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Office of the Secretary  
Public Company Accounting Oversight Board  
1666 K Street, N.W.  
Washington D.C. 20006-2803

**Re: Request for Public Comment: Concept Release on Auditor Independence and Audit Firm Rotation, PCAOB Rulemaking Docket Matter No. 037**

Dear Office of the Secretary:

The Center for Audit Quality (CAQ) is an autonomous public policy organization dedicated to enhancing investor confidence and public trust in the global capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues requiring action and intervention, and advocates policies and standards that promote public company auditors' objectivity, effectiveness, and responsiveness to dynamic market conditions. Based in Washington, D.C., the CAQ is affiliated with the American Institute of Certified Public Accountants.

The CAQ appreciates the opportunity to provide feedback to the Public Company Accounting Oversight Board's (the PCAOB or the Board) Rulemaking Docket Matter No. 037, "Concept Release on Auditor Independence and Audit Firm Rotation" (the Concept Release). This letter represents the observations of the CAQ, but not necessarily the views of any specific firm, individual, or CAQ Governing Board member.

**OVERALL COMMENT**

Independence, objectivity, and professional skepticism of independent auditors are foundations of a high quality audit and are essential to the public company auditing profession's primary function in the capital markets. The CAQ shares with the auditing profession, financial statement preparers, audit committees, regulators, and others the goal of continuously strengthening audit quality, and we believe there are a number of steps that can be taken to move us toward this shared goal. The auditing profession is committed to working with all stakeholders to continually improve audit quality and enhance the confidence investors and others place in the integrity of audited financial statements.

Recognizing that this is a concept release, we appreciate the PCAOB's efforts to seek additional consideration and input from the full range of stakeholders who will be significantly affected by any changes in this area, and believe the roundtables announced by the PCAOB are a good opportunity to do this. While we

explain in this letter our reasoning as to why mandatory firm rotation (MFR) is not a concept that will work to improve audit quality, and is in fact fraught with significant risks and unintended consequences, we also have similar concerns regarding some of the other concepts in the release. We anticipate future opportunities to more fully vet these concerns. In the meantime, we have articulated below several ideas that could advance the shared goal of continuous improvement in financial reporting and audit quality. We stress that these ideas are preliminary and that we are open and committed to fully exploring these and other possibilities for improving audit quality.

## I. ENHANCEMENTS TO AUDIT QUALITY

In 2002, the Sarbanes-Oxley Act (SOX) ushered in a host of reforms to protect investors by improving the accuracy and reliability of corporate disclosures. SOX established the PCAOB to oversee the public company auditing profession and granted the PCAOB standard setting, inspection, and enforcement authority. SOX placed significant new independence requirements on public accountants, including a requirement for lead and concurring partner rotation every five years. Moreover, SOX unequivocally assigned responsibility for overseeing the financial reporting process, including the hiring and firing of the independent auditor, to independent audit committees as the representatives of investors.

Since the passage of SOX, there have been numerous surveys and academic studies detailing the benefits derived from the Act.<sup>1</sup> For example, the CAQ's 2008 "Report on the Survey of Audit Committee Members" found that changes resulting from SOX had improved the level of engagement of audit committees. Nearly all of the audit committee members surveyed (99 percent) stated that, as a result of SOX, they devote more time to committee work, and roughly 90 percent stated they work more closely with independent auditors.<sup>2</sup> Additionally, the Securities and Exchange Commission's (SEC) 2011 "Study and Recommendations on Section 404(b)" concluded, "there is strong evidence that the auditor's role in auditing the effectiveness of Internal Control over Financial Reporting [ICFR] improves the reliability of internal control disclosures and financial reporting overall and is useful to investors."<sup>3</sup>

Since the adoption of SOX, audit firms have continued to improve their internal quality control systems, which are critical in reinforcing auditor independence, and the exercise of objectivity and professional skepticism. The objective of a system of quality control is to provide that the audit firm and its personnel are complying with professional standards and applicable legal and regulatory requirements. This objective is accomplished by individual audit firms through:

- Development of policies and procedures that promote an appropriate "tone at the top" and culture at the firm
- Establishment of policies and procedures to foster compliance with relevant ethical requirements and independence standards set out by the PCAOB, the SEC, and others
- Adoption of acceptance and retention policies that reduce the likelihood of the firm's association with a public company whose management lacks integrity
- Assignment of engagement team personnel in a manner appropriate to their skill and experience, including provision for appropriate supervision within the team
- Development of policies and procedures to provide that the design and execution of the audit engagement are appropriate

<sup>1</sup> See, *Sarbanes Oxley Effectiveness on the Earning[s]Management*, Rachel Ang (March 2007); *The Impact of Sarbanes-Oxley on Market Efficiency: Evidence from Mergers and Acquisition Activity*, Surya Chelikani & Frank D'Souza, *The International Journal of Business and Finance Research* (July 2011).

