptuous to require audit firm rotation without more empirical evidence of the causes of audit deficiencies found in the PCAOB's inspection process. Half of the auditing standards issued by the PCAOB first became effective for audits of fiscal years beginning on or after December 15, 2010<sup>1</sup> and Auditing Standard No. 7, *Engagement Quality Review*, first became effective a year earlier. Therefore, the PCAOB has not yet had the opportunity to evaluate what effect these standards have had on audit quality. It would be premature to require audit firm rotation without first considering the impact that these standards may have.

### **Recommendations to Enhance Audit Quality**

We believe that objectivity and professional skepticism are generally not audit firm issues but, rather, are issues applicable to engagement personnel. We find that audit firms usually do a good job of including in their audit manuals or other audit guidance material the substance of the authoritative professional literature with respect to auditor independence, objectivity, and professional skepticism. While we agree that the causes of audit failures are complex and vary in nature as noted on Page 6 it is our belief that they are attributable to other factors that have a more direct impact on audit quality than a possible lack of independence, objectivity, and professional skepticism due to firm tenure. These include, among other things, inadequate familiarity with the client's business, technical incompetence, insufficient experience, a lack of specialized industry experience or other necessary expertise, staffing pressures, fee constraints, inadequate supervision, inappropriate judgments, and inadequate risk assessments.

Therefore, we do not believe that these threats to quality auditing will be significantly mitigated by audit firm rotation. In our opinion, mandatory audit firm rotation will not significantly enhance auditor's independence, objectivity, and professional skepticism but will simply substitute one firm's strengths and weaknesses for those of another firm.

There are two principal alternatives to mandatory audit firm rotation that would meaningfully enhance auditor independence, objectivity, and professional skepticism. First, audit firms need to have meaningful policies and a system of quality control which

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<sup>1</sup> These include Auditing Standards Nos. 8, Audit Risk, No. 9, Audit Planning, No. 10, Supervision of the Audit Engagement, No. 11, Consideration of Materiality in Planning and Performing an Audit, No. 12, Identifying and Assessing Risks of Material Misstatement, No. 13, The Auditor's Responses to the Risks of Material Misstatement, No. 14, Evaluating Audit Results, and No. 15, Audit Evidence.

emphasizes adherence to professional standards—especially due professional care in the performance of the audit and the preparation of the audit report. As stated in the standards of the PCAOB, “due professional care requires the auditor to exercise professional skepticism.” Second, clients need to have audit committees which are competent, have appropriate levels of training and experience, and are diligent in providing oversight to the external audit function.

### **Effective Quality Control**

The standards of the PCAOB require the audit firm to adopt a system of quality control and to establish quality control policies and procedures to provide it with reasonable assurance that its personnel comply with Generally Accepted Auditing Standards (“GAAS”) in its audit engagements (Statements on Auditing Standards AU Section 161.02). We believe that the emphasis of the Profession and its regulators should be to improve firm quality control systems continually. This includes a rigorous adherence to the Profession’s Code(s) of Professional Conduct and the Board’s auditing standards and other guidance. Hiring competent individuals, providing appropriate training and supervision, and diligent and thorough review procedures are all part of a system of quality control designed to promote quality audits.

We look, for example, to the Enron audit failure in which one element was the decision by the engagement partner to disregard advice on difficult technical issues from the firm’s technical consultation resources in its national office. Would mandatory audit firm rotation have avoided or mitigated this audit failure, or rather would a firm policy which required differences of opinion to be resolved through thorough consultation procedures? In fact, the standards of the PCAOB now require the engagement quality review partner to become more fully involved in the audit review process and to concur in the conclusions reached by the engagement partner relative to the audit opinion.

Many firms have quality standards which (1) require consultation and concurrence on certain complex or evolving issues at higher levels within the firm (*e.g.*, regional or national office technical resources, or industry or subject matter specialists), or (2) require compliance with advice received from quality assurance personnel within the firm (subject, of course, to procedures to resolve legitimate differences of opinion).

It is extremely important that a firm’s system of quality control be monitored on an ongoing basis to provide it with reasonable assurance that its policies and procedures are being effectively applied. Monitoring activities include quality control reviews prior to audit completion, post-issuance reviews, and internal inspection programs—all by firm personnel who are independent of the audit engagements.

