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

**PCAOB Rulemaking Docket Matter No. 37**  
***Concept Release on Independence and Mandatory Audit Firm Rotation***

Dear Mr. Secretary:

KPMG LLP is pleased to submit our comments on the Public Company Accounting Oversight Board's (the "PCAOB" or the "Board") Release No. 2011-006, *Concept Release on Auditor Independence and Audit Firm Rotation* (the "Concept Release"). We welcome the opportunity to work with the Board and other stakeholders to identify measures that will reinforce auditor independence, objectivity, and the appropriate application of professional skepticism in furtherance of serving the public interest and increasing investor protection.

Independence, objectivity, and professional skepticism comprise the bedrocks of audit quality and are fundamental to the future of the auditing profession. It is of utmost importance to our future as a firm and to the profession that the public maintains confidence in the independence and objectivity of external auditors, and in the quality and value of independent audits. We have strong confidence that our professionals demonstrate a mindset of independence and objectivity in the execution of their professional responsibilities.

Considerable progress has been made over the last decade in enhancing audit quality and strengthening auditor independence and objectivity. These changes have included the strengthening of corporate governance systems to oversee financial reporting and the audit process, global proliferation of effective independent regulatory oversight of audit firms, and improvements to professional standards. All of these enhancements have improved the general level of audit quality. However, we believe that more can be done by the profession and other stakeholders to reinforce auditor independence, objectivity, and professional skepticism. We



further believe that there are alternatives to mandatory audit firm rotation that will better serve this goal.

We do not support mandatory audit firm rotation as it could potentially harm audit quality. The potential effect on audit quality should be the indispensable criterion for evaluating any proposed changes.

As the Board notes, the significant reforms put in place under the Sarbanes-Oxley Act (the “Act”) of 2002 “have enhanced auditor independence and along with it, the reliability of financial reporting.”<sup>1</sup> The architecture created by the Act, which is comprised of independent oversight of the public auditing profession by both the Board and audit committees and rules limiting the tenure of all audit partners, provide powerful incentives for auditors to maintain the required independence in mental attitude when conducting audits. This architecture and set of incentives underpin the efforts of KPMG to reinforce in our people the critical need for independence, objectivity, and professional skepticism.

Some of the measures we support that would improve the existing architecture are summarized below. It is important to note that a number of these suggestions have already been implemented by many auditors and audit committees, but have not been consistently adopted across all public companies.

- The auditor providing information to the audit committee that would enable it to better assess the auditor’s objectivity and skepticism.
- Developing best practices or protocols around auditor communications with the audit committees regarding Board inspections.
- The auditor providing the audit committee with the audit plan for review, discussion, and approval.
- The auditor providing information to the audit committee that would allow it to select and continuously review lead engagement partners.
- The auditor providing all public company audit committees with information on the auditor’s internal system of quality control as well as the result of any external reviews.
- A more consistently robust audit committee report to shareholders.

***I. Existing Measures that Reinforce Auditor Independence, Objectivity, and Professional Skepticism***

Auditor independence, objectivity, and professional skepticism are all critical to audit quality. For auditors to fulfill their role in applying professional skepticism to provide reasonable

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<sup>1</sup> PCAOB Release No. 2011-006 (Aug. 16, 2011) at 5.



assurance that the financial statements, taken as a whole, are free of material misstatement, they must be independent of management and be able to perform their tasks with an objective perspective. In this way, auditor independence and objectivity support professional skepticism. We agree with the PCAOB's characterization that the "auditor's ability to exercise 'professional skepticism'" is one measure of an auditor's "independence in mental attitude."<sup>2</sup> This "independence in mental attitude" is a fundamental mindset that all auditors must embrace on every audit.

In 2002, the Act provided additional and powerful incentives to ensure that all of those involved in financial reporting use best efforts to maintain high quality financial reporting and auditing practices. In terms of auditing, the Act had two broad goals: (1) to strengthen the role of audit committees in overseeing auditors and the audit process; and (2) to create the PCAOB to oversee public company auditing. The reforms of the Act are particularly relevant in the context of the Concept Release because they were designed primarily to strengthen auditor independence and restore the public's confidence that the right incentives were in place to align the interests of auditors and audit committees with those of investors. Such reforms include the following.

