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Perspective from Marc Blythe

With the recent comments from the PCAOB regarding audit quality and auditor independence, there's widespread concern about how increased oversight will affect both public and private companies.

A careful analysis reveals that the PCAOB's proposed changes can lead to streamlined processes, reduced risks, fewer surprises and improved relationships – *if* approached properly.

The key is taking the right steps at the outset for mutual advantage.

I've been getting an earful from many of you about the recent comments by James Doty, Chairman of The Public Company Accounting Oversight Board (PCAOB), regarding that organization's assertion that the existing audit structure is not independent or transparent enough.

To remedy the situation, the PCAOB is **proposing** to expand their oversight of the audit process and to ensure auditor objectivity through a variety of regulations including mandatory rotation of audit firms. The stated goals are to improve the overall quality of audits and to insulate auditors from client pressures so they can focus on protecting investors.

In this newsletter, I'll give you my thoughts on the impact of these potential changes and how to manage them for everyone's advantage. (Full disclosure: There is a role for consulting firms like Blythe Global Advisors in my recommendations.) But, first, let me share what I've been hearing.

In one ear, those of you on **the client side** are telling me that the current burdensome oversight process has resulted in strict adherence to the "checklist." Judgment decisions, the few times they are issued, take too long. Clients increasingly feel that audit firms are reinforcing processes primarily to pass PCAOB muster – sometimes at the expense of genuine, hard-earned business results. Surprises at the end of audits are on the rise, as are costs. Relationships are on the decline.

In the other ear, **audit firms** are telling me that the new proposals will raise the temperature in an already strained environment. With PCAOB oversight at its most burdensome ever, audit partners in CPA firms feel that proposals for them to take on more risk via personally signing audits, more work via expanded emphasis paragraphs, and more overall scrutiny will put them in a zero-tolerance situation. The need to walk the PCAOB gauntlet will continue to put pressure on fees and on the client/auditor relationship.

I haven't heard much from those of you in **the private company sector**, but you should not think you're exempt. These proposed regulations will have an overarching effect on how audit firms do business. Once implemented, the audit firms will apply the same processes and standards to all clients – regardless of whether the client is privately or publicly held.

Sounds like harsh days ahead, right?

Perhaps not.

While there's no denying that increased oversight has the potential to make client-auditor relationships more adversarial, I believe the new rules, if approached correctly, can actually stabilize the client-auditor environment – resulting in improved relationships, lower risks, a streamlined audit process and a minimum of late-breaking surprises. If implemented, I also believe that mandatory rotation of audit firms every five years will not have the cataclysmic effects some are predicting.

Let's focus first on what actions are needed for increased oversight to result in positive outcomes.

For starters, both parties need to understand the obligations and constraints that expanded oversight will impose on each other's respective roles and responsibilities. Then, each party needs to establish new processes to work within those obligations and restraints.

Clients and auditing firms that don't change how they work together will do so at their own peril. In order to achieve the kind of independence the PCAOB is demanding, audit firms will need to limit their services strictly to the audit process – with few to no gray areas. With audit services so narrowly defined, companies will be on their own in terms of preparing for the audit – no matter who the audit firm may be.

Let's be clear: This is not entirely new. As I've emphasized in previous newsletters, audit firms are in the business of reducing their risks and making sure their work stands up to review by outside regulators. It's why they were hired. Managing the audit for maximum efficiency is important but not their priority, and identifying/resolving accounting issues is not their principal responsibility – nor should it be. For the most part, the PCAOB's proposals reinforce these standards while diminishing opportunities for conflicts of interest.

All of the above said, the proposed restrictions will leave a gap in financial and accounting expertise that companies have historically looked to their audit firm to provide.

That's where a good consultant with Big Four experience comes in.

Because consultants are not auditors, they can offer clients advice and counsel without any conflicts of interest. On the non-audit side, they can determine the appropriate accounting treatment for complex business issues or identify current and future accounting implications and recommend on-going accounting treatment. On the audit side, they can help companies ensure their accounting processes and records are in order for an efficient audit and can review preliminary documents to avoid surprises.

Importantly, a good consultant can help a company understand complex or controversial positions their audit firm might take. At Blythe Global, we recently helped a company that had decided to fire their auditors because of a particular position. With no guarantee of what the

outcome would be, Blythe Global researched the issue in detail, determined the audit firm's position was correct and helped the company understand why it was correct. The company is still considering changing auditors, but they're doing so with better information.

The benefits that accrue to both parties when companies add a consultant into the mix are significant:

- Accounting processes are improved, and potential audit issues are addressed in a timely manner – resulting in lower risk for companies and auditors.
- Companies get the kind of expert advice they need at a reasonable (usually set) fee.
- Auditors are relieved of non-audit services. They maintain their independence but are secure in the knowledge that there's an expert level between them and their client.
- Client costs are contained because auditors stay within the scope of audit work.
- Audit firm profitability increases because client records are "audit ready" and auditors are not spending time on out-of-scope (and potentially non-billable) services.
- Relationships improve all around.

Let's turn now to the possibility of mandated five-year rotation of audit firms.

It's my view that this proposal will not lead to the disaster some see looming. Most critics are focusing on the institutional client knowledge a legacy audit team possesses and the familiarity between client and firm regarding processes. The reality is that audit firms rotate people all the time and they change processes regularly to stay current with new rules and regulations. Without minimizing the effects of changing auditors, I think this idea is worth considering – which is exactly what the PCAOB is doing right now. They have issued concept releases and are seeking comments.

Clearly, oversight is not going to lessen any time soon. When new rules are issued, wise clients and audit firms will make adjustments that are proactive and mutually beneficial – a business model that will serve them for the long term.

At Blythe Global Advisors, we have the experience to help navigate new rules and to fill the gap in financial and accounting expertise without conflict of interest. We'd be honored to help you.

**To discuss this important topic further
or if you're looking for general accounting advice and counsel,
contact marc@blytheglobal.com**

Here's a sample of the services we are currently providing to several clients.

- Assisting a public technology company evaluate alternatives for dealing with under-water stock options, including modeling the financial statement impact of different scenarios.
- Assisting an East Coast private equity firm with by-side due diligence related to a contemplated M&A roll-up transaction of three California-based businesses.
- Helping a financial services firm evaluate the accounting implications related to structuring a leasing arrangement with its customer using a special-purpose entity.
- Helping a public company respond to a comment letter received from the SEC related to its historical financial statements.

To learn more about Blythe Global Advisors and our solutions,
visit our web site at www.blytheglobal.com
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About Marc Blythe

As president of Blythe Global Advisors, Marc Blythe brings more than 23 years' experience advising companies of all sizes across all industries on their accounting and financial reporting requirements. His areas of expertise include revenue recognition, equity compensation, mergers and acquisitions/purchase accounting, restructurings/impairments, consolidations, lease accounting, derivatives and debt. Prior to forming Blythe Global Advisors, Marc was an audit partner at Ernst & Young.