<sup>2</sup> *Report on the Survey of Audit Committee Members* [http://www.thecaq.org/newsroom/release\\_03182008.htm](http://www.thecaq.org/newsroom/release_03182008.htm) (March 2008).

<sup>3</sup> *Study and Recommendations on Section 404(b) of the Sarbanes-Oxley Act of 2002 For Issuers With Public Float Between \$75 and \$250 Million*, U.S. Securities and Exchange Commission, <http://www.sec.gov/news/studies/2011/404bfloat-study.pdf> (April 2011).

Audit firms also maintain internal monitoring and inspection programs to help provide that the policies and procedures relating to the system of quality control are adequate, are appropriately updated, meet changing conditions, and operate effectively. External regulatory inspections by the PCAOB also provide an assessment of the effectiveness of the quality control systems. PCAOB inspections assess the extent to which audit firms have designed, and adhered to, adequate quality control policies and procedures that address significant aspects of public company auditing, as well as the effectiveness of the firm's performance on specific audit engagements. These inspections help to drive improvements in firm quality control systems. While an audit firm's quality control system helps it perform according to applicable standards, audit firms should continuously assess whether more can be done to strengthen these systems to further reinforce auditor independence, objectivity, and professional skepticism.

Toward that end, the CAQ believes there are a number of potential enhancements that could be explored to further enhance audit quality, including the foundational elements of independence, objectivity, and professional skepticism, without the costs and unintended consequences associated with MFR. The CAQ notes that the considerations for audit firms would need to be evaluated in terms of their appropriateness for audit firms of all sizes, and whether they would be more appropriate for annually-inspected firms.

#### **a. Audit Firms**

##### *Improve Audit Firm Communication with Audit Committees*

The CAQ believes that effective communication between the audit firm and the audit committee is a critical element of the framework that supports high quality financial reporting and auditing. Audit committees have a significant responsibility for the integrity and reliability of the company's financial statements and the related financial reporting process. To fulfill this role, audit committees currently engage in discussions with independent auditors to better understand the auditor's evaluation of matters that are significant to the financial statements. We believe that auditors should continue to look for opportunities to enhance these communications for the benefit of the investing public. For example, auditors who currently do not, could at least annually update audit committees on general PCAOB matters, including Practice Alerts and Form 4010 reports. Auditors could also look for ways to have more meaningful conversations with their audit committees regarding PCAOB inspections of that engagement. Such conversations might include:

- Notifying the audit committee when the audit of the company is selected for inspection
- Communicating inspection findings and any additional steps or procedures being taken by the audit firm to resolve the findings
- Communicating any impact on audit procedures going forward

To further assist audit committees in understanding and evaluating financial reporting and auditing matters, the CAQ is working with the National Association of Corporate Directors and the Independent Directors' Council to consider the development of tools that could serve as a catalyst for discussion with the auditor. Such tools could highlight issues for the audit committee to consider as it monitors the audit process and assesses the independent auditor, and could help focus the audit committee on the most important areas for consideration. These discussions also could provide the audit committee with the opportunity to evaluate whether any changes to the company's financial reporting, internal control, or audit process may be appropriate. One potential tool could be a list of questions for the audit committee to consider in discussing inspection activities with the auditor. Potential questions could include the following:<sup>4</sup>

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<sup>4</sup> These questions are not intended to serve as a checklist of questions to be posed verbatim. Rather they are examples that could advance the dialogue between auditors and audit committees around certain key issues. It is important for audit committees to tailor and supplement these questions to fit the unique issues of the organization.

- On what areas of the audit is the PCAOB inspection focusing?
- How do these areas relate to the areas of the audit that you believe pose the greatest risk or might impact financial reporting?
- Has the PCAOB provided any comments during its inspection related to your audit of the company?
- What comments related to the audit of our company do you expect to be in Part I of your firm's inspection report?
- What is your response to the comments and are there any additional audit procedures required?
- Will audit procedures change going forward? If so, how?
- Were any deficiencies the result of a lack of auditor independence, objectivity, or professional skepticism?
- Was there an internal inspection of the same audit? If so, were the findings similar to the PCAOB's inspection findings?

We are supportive of initiatives to educate audit committees and better prepare them to have more comprehensive discussions with audit firms regarding the PCAOB's inspections and other relevant matters. We look forward to exploring ways in which we, along with other stakeholders, can further assist audit committees in their duties and better inform the public about the important efforts of audit committees on behalf of investors.

#### Review Human Resources Policies and Procedures

An audit firm's greatest asset is its people. As we explore ways to strengthen auditor objectivity and audit quality, it is important to consider the policies and practices that directly impact the people that conduct public company audits.

The profession spends tremendous resources on the continuing education of its people. At all levels, training is a critical component of developing and honing the skills of the professionals conducting audits. As the profession reviews the curriculum and materials for these programs (including supervision and review) it should assess how well independence, objectivity, and professional skepticism are ingrained in both course content and delivery. For example, assessing the appropriateness of the assumptions and models used by management to support its fair value estimates presents unique challenges, particularly in times of economic uncertainty. Experience-appropriate training on how to apply the concepts of objectivity and professional skepticism in evaluating management judgments is important to maintaining and enhancing audit quality.