- Requiring audit committees to be independent of management, have at least one member who is a "financial expert" or explain why they do not, and making the audit committee directly responsible for appointing the auditor, pre-approving all audit and non-audit services, and determining the auditor's remuneration.
- Replacing a system of self-regulation of auditors with independent regulation via the Board, including a system of regular external inspections.
- Authorizing the Board to set the professional standards for public company audits.
- Promulgating significant reforms aimed at enhancing auditor independence, including mandatory partner rotation requirements.<sup>3</sup>

#### **A. Independent Audit Committee Oversight**

A fundamental objective of the Act is to strengthen corporate governance by enhancing the role of the audit committee. The Act elevated the role of the audit committee by delegating to the committee specific duties for overseeing financial reporting and auditing that previously had been the responsibility of the full board. The Act makes the audit committee directly responsible for the appointment, compensation, and oversight of the auditor, including resolving disagreements between the auditor and management.<sup>4</sup> If an audit committee concludes that the

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<sup>2</sup> PCAOB Release No. 2011-006 (Aug. 16, 2011) at 4.

<sup>3</sup> Lead audit engagement partners and the engagement quality review partners are required to rotate off of engagements every five years. Act § 203; 17 C.F.R. §210.2-01(c)(6)(A)(1). Audit partners other than the lead and engagement quality review partners must rotate off an audit engagement after seven years. 17 C.F.R. §210.2-01(c)(6)(A)(2).

<sup>4</sup> Act §301.



audit firm is not performing an effective audit or is condoning unacceptable accounting or disclosure practices, the audit committee can terminate the relationship. The audit committee has the authority under the Act to choose the best external auditor for the job.

Audit committees have a duty, after holding discussions with management and internal and external auditors, to determine whether to recommend to the board of directors that the financial statements be included in the annual report.<sup>5</sup> Challenging management's choices of critical accounting policies and assumptions that inform key judgments and estimates is essential for audit committees to effectively discharge this duty.

Auditor communications with audit committees support the audit committee's role in managing the work of the auditors and overseeing financial reporting by keeping the audit committee informed. Pursuant to the Act, Securities and Exchange Commission ("SEC") rules, PCAOB standards and rules, and, for certain public companies, listing standards, the auditor provides specific information to the audit committee for review and discussion. For example, the Act and SEC rules require the auditor to discuss with the audit committee critical accounting policies and practices; all alternative treatments of financial information that have been discussed with management; the ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the auditor; and other material written communications between the auditor and management.<sup>6</sup> PCAOB standards require, to the extent not included in the above, discussion of management judgments and accounting estimates, audit adjustments, uncorrected misstatements aggregated by the auditor, the auditor's judgments about the quality of the entity's accounting principles, and difficulties encountered in performing the audit, among other things.<sup>7</sup> Additionally, PCAOB rules require specific communications with the audit committee concerning independence and, if applicable, the effect of the provision of any potential permissible non-audit services on the auditor's independence.<sup>8</sup> The Board proposed revisions to its standards on auditor communications with audit committees and intends to issue a revised standard in the second quarter of 2012. We support the Board's objectives reflected in the proposal to enhance the relevance and effectiveness of the communications between the auditor and the audit committee and to emphasize the importance of effective, two-way communications between the auditor and the audit committee. A well-informed audit committee is better able to carry out its role of overseeing the financial reporting process and the auditor.

The listing rules of the New York Stock Exchange (the "NYSE") also require the audit committees of listed companies to obtain a report from the auditor about its internal quality control procedures, and any material issues raised by the most recent internal quality-control review, or by any inquiry or investigation by governmental or professional authorities, within the

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<sup>5</sup> 17 C.F.R. §229.306 (a)(4).

<sup>6</sup> Act §204; 17 C.F.R. §210.2-07. See also, SEC Release No. 33-8183.

<sup>7</sup> AU §380, *Communications with Audit Committees*.

<sup>8</sup> PCAOB Rules 3524, 3525, and 3526.



preceding five years, respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues.<sup>9</sup>

These communications mandated by the SEC, PCAOB and the NYSE provide a basis upon which audit committees can evaluate an auditor's qualifications, performance, and independence.

