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September 28, 2017

AICPA Professional Ethics Executive Committee
Professional Ethics Division
American Institute of Certified Public Accountants (AICPA)

By e-mail to: Ethics-ExposureDraft@aicpa-cima.com.

Re: Proposed Ethics Interpretation, "Long Association of Senior Personnel With an Attest Client"

Ladies and Gentlemen:

This is in response to the AICPA Professional Ethics Division's Proposed Interpretation entitled "Long Association of Senior Personnel With an Attest Client," dated July 14, 2017. We understand that the comment period was supposed to end on September 15, 2017, but regret that this proposal only came to our attention about a week after the close of the short comment period, which, despite no apparent emergency calling for action, unfortunately occurred almost entirely during a period when many people were typically on vacation. (A Google search performed on September 25, 2017, produced no evidence of any news reports announcing the issuance of this proposal, which may explain the low number of responses received.) One wonders what might have been the case had the proposal been given more publicity and had more time been allowed for responses.

Our objective is to advocate total and permanent withdrawal of this proposal. Because we believe our comments opposing this proposal are significant, we hope they will be given serious attention despite the timing. It appears that our views, although in the minority among the only four comment letters posted online as of this date, are nevertheless consistent in many respects with those expressed by the AICPA's PCPS Technical Issues Committee (the TIC), which likewise advocates withdrawal of the proposal.

Details of our views are summarized in the accompanying attachment.

Despite our deep objections to this particular proposal, we are appreciative of the work done by the Professional Ethics Division and our other standard-setters, and we fully support the mission to enhance audit quality.

Any questions about our firm's views may be addressed to the undersigned at hlevy@pbtk.com or 702/279-5389.

Very truly yours,

Piercy Bowler Taylor & Kern
Certified Public Accountants

Howard B. Levy, CPA, Principal
and Director, Technical Services

Proposed Ethics Interpretation, "Long Association of Senior Personnel With an Attest Client"
Details of Comments by Piercy Bowler Taylor & Kern September 28, 2017

Is the proposal necessary?

On September 19, 2016, the SEC announced its first ever enforcement actions taken for auditor independence impairments due to "close personal relationships" between auditors and client personnel.[1] In fact, there has never been a disciplinary matter brought by the AICPA's Professional Ethics Division against a CPA/member for having a close, non-familial relationship with a client that was deemed to impair independence. So what is compelling this proposal now? What's the problem?

It appears that the sole motivator for this proposal is the adoption of a standard on the subject by the International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants. As we will try to explain, we firmly believe this is insufficient justification for proposing what we see as an ill-advised, dangerous and unnecessary (as is pointed out in the TIC's comment letter of September 14, 2017) proposal.

We believe the proposal is unnecessary not only because it deals specifically with what ought to be viewed as a nonissue (as explained in the next section below), but also because it adds almost no useful guidance to that which can be obtained from the general material that is already in the conceptual framework. In addition, merely suggesting that long association might be a standalone familiarity threat, without regard to attendant facts and circumstances, introduces a strong bias that will likely cause practitioners to engage in a great deal of unnecessary, unproductive and costly, defensive back pedaling, wheel spinning and hoop jumping, *i.e.*, self-serving analysis and documentation, seeking safeguards to enable them to rationalize away what is essentially only an imaginary threat. Moreover, suggesting that such an imaginary threat might be mitigated by imposing a non-mandated rotation exposes the ensuing engagement to all the potential adverse effects of partner or firm rotation on audit quality, as discussed at considerable length in the last section below.

We see other likely serious adverse consequences of adopting this proposal, which are also discussed below.

Does a long association with an audit (or other attest) client constitute, by itself, a familiarity threat to independence?

The familiarity threat is defined in the AICPA's *Code of Professional Conduct* as the threat of becoming "too sympathetic to the client's interests or too accepting of the client's work or product" due to a "long or close relationship" with the client (ET section 1.210.010.14). For reasons explained below, we think the use of the word, "long" in this definition is unfortunate and misleading. We firmly believe it is not the mere duration of the association that potentially poses a familiarity or any other threat to independence; rather, it is the *nature* of the association — and the behavior. For instance, a very short romantic relationship involving a key member of the engagement team is clearly a threat when a long-standing, professional relationship with an attest client is not. Egregious, inappropriate behavior such as that of a romantic relationship, would clearly represent "a failure of integrity and/or objectivity," as the TIC points out in its comment letter. Sometimes such inappropriate behavior may be observed in conjunction with a long association, but is not to be presumed. Without the observed inappropriate behavior, there should be no threat identified.

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[1] An analysis and details of these enforcement actions can be found in an article by the undersigned entitled "Has the SEC Awakened a Sleeping Giant? The Familiarity Threat to Auditor Independence, published January 2017 by the New York State Society of Certified Public Accountants in The CPA Journal, pp. 54-57 (https://www.cpajournal.com/2017/01/22/aud-has-the-sec-awakened-a-sleeping-giant/).