The processes of goal setting and evaluating performance are also critical components in the development of audit professionals. At all levels, the skills and behaviors expected must be carefully and effectively communicated, and then evaluated. Independence, objectivity, and professional skepticism and their attendant skills should be explicitly included in the goal setting and evaluation processes for all audit professionals. Additionally, compensation practices for all audit professionals should reward behaviors that contribute to audit quality, and behaviors contrary to audit quality should be dealt with appropriately.

#### Enhance Audit Firm Transparency

Additional transparency related to firms' quality control and other internal processes and procedures can provide important information to audit committees who have a responsibility for assessing and evaluating the audit firm. Based on this information, audit committees would be in a better position to ask relevant questions that may, in turn, provide valuable feedback. Firms and audit committees should explore whether the information audit committees currently receive from the firm could be enhanced to further their oversight

of the independent auditor, including information about the auditor's systems and processes that underpin auditor independence, objectivity, and professional skepticism.

The New York Stock Exchange listing requirements require audit committees to receive annually a report from the independent auditor which contains certain information about the audit firm, including:

- Description of the firm's internal quality control system
- Statement concerning the firm's independence practices (description of written independence policies, training, and monitoring of compliance)
- Description of the firm's governance structure

These requirements might be a good starting point for considering whether additional firm information might be helpful to audit committees; however, consideration must be given as to whether this information might be provided by audit firms of all sizes, or whether this would be more appropriate for annually-inspected audit firms.

#### **b. Audit Committees**

Today's audit committee plays an essential role in the corporate governance framework. Its primary role is to assist the board of directors in overseeing the quality and integrity of the company's financial statements. In order to fulfill this responsibility, the audit committee oversees the company's management and the financial reporting process, the effectiveness of ICFR, the qualifications and performance of the internal audit function, and the qualifications, performance and independence of the independent auditor. In short, the audit committee is central to fostering the quality of the financial reporting process and protecting shareholder interests through its oversight of the audit process.

Prior to the implementation of SOX, the process for the selection and assessment of the independent auditor was often controlled by management. SOX mandated that the independent audit committee, not company management, be directly responsible for the appointment, compensation and oversight of the work of public company auditors – a change that notably enhanced auditor independence. In addition, the audit committee must pre-approve all audit and non-audit services performed by the external audit firm. To help provide that the audit committees performing those functions represent shareholders first and foremost, the listing requirements for exchange-traded companies prohibit the inclusion of company officers and/or consultants on an audit committee of listed companies and mandate that audit committee members be independent from management.

Because audit committees oversee the entire financial reporting process, they form a central point between the activities of company management, the internal auditor, and the independent auditor. As such, they play a critical role in our system of investor protection, and are best positioned to select, oversee, and evaluate the independent auditor. We believe that the role of the audit committee, like other roles in the financial reporting supply chain, should continue to be supported and strengthened, and that audit committees should be central to our collective efforts to continuously improve audit quality.

#### *Oversight of the Independent Auditor*

As noted, SOX charged audit committees with the important responsibility of overseeing the independent auditor. To further strengthen the audit committee's oversight of independent auditors on behalf of investors, we recommend that audit committees take an even more active role in certain activities related to their supervision of the independent auditor and describe these activities in the audit committee report.

- Participation in Selection of Successor Lead Audit Partner

While audit committees are not charged with selection of individual audit partners, we believe that audit committees should be actively engaged in this process where practical. For example, audit committees could participate in interviews with the proposed candidates and work with management to provide feedback to the audit firm regarding the selection of the engagement partner. Active participation in this process could help satisfy the audit committee regarding the competence and experience of the audit partner, and could include specific questions related to the auditor's application of objectivity and skepticism in prior engagements.

- Review of Audit Plan

The audit plan prepared by the independent auditor generally includes the auditor's assessment of risks related to the financial statements and the audit, the planned procedures to address those risks, milestones for completion, and resources available to execute the plan. A rigorous discussion between the audit committee and the independent auditor about the audit plan is an important part of the audit committee's oversight responsibilities. In many instances, this type of discussion occurs and contributes to the overall quality of the audit plan and the audit. Audit committees might consider enhancing their process for reviewing and challenging the audit plan so that they are better able to satisfy themselves, on behalf of their boards and investors, that the audit scope is adequate and sufficient under the circumstances.

- Audit Service Assessment

Assessing the services provided by the independent auditor is another important component of the audit committee's oversight of the financial reporting process. Protocols and processes for conducting such an assessment vary widely. We suggest that audit committees lead the process by which the audit firm and the lead audit partner are assessed, and that this process incorporate a review of compliance with independence requirements, as well as the application of objectivity and professional skepticism. The audit committee should own the results of the assessment and make sure that the audit firm is properly informed of the results and responds appropriately to any feedback. This process could inform the audit committee's decision to retain the audit firm.