Improvements in audit firm quality standards will do more to improve audit performance than mandatory audit firm rotation. Lack of professional skepticism can result from poor training, lack of appropriate supervision, and many other factors in addition to a lack of independence and objectivity. Mandatory firm rotation will not cure such deficiencies. Adherence to high quality standards will.

## Effective Audit Committees

We agree with the finding of the Report of the National Commission on Fraudulent Financial Reporting (the Cohen Commission of October 1987) that the audit committee is in the best position to determine whether the rotation of the audit firm is appropriate. In PCAOB Release No. 2010-0001, "Proposed Auditing Standard Related to Communications with Audit Committees and Related Amendments to Certain PCAOB Auditing Standards" of March 29, 2010, PCAOB member Goelzer stated:

“The provisions of the Sarbanes-Oxley Act that deal with the committee’s oversight of the audit are predicated on the idea that independent, informed, and pro-active audit committees can and should be one of the keys to protecting the interests of public company investors.”

Oversight of the audit process by an effectively operating audit committee is a valuable tool to ensure a high quality audit. A knowledgeable audit committee understands the company’s issues and needs and is in the best position to evaluate the independence and performance of the audit firm in fulfilling the company’s audit requirements. We believe that the PCAOB should work with the appropriate regulatory bodies to enhance guidance for audit committees.

The primary objectives of PCAOB Release No. 2010-001 were to “(1) enhance the relevance and effectiveness of the communications between the auditor and the audit committee; and (2) emphasize the importance of effective, two-way communications between the auditor and the audit committee to better achieve the objectives of the audit.” By strengthening the existing requirements for auditor communications, the audit committee would be better able to oversee and monitor the external audit function. Combined with the strengthening of the audit committee financial expert, we believe that the adoption of this standard (which we understand will soon be re-exposed), will add significantly to the effectiveness of the audit committee’s oversight of audit engagements.

One such provision of the “Sarbanes-Oxley Act of 2002” required that all audit committees have at least one member with financial and accounting expertise (the “audit committee financial expert”). Under the rules, the definition of what constituted the audit committee financial expert was very broad and permitted a company whose audit committee did not have such an individual to only disclose the reasons therefore.

The rules indicate that a person shall have acquired the necessary financial expertise through:

- (A) Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions with similar functions;
- (B) Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant or auditor or person performing similar functions;

- (C) Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements or;
- (D) Other relevant experience.

These rules are such that many audit committee financial experts lack relevant knowledge of auditor independence requirements, PCAOB auditing standards, and accounting standards generally accepted in the U.S. We believe that an audit committee would be able to understand the financial reporting issues better and the auditor's responses to those issues if were comprised of members with more extensive financial reporting experience—particularly if it included one or more members with public company audit experience.

Therefore, we suggest that the PCAOB urge the Securities and Exchange Commission ("SEC") to strengthen the definition of the Audit Committee Financial Expert in Section 229.407(d) (5) (ii) of Regulation S-K. The role of the audit committee financial expert would be improved significantly if he or she were required to be a current or recent auditor of public companies. Having an individual with sufficient public company audit experience would help to strengthen the audit committee's ability to oversee the appointment, compensation, and work of the external auditor effectively. Audit committees should evaluate their level of financial expertise regularly and supplement it by engaging outside consultants with financial reporting and auditing expertise as needed.

### **Unintended Adverse Consequences to Smaller Firms**

Adoption of audit firm rotation would likely have the unintended consequence of further concentrating the audits of SEC Issuers in the largest audit firms, those constituting the "Big 4" and the "Second Tier." This would have a negative impact on competition and detract from the Board's objective of enhancing auditor independence, objectivity, and professional skepticism.

The current population of PCAOB Registered CPA Firms below the First and Second Tier includes a number of firms with 10 or fewer partners. Many, if not most, of these firms have no more than 2 or 3 partners qualified to audit SEC Issuers. There is also a number of Registered CPA Firms with 5 or fewer partners in which only 1 or 2 partners are qualified to audit SEC Issuers. Many of these firms perform less than 5 audits of SEC Issuers each year.

