CONCEPT RELEASE ON AUDITOR INDEPENDENCE AND AUDIT FIRM ROTATION PCAOB Rulemaking Docket Matter No.37뀀ロη

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### 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

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The Black Economic Council, the Latino Business Chamber of Greater Los Angeles and the National Asian Amer ican Coalition have been raising in a variety of legal and administrative forums for a number of years the:<sup>1</sup>

- (a) Need for independent audits;
- (b) Need for a far larger number of CPA firms that are effective competitors to the Big Four; and
- (c) Limitations on terms for CPA audits.

Please note that on January 9<sup>th</sup>, we responded to Docket No. 29 regarding transparency of public audits in a fashion that is relevant to this proceeding as well.

The three Minority Parties are aware that the listed time for comment was December 14, 2011. However, the Minority Parties have limited staff (just one DC person) and were only made aware of PCAOB Docket No. 37 on January 4, 2011 by the PCAOB. We are therefore submitting our comments on the assumption that the extension of time will be granted, particularly since there is still substantial time for input relating to the tentatively scheduled Round Table meeting in March 2012 at which interested persons will be able to present their views on independent and mandatory firm rotation.

In this filing, we also would like to note that we will nominate a member in this filing from the three Minority Groups to participate in the Round Table meeting of March 2012. Most probably, it will be our Deputy Director Mia Martinez, who heads our DC regulatory and congressional liaison office.

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 Institu te from 1994 to 2008), has raised issues relating to the lack of competition among the Big Eight (now Big Four) as to:<sup>2</sup>

- (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 <u>per se</u> harmful to the public interest as it affects antitrust laws seeking to promote competition an d as it affects the financial and economic security of a 15 <u>trillion</u> 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 complied, there were twice as many competitors (Big Eight).)

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. <sup>3</sup>) But, all evidence demonstrates that there is fa r 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 <u>spirit</u> of the Sarbanes–Oxley Act. In fact, beginning in the early seventies, there have been many comments by prestigious insiders on the need for mand atory 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 art ificially 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

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<sup>3</sup> 潮面和 ata was denied to the Minority Part ies 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. 뀀口ŋ

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

### **Specific Recommendations**

The Minority Parities 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 exam ined 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

a year.<sup>4</sup> The public interest cost has been, however, far greater. That is, Deloitte & Touche is the cornerstone for Sempra's 2.4 billion dollar proposed rate increase that will be borne by consumers, including small businesses in their service area.

The audit committee of Sempra has routinely, without significant discussions or requests for truly independent bidding, chosen Deloitte & Touche for more than 50 consecutive years. This is by itself a statement to all potential competitors of "No Bidding Welcome." Obviou sly, no large CPA firm could afford to waste its time and revenue in having senior partners expend hundreds of hours in wooing an account for a long-lasting and intimate relationship with Deloitte & Touche. It is in the vernacular the equivalent of a "marriage," except that most marriages end after seven years.

As an example of these types of "marriages," see PCAOB's summary of recent large CPA firm audits contained in this docket. The PCAOB found that one of the largest accounting firms used the following phrases to demonstrate its "marriage" to the company it was auditing:

- "Your auditor should be a partner in supporting and helping [the issuer] achieve its goals, while at the same time helping you better manage risk;
- Support the desired outcome where t he audit team may be confronted with an issue that merits consultation with our National Office; and
- Stand by the conclusions reached and not second guess our joint decisions."

Deloitte & Touche also presents a special problem that might be of immediate concern to the United States government and international investors in energy. Upon information and belief, Deloitte & Touche may be the auditors for almost 40 percent of major US energy companies. As a result, there could be a national concern as to the a ccuracy of reporting of the value and extent of the reserves of natural gas as it affects the US' future vulnerability in relying on foreign energy.

<sup>4</sup> The provide any definitive information of senior Sempra officials, the CEOs for the two primary Sempra subsidiaries, SDG&E and SoCal Gas, each stated that they were oblivious to the Deloitte & Touche report made by the PCAOB even if it occurred six weeks prior to the cross examination and were not responsible in effect for determining the accuracy of Deloitte & Touche data. To date, Sempra and its subsidiaries have refused to provide any definitive information on whether Sempra was one of the companies audited by the PCAOB and has stated that they are fully satisfied with Sempra and have no inclination to change auditors as a result of the PCAOB reports on Deloitte & Touche.

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### 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.<sup>5</sup>

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 sel ections 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...."

The three Minority Parities who have been meeting on a regular basis over many years with the Federal Reserve, Department of Treasury, FDIC and OCC also believe that many of the problems, such as those involving Countrywide, Washington Mutual, World Savings, Wachovia, Morgan Stanley, Bear Sterns and Lehman Brothers might have been avoided, had there been independent financial auditors subject to mandatory limits on their terms.<sup>6</sup>

Respectfully submitted,

<u>/s/ Len Canty</u> Len Canty Chairman Black Economic Council

<u>/s/ Jorge Corralejo</u> Jorge Corralejo Chairman Latino Business Chamber of Greater Los Angeles

<u>/s/ Faith Bautista</u> Faith Bautista President and CEO National Asian American Coalition

<u>/s/ Robert Gnaizda</u> Robert Gnaizda Legal Counsel

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