#### Enhanced Audit Committee Communications to Investors

Currently, investors are provided with the information to understand how audit committees discharge their important duty to oversee the external audit through the audit committee report provided to shareholders. Greater transparency into this oversight process would provide investors with more confidence in the diligence of the audit committee in overseeing the company's financial reporting and audit processes. While many audit committee reports are robust and provide a clear lens into the oversight process, we believe there are areas that may deserve additional focus by some audit committees. For example, a more robust audit committee report could include the following information:

- Policies or practices used by the audit committee to address risks to the auditor's independence, objectivity, and professional skepticism
- Description of the audit committee's oversight of the accounting and financial reporting processes of the company, including the internal and external audit functions, and the nature, timing and extent of the communications between the audit committee and those functions
- Description of the process by which the audit committee discharged its duties with respect to evaluating the performance of the independent auditor, including the criteria the audit committee used

to determine whether to recommend the reappointment of the auditor or the appointment of a new auditor

This information can help form the basis for any shareholder votes on the appointment, or reappointment, of the external audit firm. We believe this enhanced reporting will provide not only greater transparency, but also increased discipline in these processes and communications. In addition, because the audit committee's responsibilities are so critical to investors' confidence in the financial statements and auditor's report, we suggest that the audit committee report be made available to investors in a more easily accessible way, such as on a company's website.

#### Strengthen Definition of "Financial Expert"

The existing corporate governance rules require that audit committees be composed of independent directors, at least one of whom qualifies as a "financial expert." The current definition of a "financial expert" allows professionals with executive experience to qualify as a "financial expert" even if they have limited accounting or auditing expertise.

As the complexity of financial reporting and auditing continues to increase, we believe that it is important for the audit committee to have a member with direct financial accounting or auditing experience. This detailed knowledge of accounting or auditing provides a basis for effective dialogue with the auditor on key audit areas, including estimates and judgments, and would better enable the audit committee to evaluate the performance of the auditor with respect to these matters. We suggest that the definition be re-evaluated to acknowledge these increasing complexities and include a framework of skill sets and experiences that would satisfy an increased requirement for accounting or auditing expertise.

#### **c. PCAOB**

##### Evaluate the Impact of the PCAOB's Standard-Setting Agenda

SOX established the PCAOB as the regulatory agency charged with oversight of the public accounting profession. The PCAOB was given significant authority to inspect public company audits, review audit firm quality control systems, sanction audit firms, and set public company auditing and related professional practice standards. In this capacity, the PCAOB represents the public interest and has both broad investigative and disciplinary authority over registered public company audit firms.

Since the passage of SOX, numerous standards have been implemented by both the SEC and PCAOB that directly (or indirectly) contribute to enhancing auditor independence, objectivity, and professional skepticism. Over the past two years alone, the PCAOB has approved nine Auditing Standards; all arguably focused on auditor objectivity and enhancing audit quality:

- **Auditing Standard No. 7, Engagement Quality Review (AS 7 or EQR)** – In July 2009, the Board adopted AS 7, that provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made, and conclusions reached, by the engagement team. AS 7 also serves as a safeguard against erroneous or insufficiently supported audit opinions and, accordingly, can contribute to audit quality. This standard was effective for EQRs of audits and interim reviews for fiscal years that began on or after December 15, 2009.<sup>5</sup>

<sup>5</sup> PCAOB Release No. 2009-004, Final Rule (July 28, 2009).

- **Auditing Standards No. 8 – 15, Risk Assessment, Planning & Supervision (AS 8 – 15)** – In August 2010, the Board adopted a suite of risk assessment standards that focused on enhancing the effectiveness of the auditor's assessment of, and response to, the risks of material misstatement in the financial statements. These standards were effective for audits of fiscal periods beginning on or after December 15, 2010.<sup>6</sup>

It is important to note the relationship between the timing of the PCAOB's inspection observations that the Concept Release describes as contributing to the Board's concerns, and the timing of the Board's recent standard-setting activity. Auditor performance during 2009—which forms the basis for the PCAOB's 2010 inspections and its 2011 reports—occurred largely prior to the effective date of these nine significant new professional standards that are likely to have an important effect on audit quality. Even more importantly, the PCAOB's inspections of fiscal year 2011 audits—the first audits that will have the full benefit of the new risk assessment, planning and supervision standards—have not yet begun.

In addition to recently adopted standards, the Board's current standard-setting agenda<sup>7</sup> includes several projects that are focused directly (or indirectly) on enhancing auditor independence, objectivity, and professional skepticism. For example, projects related to refining the current quality control standards, improving audit firm communications with audit committees, and assignment and documentation of firm supervisory responsibilities, all could be critical in the continuous enhancement of audit quality. We believe that the many recent and planned changes to PCAOB auditing standards, once implemented and in full effect, will be found to make considerable contributions to improved audit quality. Thus, we encourage the PCAOB to include in the deliberative process related to this Concept Release, an evaluation of the effectiveness of recent and planned standard-setting activities.