Additionally, SEC rules provide that certain information about the audit committee's interaction with its auditor must be disclosed to shareholders. Among other things, the committee must state whether it has done the following:

- reviewed and discussed the audited financial statements with management;
- discussed with the independent auditors the matters related to the conduct of the audit that are required to be discussed pursuant to the auditing standards of the Board (*i.e.*, AU §380);
- received the written disclosures and the letter from the independent auditor as required by the Board, confirming the auditor's discussions with the committee concerning the auditor's independence and that these matters were discussed with the auditor; and
- recommended to the board of directors that the audited financial statements be included in the company's annual report.<sup>10</sup>

## **B. Independent Regulatory Oversight**

The establishment of the Board and the introduction of regular external inspections of public company audit firms under the Act have resulted in fundamental and positive changes to audit firm oversight and improvements in audit quality. In particular, the Board's inspection program further incentivizes auditor independence, objectivity, and professional skepticism by providing the possibility that a pair of "fresh eyes" will review the audit work. The Act also charges the Board with the responsibility and authority to set auditing standards, including those covering firm quality controls, ethics, and independence.

Some recent standards adopted by the Board include AS No. 7, *Engagement Quality Review*, which became effective for 2010 quarterly reviews and year-end audits, and AS Nos. 8-15, *Risk Assessment Standards*, which are effective for 2011 audits. Board members have indicated that they expect these standards to significantly benefit investors through improved audit quality. The Board also has issued a number of Staff Practice Alerts. Many of these new requirements bear directly or indirectly on auditor objectivity and professional skepticism. Additionally, we understand that the Board plans to propose new quality control standards in the third quarter of 2012. The quality control standards address, among other things, requirements for maintaining independence, exhibiting professional skepticism, and monitoring compliance with auditing

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<sup>9</sup> NYSE Listed Company Manual § 303A.07(a)(b)(iii)(B).

<sup>10</sup> 17 C.F.R. §229.407(d)



standards. Amendments to the quality control standards will likely relate directly to the objectives and concerns the Board cites in the Concept Release.

### **C. Internal Oversight**

Independence and objectivity are essential to professional skepticism, but there are other drivers that bear on one's ability to exercise this skepticism, such as competence and the personal qualities and traits of individual audit partners and staff. The need for the auditor to consider all evidence and not be satisfied with evidence that is less than persuasive is the core to any audit. In our opinion, the evaluation of audit evidence is predicated on the auditor having the necessary technical skills and an appropriate understanding of the business being audited as well as being impartial, inquiring, and free from external pressures brought on by tight deadlines or management expectations. Additionally, we believe that the practical application of skepticism requires judgment and will vary according to circumstances.

Our audit professionals understand that their central role is to independently challenge, in an efficient and effective way, the accounting and financial reporting decisions of the companies we audit. We have confidence that every day our people approach their duties with a high degree of objectivity and skepticism.

KPMG has invested considerably in ensuring that our policies and processes, audit methodology, and quality assurance programs increase our auditors' abilities to provide quality, independent audit services. Our efforts to reinforce independence, objectivity, and professional skepticism are consistent with and complementary of the framework of corporate governance mechanisms, independent regulatory oversight and professional standards promulgated by the Act and the Board.

Of particular note is our Quality Performance and Compliance Review Process ("QPCP"), wherein individual partners' performance on audit engagements is evaluated at least once every three years, and managers are subject to review as well. Our internal inspection processes are led by a central, full-time review team that is comprised of partners and managers, supplemented by other individuals with applicable industry and technical knowledge. We review these engagements to monitor adherence to our policies and processes, which are based on the professional standards, including those designed to reinforce independence, objectivity, and professional skepticism. We use the results to build training that communicates to audit professionals common inspection findings, those areas where audit quality can be improved, and applicable guidance. The results of the process are communicated to KPMG's board of directors via its Professional Practice, Ethics and Compliance Committee. Any less-than-satisfactory ratings received by partners and managers in our internal inspection process are considered in their performance rating and compensation reviews.



## ***II. Potential Actions that Could Be Taken by the Firms and Others To Strengthen the Framework that Underpins Independence, Objectivity, and Professional Skepticism***

As noted above, a considerable amount of progress has been made over the last decade in enhancing audit quality, but we believe that additional actions could be taken that will more effectively address the issues raised by the Board in the Concept Release than mandatory audit firm rotation.

Within the existing framework, which we believe is the appropriate model, audit committees have significant responsibility for assessing the auditor's performance. Audit committees are essential to effective corporate governance and are best placed to make decisions on what is in investors' best interests. We suggest consideration of the following enhancements, aimed at increasing the information and resources available to audit committees, which could, in turn, increase their ability to monitor auditor performance and gauge audit quality. A number of the suggestions below have already been implemented by many auditors and audit committees, but have not been consistently adopted across all public companies.

