



CONCEPT RELEASE ON AUDITOR
INDEPENDENCE AND AUDIT FIRM
ROTATION

KPMG

PCAOB Rulemaking
Docket Matter No.37 KPMG

**COMMENTS OF THE BLACK ECONOMIC COUNCIL, LATINO BUSINESS
CHAMBER OF GREATER LOS ANGELES AND THE NATIONAL ASIAN AMERICAN
COALITION ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION**

Len Canty
Chairman, Black Economic Council

Jorge Corralejo
Chairman, Latino Business Chamber of Greater Los Angeles

Faith Bautista
President and CEO, National Asian American Coalition

1850 M Street, NW, Suite 1500
Washington, DC 20036
Telephone: (202) 559 7483
Fax: (202) 204 5843
Email: mmartinez@naacoalition.org

January 13, 2012

꺆꺆꺆

The three Minority Parties have special expertise in that they have examined the audit procedures of Deloitte & Touche. Deloitte & Touche has been Sempra’s sole auditor for more than 50 years and the audit committee of Sempra has been totally compliant in always recommending Deloitte & Touche. Further, Sempra has been permitted to provide non-audit services, thereby further linking Deloitte & Touche and Sempra into a partnership.

Lastly, in a multi-ethnic world and a growing multi-ethnic America, it is not beneficial to the society as a whole to encourage white -only insider bidding for audit services. (The Big Four, for example, keep secret their racial/ethnic employment data and generally their gender data.³⁾ But, all evidence demonstrates that there is far more diversity among middle sized firms that could perform national audit work for the vast majority of Fortune 500 firms.

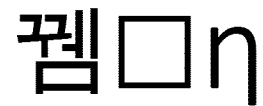
Further, as the comments set forth herein demonstrate, PCAOB could encourage far more competition among the top 100 CPA firms, which would likely lead to lower costs. This can be accomplished, for example, by requiring change in auditor every six years for Fortune 1,000 companies and every ten years for all other companies, including nonprofits, with 50 million dollars or more in revenue annually.

The Minority Parties believe their recommendations herein are fully consistent with the spirit of the Sarbanes –Oxley Act. In fact, beginning in the early seventies, there have been many comments by prestigious insiders on the need for mandatory audit firm rotations that would free the auditor from the effects of management pressure and provide an opportunity for a fully independent examination of a company’s financial reporting.

There is no evidence that the overall cost of such would be significant. Even the Big Four in their self-serving statements have estimated that the additional costs would be 20 percent for the first one or two years only. This cost by itself is marginal, given the multibillion-dollar revenue of Fortune 500 corporations. For example, assuming the average audit cost for Fortune 500 corporations is five million dollars per annum, the additional cost would amount to less than one -hundredth of one percent of annual revenue in the average case (0.01).

Further, this artificially narrow Big Four cost perspective fails to take into account the extraordinary impact of competition in reducing costs. It is possible, for example, that within five years, 50 to 100 large CPA firms will have the capacity to bid on these audit contracts, many of whom are likely to be far more diverse racially and ethnically than the Big Four. In addition, another 500 CPA firms could be in position to develop such

³ Employment data was denied to the Minority Parties after being requested in 2010 for presentation before the California Public Utilities Commission, which was examining diversity at large CPA firms used by the utilities, including Sempra , Edison and PG&E. 꺆꺆꺆



capacity, particularly if they formed a consortium with one or two other similarly sized firms.

Specific Recommendations

The Minority Parties recommend that audit terms be limited to six years for all audits of Fortune 1,000 sized companies.

Further, audit terms should be limited to ten years for all other companies with 50 million dollars or more in revenue, including very large nonprofits.

No firm should be eligible to bid for another audit for 12 years after it has completed its last audit with any affected company.

These proposed audit rotations will encourage the development of competing CPA firms that will have the capacity to bid and serve as independent auditors free from any type of cozy management relationships.

In further support of this mandatory audit rotation, we call to your attention the PCAOB's own study of the annual inspections of the largest audit firms for the last eight years. For example, close to 50 percent of all audits conducted of Fortune 500 corporations for the year 2007 and almost 50 percent of those for the year 2010 examined by the PCAOB were found to be suspect. These included accusations of unduly cozy relationships with management and, in some cases, there being an appearance of actual partnership between the auditor and the manager.

Further, in the most recent report from the Netherlands' financial authorities examination of Big Four firms, weaknesses were found in almost two-thirds of audits reviewed. Of the 46 Netherland audits relating to the Big Four, 29 were identified as having, for example, "insufficient professional skepticism exercised by the external auditor."

Given that similar problems have also been identified by the equivalent of the PCAOB in the United Kingdom in its audits of the Big Four, we also recommend that the PCAOB consult with the European Commission on mechanisms to encourage far greater diversity and competition among auditor firms that will eventually reduce costs and promote far more independence.

Deloitte & Touche and Experience of Minority Parties

It is the position of the Minority Parties, borne out in part by the 2010 PCAOB report, that our experiences with Deloitte & Touche are highly likely to be similar at the other Big Four CPA firms. In the Sempra case that we have examined and is now pending before the California Public Utilities Commission, we have questioned a cozy relationship that has existed with Deloitte & Touche and Sempra for more than 50 years. The cost of the audit and services has averaged more than seven million dollars



Role of Outside Investors, Such As CalPERS

The three Minority Parties assume that the PCAOB, subsequent to its March 2012 Round Table meeting, will put in place an effective mandatory audit rotation system.

It is also our expectation that large investor groups that have a long history of acting in the public interest, such as CalPERS and CalSTERS, will, on their own, question lengthy terms for the same auditor and will consider an extensive examination of the PCAOB's 2007 and 2010 analysis of large CPA firms to determine whether shareholders interests have been harmed by the lack of independent audits.⁵

We therefore recommend and urge that the PCAOB within 15 days of this filing request comments from the 100 largest public pension funds in the nation.

Other Observations Relating To Random Audits

We have reviewed the comments in the PCAOB report regarding Docket No. 37 relating to selection and compensation of auditors and offer the following brief comments, which we are prepared to elaborate upon.

Firstly, we look favorably on random audit selections via a third party, although we prefer the mandatory rotation every six years for very large companies.

Secondly, with or without a random audit, we strongly support financial statement insurance.

Thirdly, whether as a part of or independent from mandatory audit rotations, we favor limiting a CPA auditor to just audit services. That is, we would not allow a CPA auditor to also provide other services, such as consultation management services. This separation between audit and other services would minimize the "marriage" relationship, enhance independence, minimize perceptions of partnerships between the issuer and the auditor, minimize cozy management relationships and greatly increase the number of CPA firms that compete for the audit business of Fortune 500 corporations and other large firms.

In conclusion, Enron-type problems can be avoided in the future if we follow the advice of John Biggs, the former chairman and CEO of TIAA-CREF. He has testified that, "Had Arthur Andersen in 1996 known that Peat Marwick was going to come in 1997, there would have been a very different kind of relationship between them and Enron....There is a very high probability that had rotation been in place at Enron with Arthur Andersen you would not have had the accounting scandal that I think we now have...."

⁵ The Minority Parties began discussions with the leadership of CalPERS on Wednesday, January 4, 2012 regarding our letter of December 7, 2011.