#### Analyze the Root Causes of Inspection Findings

As stated within the Concept Release, “the root causes of audit failures are complex and vary in nature and continue to be explored by the Board. The Board plans to deepen its understanding of root causes in upcoming inspection seasons.”<sup>8</sup> We believe that “root cause” analyses are critical in educating the auditing profession, audit committees, and investors as to the reasons behind the PCAOB's continued concerns with inspection findings. Toward that end, we suggest that the PCAOB consider sharing the results of its root cause analyses, through a Rule 4010 report, Practice Alert, or some other means. We also suggest that the Board consider an assessment of the positive aspects identified during inspections and identify representative “best practices” or positive steps taken by audit firms in improving audit quality.

We also believe that timely “root cause” analyses could assist the PCAOB in its standard-setting agenda. For example, an analysis of inspection results could reveal deficiencies related to particular auditing standards widespread across registered accounting firms. This could suggest areas where guidance might be needed, whether in the form of a Practice Alert or a formal standard setting project.

## **II. MFR DOES NOT APPEAR TO IMPROVE AUDIT QUALITY**

The Concept Release indicates it is aimed at the goal of improving the auditor's independence, objectivity, and professional skepticism, and we agree that these fundamental elements of audit quality must be continuously assessed and enhanced. We have concerns, however, with the Board's presumption that audit quality issues, defined as PCAOB inspection findings, would be remedied by MFR. While we are wholly

<sup>6</sup> PCAOB Release No. 2010-004, Final Rule (August 5, 2010).

<sup>7</sup> PCAOB Standard Setting Agenda, Office of the Chief Auditor (November 2011).

<sup>8</sup> Concept Release, page 6.

committed to improving audit quality, we do not see any evidence that MFR would result in direct and measurable improvements in audit quality, and we believe that such a mandate would have far-reaching, costly, and unintended consequences, not only for auditors and audit firms, but for public companies, audit committees, and investors.

The PCAOB's Concept Release acknowledges that the Board is currently unable to demonstrate that objectivity and professional skepticism are impaired by the tenure of the audit engagement. Several of our larger member firms also are unable to identify any positive correlation between auditor engagement tenure and whether audits inspected by the PCAOB received any written comments. Moreover, we are not aware of any credible empirical research demonstrating that longer audit firm tenure impairs auditor independence, objectivity, or professional skepticism. To the contrary, numerous academic studies have suggested that audit quality improves on longer tenured audits.<sup>9</sup> We believe it is imperative for the PCAOB to demonstrate that MFR would improve audit quality, before imposing such a significant and costly change on public companies and audit firms.

We also note that there are many existing factors that already limit the tenure of the engagement team and company management. In addition to the natural turnover within the audit engagement team, due to staff attrition and promotion, current independence requirements require lead audit partners and engagement quality control review partners to rotate every five years. Certain other partners involved with a company's audit must be rotated after seven years. Moreover, there is a similar natural turnover of public company CFOs and CEOs. As detailed in a Crist/Kolder Associates 2011 study on executive management volatility,<sup>10</sup> from January 1, 1995 through July 31, 2011, the average CFO and CEO tenure within the S&P 500 was 5.1 and 6.8 years respectively. We believe that the factors described above already limit the length of the relationships between the engagement team and company management and stifle any opportunity for "coziness" between the auditor and the company's senior management team.

### III. POTENTIAL UNINTENDED CONSEQUENCES FROM MFR

The CAQ is not aware of any evidence that MFR improves audit quality or otherwise benefits investors. In fact, some studies show that MFR could have unintended consequences that ultimately *reduce* audit quality and increase costs for public companies.

#### a. Impact on Audit Quality

We agree that independence, objectivity, and professional skepticism are vital to the execution of high quality audits; however, they are not the only factors that affect audit quality. For example, audit quality depends also on the auditor's skill and experience, the soundness of the audit methodology, the effectiveness of the audit tools used, the adequacy of technical support, and even the quality of the auditing standards.

It is important that these drivers of audit quality be considered in the aggregate, and not in isolation when examining the potential impact of MFR. For example, in attempting to address the Board's concerns related to independence, objectivity, and professional skepticism by imposing MFR, the PCAOB could impair the profession's ability to develop and retain specific competencies, such as industry expertise. This could have a detrimental effect on audit quality since industry expertise is a key driver of audit quality, according to

<sup>9</sup> See, *Auditor Tenure and Perceptions of Audit Quality*, The Accounting Review, Vol. 8, No. 2. Ghosh and Moon (2005); *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?* Mara Cameran, Annalisa Prencipe, and Marco Trombetta (Working Paper 2008); *Mandatory Audit Firm Rotation and Audit Quality*, Andrew B. Jackson, Michael Moldrich, and Peter Roebuck (July 2007).

<sup>10</sup> *The Volatility Report 2011*, Crist/Kolder Associates, pages 24 – 25 (<http://www.cristkolder.com/VolatilityReport2010.pdf>)

research on this subject.<sup>11</sup> MFR could also affect the profession's ability to attract and retain talent, which would have an obvious impact on audit quality. These and other potential unintended consequences are discussed more fully below.