It seems that those who see long associations with audit clients alone as more than just an imaginary threat to auditor independence do so based upon a clearly inappropriate rebuttable presumption that auditors are more like weak-willed used car salesmen rather than the professionals they are who have dedicated their lifelong careers to high principles such as integrity, objectivity and public service. In the words of the TIC, it "puts an unfair taint on the over-whelming majority of long associations by members with attest clients that represent no risk to independence." It is sad, indeed, to think that the official literature of our primary professional organization would present such a biased, negative view of its own members without presenting the far more persuasive mitigating benefits of such associations that tend to enhance audit quality.

In his October 11, 2011, letter to the PCAOB when it was considering mandating firm rotation (also in response to IESBA action taken in Europe), the highly esteemed Prof. Dennis R. Beresford, former Chair of the Financial Accounting Standards Board, wrote:

> "Those who favor mandatory audit firm rotation apparently feel that a change in audit firm increases independence, objectivity, and skepticism while somehow not sacrificing any of the quality side of the equation. Or they implicitly are willing to sacrifice some measure of performance quality in exchange for what they believe will be improved independence, objectivity, and skepticism. However, I believe the opposite is true: little will be gained in the way of independence, objectivity, and skepticism with a good chance of a loss in quality."[2]

The two SEC enforcement actions taken recently against the same large firm were based on inappropriate engagement partner behavior observed with respect to the client that in one case was described as follows: "exchanged hundreds of personal text messages, emails, and voicemails during the auditing periods investigated, stayed overnight at each other's homes on multiple occasions, and traveled together with family members on overnight trips 'with no valid business purpose.'" In the second matter, the engagement partner maintained a "close personal and romantic" relationship with the client's CFO "marked by a high level of personal intimacy, affection, and friendship, near daily communications about personal and romantic matters, and the occasional exchange of gifts on holidays and birthdays." Neither of these historic, first ever actions taken against U.S. CPAs asserting independence impairments arising from "close personal relationships" had anything to do with the duration of the relationships — only with behavior. It should be noted that a long-standing association with an attest client does not, in and of itself, constitute a "close personal relationship," and the SEC enforcement actions made no mention of the duration of the relationship playing a role in the SEC's conclusions.

It seems that these two SEC enforcement actions are in no way indicative of a need to strengthen or expand the applicable ethical rules or interpretations but rather suggest that improvements to the quality control (QC) standards are warranted that would require firms to adopt policies that would address and prohibit specific types of inappropriate behavior that would present the familiarity threat and likely be inconsistent with independence.

Long associations with clients, when maintained appropriately at the business/professional level (which most typically is the case), enhance audit quality by deepening the auditors understanding of the client's business/industry and the risks associated with it and by enhancing the client's trust and confidence in the auditor, which in turn fosters more frank and open communications and client cooperation.

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2 https://pcaobus.org/Rulemaking/Docket037/029_Dennis_R_Beresford.pdf

Likely economic consequences of the proposal

The large majority of CPAs practicing in the U.S. do so in relatively small practice units. Unlike the large national firms, these local and regional firms do not have multi-million dollar advertising and promotion budgets, nor do they have huge institutional reputations such that their names are household words. The lifeblood of these firms — in fact, their only path to growth and prosperity — is the building of relationships by their individual personnel with members of the business communities in their local markets, people who can be viewed as potential clients or business referral sources. These relationships sometimes take years to cultivate, and are arguably the most valuable assets of any CPA firm. Any introduction of language into our own *Code of Professional Conduct*, such as is proposed, that would effectively discourage cultivating such relationships (*i.e.*, "long associations") with attest clients because they might be viewed by some as familiarity threats may alter substantially the way small firms have to market their attest services. Alternatively, some small firms may be forced to eliminate attest services entirely from their mix of products offered, because they are unable to establish adequate safeguards to mitigate an imaginary independence threat and still maintain audit quality.

Other likely adverse consequences

Probably the most serious consequence of adopting this proposal would be to provide valuable ammunition to potential litigants and other adversaries to challenge the judgment of auditors regarding the efficacy of safeguards cited in whatever self-protective conceptual framework analysis they may have prepared to address the proposed interpretation. It is clear to us that this consequence would have been of little or no concern to the IESBA when it recently passed its ethical standard on the subject because, unlike in the U.S., litigation against auditors in Europe is rare.

Also, we are suspicious that this proposal may represent a thinly veiled step one in the direction of ultimately adopting a mandatory partner or firm rotation requirement, to which we would be even more vehemently opposed, as explained in the next section. We believe that a mandatory auditor rotation requirement would represent a severe disservice to our clients and more significantly to the users of our client's financial statements.