To be able to perform these SEC Issuer audits, firms below the Second Tier need to build and maintain the necessary skill sets despite having far more limited resources than the larger firms. These firms would be more challenged than larger firms to educate, train, and retain professional staff and to weather a lower realization rate in the earlier years of a new audit engagement gained as a result of audit firm rotation. Therefore, it is highly likely that the loss of a client due to audit firm rotation would disproportionately

impact firms below the Second Tier which already feel the impact of engagement partner rotation requirements.

Moreover, the audit committee of an SEC Issuer needing to hire a new auditor because its current auditor is required to be rotated would likely be influenced to select a larger firm with greater market presence to avoid criticism by investors or other stakeholders should financial reporting problems later surface. It is less likely that an issuer required to replace a Big 4 or Second Tier audit firm would rotate to a smaller firm with less visibility but which, nonetheless, is well qualified to perform the audit.

In the past, smaller firms may have been able to retain SEC issuers as audit clients due to the personal, “hands-on” service provided by one of its partners. Many smaller audit firms of public companies are retained because of the confidence of the audit committee in the individuals leading the engagement team and their knowledge of the specific industry, business operations of the company, or the specific issues it is facing. However, having lost a client due to mandatory firm rotation, the memory of this service likely will have eroded, and the partner who had previously led the engagement team may well have retired or left the smaller firm before it could be re-appointed as auditor.

Further impeding the ability of small firms to replace successfully SEC Issuer audit engagements lost due to mandatory firm rotation are the lower fee realization rates that they may have to incur in the early years of new client relationships. Lacking the financial resources of larger firms, it would be more difficult for small firms to be competitive bidders for such audit engagements.

SEC issuer-permitted, non-audit services, such as income tax services, can represent proportionately more lucrative fees for smaller firms. Their loss of such non-audit fee revenue due to their replacement as auditors would be another unintended consequence of mandatory firm rotation.

For all the above reasons, we believe that it is highly likely that the loss of an SEC Issuer client due to mandatory firm rotation would disproportionately impact firms below the Second Tier which have already felt the impact of engagement partner rotation requirements.

### **Questionable Practicality of Audit Firm Rotation in Certain Situations**

Some audit firms have achieved market leadership in certain situations that would make it impractical for other firms to become successor auditors at the same level of competency. For example, some firms have developed specialized practice groups to audit companies in certain specialized industries. Others have developed significant presence in certain geographical areas in order to audit companies with significant operations in these areas. These firms have devoted many years and considerable funds to develop their positions of leadership in these situations. Finding suitable replacements upon rotation of such audit firms would present audit committees with undue difficulties and potentially insurmountable problems as potential successor firms could be scarce.

## **Conclusion**

In conclusion, we believe that there are alternatives to audit firm rotation that will contribute significantly to the PCAOB's objective of enhancing auditor independence, objectivity, and professional skepticism. In particular, it is our opinion that added emphasis by the PCAOB inspection process to audit firms' quality control policies and procedures and the strengthening of the audit/financial reporting capabilities of audit committees have the highest potential.

These are by no means the only steps the PCAOB can take. Other steps, such as required periodic rotation of all key members of engagement teams, should be considered as well.

In addition to our concerns about audit firm rotation, we do not believe the resulting benefits would hold up to cost/benefit analysis. The Concept Release sets out many of the costs incident to mandatory audit firm rotation—particularly the increased initial-year audit costs (more than 20% according to responses of larger firms to the 2003 U.S. Government Accountability Office survey, due to, among other things, duplication of the start-up and learning time necessary to gain familiarity with a new client) and the potential time and disruption impact on the client's financial reporting staff.

Implementing the alternatives that we recommend without incurring these costs preserves the benefits of the auditor's continuing client relationship and its knowledge base as to the client's operations, internal controls, and financial reporting processes. The combination of our recommendations with engagement partner rotation and improved audit committee practices stemming from the Sarbanes-Oxley Act, the recently effective PCAOB auditing standards, and prospective new PCAOB auditing standards (such as the aforementioned PCAOB Release No. 2010-0001) should go a long way to improve audit quality. Therefore, the uncertain benefits and significant costs of mandatory audit firm rotation make its adoption, at a minimum, premature at this time.