#### Limits the Audit Committee's Ability to Determine the Best Audit Firm for the Company

Audit committees have a statutory responsibility to oversee the external audit process, including the selection of the appropriate audit firm to conduct the audit. Forcing rotation of the existing auditor reduces the choices available to the audit committee. Moreover, MFR eliminates from the audit committee's choice the one firm that the audit committee previously decided was best able to provide the audit services needed by the company. This will constrain audit committees in their selection of audit firms that are able to provide the highest quality audit in the most efficient way.

This lack of choice could be exacerbated by other constraints, such as independence restrictions that would prevent some firms from being eligible to conduct the audit. Other constraints could include the geographical reach, proximity, expertise, and specialization of available audit firms.

As a result of these constraints, MFR may force an audit committee to select a firm that may not be best suited to meet the company's audit requirements. Or the company could be forced to change some or all of its other financial service providers (e.g., tax advisor) to comply with existing independence requirements. The time and resources required to manage all of these transitions would be significant, with no demonstrable benefit.

#### Causes Loss of Institutional Knowledge and Experience

The audit firm's ability to develop an understanding of a company's operations is critical in performing an effective audit. Institutional knowledge and experience is cumulative, and as an audit firm's knowledge increases over time, the auditor's ability to efficiently perform an effective audit improves. MFR would hinder this accumulation of knowledge and experience, which could impact audit quality. Various academic studies have also concluded that audit quality suffers when the auditor lacks a solid base of experience and understanding of a public company's business.<sup>12</sup>

MFR also could be particularly disruptive for multi-national engagements. The transactions and structures of multi-national companies, along with the various accounting standards and regulations governing them, have increased in complexity. This requires the auditor to develop or retain significant specialized expertise. For these types of audits, the loss of institutional knowledge and experience resulting from MFR would be severe. This loss of knowledge would present a material cost to the company and to the capital markets. Additionally, staggered MFR terms in various countries could create additional inefficiencies and present severe logistical challenges for multi-national audit engagements.

<sup>11</sup> See, *Audit Quality Attributes, Client Size and Cost of Capital*, Guy D. Fernando, Randal J. Elder, and Ahmed M. Abdel-Meguid (April 2008); *Auditor Industry Specialization and Earnings Quality*, Steven Balsam, Jagan Krishnan, and Joon S. Yang (September 2003); *Auditor Industry Specialization, Auditor Changes, and Accounting Restatements*, Accounting Horizons, Vol. 22, No. 4, Robin N. Romanus, John J. Maher, and Damon M. Fleming (2008); *Earnings Quality: Some Evidence on the Role of Auditor Tenure and Auditors' Industry Expertise*, Ferdinand A. Gul, Simon Yu Kit Fung, and Bikki Jaggi (March 2009).

<sup>12</sup> See, *A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy*, SDA Bocconi University (Milan-Italy) M. Cameran, M. Livatino, and N. Pecchiare A. Viganò (2003); *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge*, Bin Srinidhi, Sidney Leung, and Ferdinand A Gul (April 2010); "Required Study on the Potential Effects of Mandatory Audit Firm Rotation" GAO Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services (November 2003).

Companies do voluntarily change auditors from time to time, and auditors and companies do manage these transitions. However, there are significant differences between voluntary audit firm rotation and MFR. For example, when an audit committee decides to change auditors, it has generally weighed the costs and benefits of this decision and stands prepared to invest company resources in evaluating and identifying the new audit firm and informing the new auditor about the company's operations and accounting policies and practices. If, however, auditor rotation is mandated, there could be circumstances where the company under-invests in this effort, perhaps because of competing demands on corporate resources, such as a major financing transaction. This could put additional strains on the audit committee, as it would need to be especially vigilant in ensuring that management was committing the necessary resources to working with the new auditor.

Academic research has also suggested the potential for higher audit risk during the first year of the audit engagement.<sup>13</sup> Companies and auditors currently manage these risks with voluntary changes in audit firms, but there is an incremental effort to doing so. Sharply increasing the rate of auditor rotation would cause an increase in this effort, with no indication that commensurate benefits would accrue to the company or investors, or that audit quality would improve.

### Limits Auditor Specialization

Many audit firms have established professional practices in certain market sectors in which the audit firms develop and maintain specialized expertise. This expertise is vital to the execution of high quality audits, especially in complex industries and accounting areas.<sup>14</sup> MFR could hinder this knowledge development and limit firms' ability to provide high quality audits. For example, if an audit firm specializing in a particular industry is forced to rotate from an engagement without a similar specialized engagement to take its place, the audit firm could be limited in its ability to maintain this specialized industry expertise.

MFR would introduce a serial churn in the profession at a rate which is well above the organic rate. This would likely impair the ability of firms that previously specialized in certain industries to continue to do so, as MFR would eliminate a sizable block of potential audit engagements for several years at a time. Reducing the ability of the profession to develop and maintain specialized expertise would reduce audit quality, to the ultimate detriment of public companies and their investors.

