



Since the Cohen Report in 1978, our legal counsel, Robert Gnaizda, (formerly senior partner for Public Advocates from 1971 to 1994 and formerly General Counsel for the Greenlining Institute from 1994 to 2008), has raised issues relating to the lack of competition among the Big Eight (now Big Four) as to:²

- (a) The lack of independent audits, particularly in the context of cozy management relationships;
- (b) The need to create far greater competition through mandatory audit firm rotations; and
- (c) The lack of diversity, particularly relating to race and ethnicity among the largest CPA firms.

Introduction

The very existence of only four dominant CPA firms doing almost all the Fortune 500 audits is on its face harmful to the independence of audits. It is also per se harmful to the public interest as it affects antitrust laws seeking to promote competition and as it affects the financial and economic security of a 15 trillion dollar federal government GDP that relies very heavily on the accuracy and independence of the audits.

This Big Four dominance is compounded by the extremely long term of these audit firms and the rare switching of CPA firms among Fortune 500 corporations. According to the PCAOB report data contained in this docket, the top 100 corporations have averaged 28 years with the same auditor and all Fortune 500 firms have averaged 21 years. In fact, the average will be far longer in the near future, unless rotation of audits are mandated. (For example, when the data was first compiled, there were twice as many competitors (Big Eight).)

² Counsel for the Minority Parties first challenged the hegemony and unfair dominance of the then Big Eight before the California Board of Accountancy and the Sacramento California Superior Court. This was done on behalf of 350 highly qualified Filipino American accountants, who brought suit as a result of anti-competitor pressures from the Big Eight to prevent them from becoming CPAs. Eventually, the Big Eight, after losing both in court and before the Sacramento California Board of Accountancy, accepted the admission of 350 fully qualified Filipino American CPAs. They did so, however, only after contending that such an admission would lead to gross incompetence and delusion of quality. The uncontroverted evidence to date is of the quality of a Filipino American CPA is higher than the profession as a whole and the public level of complaint is lower than the professional as a whole. In addition, many of these Filipino American CPAs has disproportionately provided audits for small and medium sized businesses and nonprofits. (It should be noted that this suit was brought in part by the Filipino American Political Association on behalf of the underserved Filipino American community in California.)

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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.