The compelling case against auditor rotation

It has been long observed that the large majority of audit failures occur in the first two years of an audit engagement; this is consistent with reasonable expectations. We firmly believe that these observations and expectations support the idea, long embedded in auditing standards, that an auditor's knowledge of the financial statement issuer's business and industry, its inherent risks, motivators and operating practices, is of near paramount importance (second only to independence) in conducting a quality audit. An auditor's intuitiveness and effectiveness is inherently less in the early years of a client relationship and improves measurably and significantly, along with audit quality, with each successive year on any particular client engagement.

We believe that to deepen and enhance such knowledge, there is no substitute for experience with the client. Further, we support the views of many others that the value of such experience in relation to audit quality increases over time and far exceeds any imaginary threat to independence created by long-term association and the limited benefit (if any) that one can expect to be realized from any so-called "fresh look." To the contrary, we believe that mandated auditor rotations substantially heighten the risk and frequency of audit failures resulting from lack of depth of such knowledge in the early years following a partner or firm rotation.

In fact, we firmly believe that partner or firm rotation has virtually nothing to do with auditor independence and can only impair, not improve, audit quality, and we are unaware of any evidence that would even suggest that auditors' independence, the appearance thereof or the quality of audit work would be even slightly enhanced by imposing any additional restrictive auditor rotation requirements.

In 2001, the Public Company Accounting Oversight Board (PCAOB) began its long and aggressive push to mandate periodic audit firm rotations for SEC issuers. For many reasons, amidst forceful objections from auditor, issuers and others, this effort failed. Among the most significant reasons were:

- Despite the sheer weight of the research gathered or conducted by the PCAOB in support of its biased conclusion regarding mandatory firm rotation, the PCAOB subtlety acknowledged its inability to justify mandatory rotation convincingly by couching its exaggerated claims of both the need for and benefits to be expected from such rotation in notably weak, uncompelling and inconclusive language such as "may," might," and "could." Such claims are pure speculation and unsupportable. Selected examples stated in PCAOB Release No. 2011-006, "Concept Release on Auditor Independence and Audit Firm Rotation," include [***emphasis added***]:

  "By ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and ***might***, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper."

  "Some observations from the engagement reviews suggest that the [inspected firm] ... ***may not*** exercise sufficient professional skepticism."

  "The deficiencies identified by the inspection team suggest that [the inspected firm's] engagement teams **may be** placing too much reliance on management's responses to the teams' inquiries and not sufficiently challenging or evaluating management's assumptions, and that they ***may not be*** applying an appropriate level of professional skepticism in subjective areas susceptible to management bias."

  "...the deficiency ***may have*** resulted from a lack of sufficient professional skepticism when evaluating management's plans and the assumptions and assertions underlying management's analyses when estimates requiring judgment are involved. In addition, a more effective review by the engagement leadership ***might have*** prevented or detected the deficiency."

- Forced firm rotation would effectively limit an issuer's choice of auditors and reduce or eliminate healthy competition among firms based on audit quality and other valid client retention considerations. It would relegate the temporary engagement of one firm *vs.* another to the status of an interchangeable commodity.

- It would severely disrupt the business of the issuers, the auditors, and the financial markets in general.

More than any lack of objectivity and/or skepticism attributable to client loyalty, we believe that audit deficiencies occur far more frequently as a result of the effects of other causes such as time and fee pressures from competitive bidding and/or contractual fee limits on engagements (particularly common among issuers having income and cash flow difficulties), cause auditors to miss issues and/or to take shortcuts. We are adamant in our view that any additional auditor rotation requirements, either at the partner or the firm level, would not likely enhance auditor independence, skepticism and objectivity beyond the safeguards that are already in place nor would they alter significantly the inevitable probability of occasional future lapses in auditor judgment or skepticism.

As reported July 2015 by Michael Cohn in *Accounting Today*,[3] an academic study entitled "The Effects of Auditor Rotation, Professional Skepticism, and Interactions with Managers on Audit Quality," published in the July/August 2015 issue of American Accounting Association's (AAA) journal, *The Accounting Review*, casts doubt on whether efforts to require companies to rotate their audit firms will likely lead to greater professional skepticism on the part of auditors. The study concludes that mandatory audit firm rotation could actually inhibit rather than encourage professional skepticism "to the detriment of audit effort and financial reporting quality."

The AAA study argues that auditors who are subject every few years to mandatory rotation feel less confident about their ability to conduct an audit for a new client effectively. "Rotating auditors, aware that they will not be in a long-term relationship, will ... likely perceive themselves to be less competent in evaluating the honesty or dishonesty of the [corporate] manager relative to auditors who do not rotate," the authors wrote. As a result, "rotating auditors would find it difficult to garner psychological support for the probability of manager dishonesty, leading them to be less likely to choose high levels of audit effort than non-rotating auditors." The study also suggests that clients may be more likely to take advantage of the relative inexperience of new auditors after a rotation and concludes, consistent with the intuitive views of experienced auditors, that rotation increases "the likelihood of audit failures."

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[3] https://www.accountingtoday.com/news/study-questions-impact-of-audit-firm-rotation-on-auditor-skepticism