Some have argued that MFR could encourage more specialization as firms attempt to distinguish themselves from the competition. We believe the opposite would occur. In order for the market to support incremental investment in specialization, companies must be able to differentiate between audit firms. However, the concept of MFR rests on a faulty premise that audit firms provide commoditized services and can be switched out quickly with no impact on the quality or cost of the service. By promoting this faulty premise, MFR could, in fact, reduce market demand for specialization and, in turn, reduce investment in specialization, creating a cycle that is detrimental to audit quality.

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<sup>13</sup> *Audit Firm Tenure and Fraudulent Financial Reporting*. Auditing: A Journal of Practice and Theory, Vol. 23, Issue 2. Carcello, J.V. and Nagy, A.L. (September 2004).

<sup>14</sup> See, *Earnings Quality: Some Evidence on the Role of Auditor Tenure and Auditors' Industry Expertise*, Ferdinand A. Gul, Simon Yu Kit Fung, and Bikki Jaggi (March 2009); *Auditor Tenure and Audit Quality: The Role of the Demand for Unique Client Specific Knowledge*, Bin Srinidhi, Sidney Leung, and Ferdinand A Gul (April 2010); *Does auditor tenure improve audit quality? Moderating Effects of Industry Specialization and Fee Dependence*, Chee-Yeow Lim, Singapore Management University, and Hun-Tong Tan (September 2009).

### Creates Resource Strains

MFR would increase the number of audit firm transitions, which could strain existing company, audit committee, and audit firm resources. New audit engagements typically require higher levels of firm resources to help provide the audit firm with an understanding of the company's business and operations. New engagements also require access to an array of company personnel to assist the audit firm in understanding the company and its environment, including ICFR. Audit committees need to spend time soliciting proposals from several firms, reviewing proposals for the audit, and overseeing the auditor transition. Overall, the level of resource commitment for a new audit engagement is increased for all parties involved.

When an audit transition is initiated voluntarily in the normal course, there are benefits associated with the change, which are balanced against the costs. MFR provides no such balance and will strain company resources with no known demonstrable benefit.

### Limits Ability to Attract and Retain Talent

The U.S. Department of the Treasury's Advisory Committee on the Auditing Profession stated in its 2008 report, "To ensure its viability and resilience and its ability to meet the needs of investors, the public company auditing profession needs to continue to attract and develop professionals at all levels who are prepared to perform high quality audits in this dynamic environment."<sup>15</sup> We agree that audit quality is enhanced by the audit firms' ability to attract and retain high-quality professionals to conduct audits, particularly within highly specialized industries. MFR could impact audit firms' ability to attract and retain this talent pool, as forced rotation could result in higher attrition of staff that leave for other professions and could make the profession a less attractive career choice to potential new public company auditors. Higher attrition could result from diminished clarity related to potential career paths (e.g., ability to specialize in a certain industry), as well as from accelerated staff rotation across companies, industries, and geographic locations.

The public company auditing profession already faces significant challenges in attracting and developing professionals at all levels to perform high quality audits. We believe MFR will only add another challenge in attracting and developing professionals within the auditing profession, again with no demonstrable benefit.

### Could Increase Audit Market Concentration

The Concept Release suggests that MFR could "operate as a catalyst to introduce more dynamism and capacity into the audit market." The CAQ fears the opposite could occur – that MFR could lead to increasing concentration, decreasing the number of auditors competing for new engagements.<sup>16</sup>

As noted at the PCAOB's November 2011 Standing Advisory Group meeting, MFR could cause some audit firms with smaller public company audit practices to abandon their public practice and focus instead on private company audits.<sup>17</sup> This shift from serving the public company market could occur if some smaller audit firms are not able to absorb the additional administrative and financial burden associated with MFR, including the costs of tendering, transitioning, and developing and maintaining additional expertise to compete for new engagements. This detrimental impact on small business is an unintended consequence that the PCAOB must consider carefully. Some multi-disciplinary firms could abandon their public company

<sup>15</sup> Advisory Committee on the Auditing Profession, Final Report, Section VI Human Capital, VI:1, <http://www.treasury.gov/about/organizational-structure/offices/Documents/final-report.pdf> (October 2008).

<sup>16</sup> *Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market*. Soo Young Kwon, Young Deok Lim, and Roger Simnett (November 2010).

<sup>17</sup> PCAOB, Transcript Excerpt: Standing Advisory Group Meeting, [http://pcaobus.org/Rules/Rulemaking/Docket037/11092011\\_SAG\\_Independence\\_Transcript.pdf](http://pcaobus.org/Rules/Rulemaking/Docket037/11092011_SAG_Independence_Transcript.pdf) (November 9, 2011).

audit practice in favor of providing non-audit services to public companies. This dynamic, much like the impact on smaller audit firms described above, would also have a detrimental impact on the composition and quality of the audit market.