- Audit Committee Assessment of Auditor Objectivity and Professional Skepticism – Auditors could be required to provide information to audit committees that would allow them to undertake a focused evaluation of the auditor's objectivity and skepticism. One way this could potentially be accomplished is by providing the audit committee the results of any relevant internal quality control review. Contemporaneously, a framework could be developed to assist auditors in understanding what information may best assist audit committees in assessing the strength of their auditors' skepticism and objectivity. Such a framework might include, for example, a communication to the audit committee by the auditor that focuses on the financial statement assertions involving the highest degree of judgment and measurement uncertainty, with an evaluation by the auditor of the risk and the auditor's responses to such risk, which would specifically include discussion of the persuasiveness of the audit evidence the auditor obtained.
- Auditor Communications with the Audit Committee on Board Inspections – We understand that the Board may be considering publishing guidance to help committees better understand Board inspections. We support this project. We believe that it is important that audit committees understand and appreciate the role that the Board's inspections program plays in assuring audit quality and how audit committees should view Board inspection observations as part of their overall process for evaluating the performance of the auditor. We believe that audit committees can use Board inspection results to better understand areas of audit risk the Board has identified, discuss those areas with the auditor to determine whether and to what extent those risks are present in the context of the client company's financial reporting, and become knowledgeable of what actions the independent auditor is taking to manage those risks. Auditors could be required to provide information to audit committees that would allow them to strengthen their knowledge of the Board's inspection process and make it a





more meaningful part of the audit committee's oversight of the audit. Contemporaneously, a framework or guidance could be developed for discussions between the audit committee and the auditor when the company's audit is the subject of a Board inspection, which could include disclosure by the auditor of critical questions raised by the Board and the auditor's responses to them.

- Audit Committee Review of the Audit Plan – We suggest a more formalized process by which the auditor is required to provide the audit plan to the audit committee for review, discussion and acceptance, with appropriate input from management. The audit plan prepared by the 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 auditor about the audit plan is an important part of the audit committee's oversight responsibilities. In our experience, this type of discussion already occurs in many instances and contributes to the overall quality of the audit plan and the audit. Formalizing the process will help ensure that the audit committee, on behalf of the board of directors and investors, is satisfied that the audit scope is adequate under the circumstances.
- Lead Engagement Partner Evaluation – Auditors could be required, prior to a required lead engagement partner rotation, to provide the audit committee with information on potential successor lead engagement partners that would be sufficient to allow the committee to be actively engaged with the audit firm on the selection of the replacement lead engagement partner. Auditors could be required to allow the audit committee to participate in interviews with proposed candidates and provide feedback to the audit firm on the final selection of the new lead engagement partner. Auditors also could be required to support the audit committee in continuously assessing the performance and suitability of the lead engagement partner through private sessions with the partner during audit committee meetings. We currently employ a number of these practices with many of our audit clients. Formalizing the process and making it a requirement will help to ensure that shareholders of all public companies can have the same expectation regarding the level of involvement the audit committee has in the selection of the lead engagement partner.
- Information on Quality Controls – Auditors could be required to provide a report to the audit committees of all of their public company clients about their audit firm's internal quality control procedures, and any material issues raised by the most recent internal quality control review or by any inquiry or investigation by governmental or professional authorities respecting one or more independent audits carried out by the firm, and any steps taken to deal with any such issues. Although this information already is provided to many of our audit clients due to the applicability of the NYSE listing requirements, a Board requirement that the information be provided could help to assure shareholders that audit committees of all public companies have the same information on which to evaluate matters that may bear on the professionalism and objectivity of auditors.





- A Consistently Robust Audit Committee Report to Shareholders – We believe that making audit committees’ reports more consistently robust by requiring audit committees to describe how the committee discharged its duties in appointing, compensating, retaining, and overseeing the work of the independent auditor could more effectively address the Board’s concerns about the conflicts of interest that may arise in the context of the auditor-client relationship than would mandatory audit firm rotation. The discipline of providing such disclosures should enhance the quality of the audit committee’s diligence in forming a basis independent of management’s views and recommendations for deciding to appoint a new auditor or reappoint the incumbent auditor. This report could contain information on the audit committee’s review of each of the matters set forth above, such as the committee’s assessment of the auditor’s objectivity and professional skepticism, Board inspection results, the audit plan, and, if appropriate, the selection of the lead engagement partner. The report also could include confirmation that the audit committee has received information from the auditor regarding the audit firm’s internal quality control procedures and any material issues arising from the most recent reviews.