#### **b. Increased Costs and Disruption**

The Concept Release acknowledges concerns that MFR could “risk significant costs and disruption” to the capital markets.<sup>18</sup> Since we currently do not operate in an environment of mandatory firm rotation, obtaining an accurate picture of potential costs to relevant parties in the United States is obviously challenging. The Concept Release cites the 2003 Government Accountability Office’s “Required Study on the Potential Effects of Mandatory Audit Firm Rotation” which estimates that under an MFR environment, initial year costs associated with the provision of audit services could increase by at least 20 percent for the audit firms, and audit selection costs and audit support costs could increase by at least 17 percent for public companies.<sup>19</sup> While we have begun to think about the potential costs and disruptions of MFR in today’s environment, and outlined several major considerations below, it would be imperative for the PCAOB to obtain a more current and comprehensive impact analysis prior to any movement to adopt a proposal as far-reaching as MFR.

##### Public Companies

A company must devote resources to the selection of a new audit firm. These efforts could result in costs associated with designing and responding to requests for proposals, holding meetings between various company and audit firm representatives (both domestically and internationally) to provide information that would allow the submission of meaningful proposals, and any other processes necessary to evaluate and select a new audit firm.

Once an audit firm is selected, there is additional time and cost associated with educating the new audit firm regarding the public company’s business. This includes providing the firm with an orientation to the company’s operations both domestically and abroad, accounting systems and records, internal control systems and procedures, and accounting methodologies. Such activities require company personnel and board and audit committee members to devote significant time and effort to the external audit function and activities in order to maintain audit quality. These costs always occur with a change of auditor, but are considered by the audit committee in the context of the expected benefits of the change; the costs are not arbitrarily imposed.

MFR also could increase the company’s costs for non-audit services. Many public companies use the same firm to provide audit and tax services, which generates obvious synergies and cost savings. When companies are forced to rotate their auditor, they also may be forced to change non-audit service providers. Large multinational companies may be using each of the largest four audit firms for a different service, and MFR could cause a simultaneous rotation of several service relationships. In these cases, MFR could cause a substantial increase in other costs not directly related to the financial statement audit.

##### Audit Firms

From an audit firm’s perspective, there are significant time commitments associated with undertaking a new audit engagement, including gaining an understanding of the new public company, reviewing the predecessor audit firm’s working papers, educating the audit staff about the company’s business, industry, financial systems, internal controls, and complex accounting transactions. This typically results in a larger number of

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<sup>18</sup> Concept Release, page 3.

<sup>19</sup> Ibid, page 14.

audit planning hours and audit hours overall, which would increase audit costs and could increase audit fees to public companies.

Additionally, as tenure periods expire due to MFR, audit firms will incur the expenses associated with business development and proposal preparation on a regular basis. For major, multi-national audits, these are not insignificant costs. Developing or acquiring experienced staff to position a firm to be able to demonstrate competencies in a given industry sector in which they do not currently have sufficient expertise would increase costs. Having to relocate staff to provide coverage in certain geographies for new or potential audit engagements imposes a cost on firms that they might not have chosen to incur were it not for MFR. This would also take a toll on audit staff, and further impair the profession's ability to attract and retain talent.

#### Impact on Confidence in the Capital Markets

Costs and disruptions to public companies could be more severe during periods in which a public company is going through a significant event such as a corporate financing, merger, acquisition, corporate restructuring, implementation of new financial reporting requirements, bankruptcy, or significant turnover of management. If the company is forced to change auditors during such an event, corporate resources could become stretched and affect the ability of the company to appropriately deal with the event. The mounting costs described above could raise the cost of capital for U.S. companies, and if audit quality deteriorates as a result of MFR, investor confidence in U.S. companies could suffer.

\* \* \* \* \*

Auditor independence, objectivity, and professional skepticism are critical to the execution of high quality audits. The CAQ is continuously exploring ways to improve audit quality and is working actively with other stakeholders toward this goal. We believe that a holistic approach that examines opportunities for improvement in the roles and responsibilities of all members of the financial reporting supply chain will best meet the needs of investors and other stakeholders. We encourage the Board to consider the ideas we have put forth in this letter that we believe will advance our shared goals of continuously improving financial reporting and audit quality.

As noted above, we are not aware of any indication that MFR would improve audit quality. In fact, MFR is likely to harm audit quality and generate other unintended consequences. It is vital that the Board carefully consider these consequences and their impact on public companies, audit committees, audit firms, and investors before taking further action.

We appreciate the opportunity to comment on the PCAOB's Concept Release and welcome the opportunity to offer our views on ways to enhance auditor independence, objectivity, and professional skepticism, which are central to the role that auditors play in the capital markets. We also welcome the opportunity to work with the PCAOB staff and stand ready to assist the PCAOB in any way we can.

Sincerely,



Cynthia M. Fornelli  
Executive Director  
Center for Audit Quality

cc:

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Daniel L. Goelzer, Board Member  
Steven B. Harris, Board Member  
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