We believe that audit committee oversight, the Board’s inspection program and standard setting, partner rotation, and the firm’s internal quality control programs already provide substantial incentives for auditors to maintain the necessary “independence of mental attitude.” Enhancing audit committee interaction with and oversight of the auditor and the audit process will further reinforce auditor independence, objectivity, and skepticism. Increased, but targeted, Board standard-setting in this area will make the existing oversight architecture even more effective. We do not believe mandatory audit firm rotation addresses the concerns noted in the Concept Release.

### ***III. Audit Quality Risks and Costs of Mandatory Audit Firm Rotation***

Substantial evidence does not exist, either in the Board’s inspection data or external studies, to support the position that mandatory audit firm rotation is necessary or appropriate for the protection of investors. Starting from the presumption that an unacceptable number of the deficiencies noted through the Board’s inspection process are the result of failures of skepticism and objectivity, as opposed to failures attributable to, for example, competency, methodology, or time pressures, the Board itself concedes that there is no identifiable link between the length of an auditor firm’s tenure with a client and these failures.<sup>11</sup> Moreover, the findings from external studies on the subject are, at best, arguable and inconclusive on whether auditor rotation increases audit quality.<sup>12</sup> In fact, there is some evidence that mandatory audit firm rotation could decrease audit quality and that fraudulent financial reporting is more likely to occur in the early years of the audit-client relationship.<sup>13</sup> It would be arbitrary under applicable legal standards for

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<sup>11</sup> PCAOB Release No. 2011-006 (Aug. 16, 2011) at 16.

<sup>12</sup> *Id.*

<sup>13</sup> *See, e.g.*, L. R. Davis, B.S. Soo, and G.M. Trompeter, “Auditor Tenure and The Ability to Meet or Beat Earnings Forecasts.”(Working paper, Boston College, 2005) (finding that firms with auditors with three or less years of tenure



the Board to move forward with a proposal that would dramatically change the fundamental principle that the audit committee is in the best position to decide which is the best external audit firm to audit the company's financial statements without more empirical evidence that the perceived problem can be solved by the proposed solution.

Moreover, mandatory audit firm rotation likely would place significant burdens and costs on auditors and public companies. For example, mandatory audit firm rotation would present audit firms with significant uncertainty regarding audit capacity needs and where best to locate talent with particular skill sets, inhibit longer-term investment in the development of specialized industry sector knowledge, and detract from the ability of audit firms to attract and retain professional talent. The prospect of constant geographic relocations likely would decrease the overall attractiveness of the public accounting profession as a place to build careers and make it much harder for audit firms to retain seasoned audit professionals. Indeed, our experience with mandatory partner rotation leads us to believe that the costs and impracticality of constantly rotating entire audit teams likely would be prohibitive. As a result, the workforce providing public company audits would be hired on an as-needed and per-engagement basis. The evolution to a much more transitory workforce likely would lead to negative impacts on audit quality with further negative consequences for the vibrancy and sustainability of the private-sector public accounting profession over the longer term. Also of concern from an audit quality perspective is the distraction of our professionals' time and attention resulting from the need to respond to a substantial increase in public company audit tenders.

Mandatory audit firm rotation also presents many practical implementation problems that could significantly increase costs to public companies and their shareholders – costs which have not been fully quantified in any study. Most obvious is that companies would suffer increased costs as new auditors are appointed and seek to understand fully the work of the company and the prior auditor.

Also troubling from the perspective of a public company is that mandatory audit firm rotation would undermine the audit committee's ability to always select the best auditor for the job and determine whether changing auditors is in the best interests of the company and its shareholders.

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are more likely to use discretionary accruals to meet or beat earnings forecasts for a sample ranging from 1998 to 2001); J.V. Carcello and A.L. Nagy, "Audit Firm Tenure and Fraudulent Financial Reporting," *Auditing: A Journal of Practice & Theory* 23 (2004): 55-69 (using a sample of firms cited for fraudulent reporting from 1990 to 2001, found that fraudulent financial reporting is more likely to occur in the first three years of the auditor-client relationship and with no evidence that it is more likely given longer auditor tenure); G. Nashwa, "Auditor Rotation and The Quality of Audits," *The CPA Journal* 74 (2004): 22-26 (finding that among a sample of 90 U.S. failed companies between 1996-2001, failures occurred more frequently in the first three years of audit tenure); V. Johnson, I. Khurana, and J. Reynolds, "Audit-Firm Tenure and the Quality of Financial Reports," *Contemporary Accounting Research* (Winter, 2002): 637-660 (finding that short audit firm tenure (2-3 years) compared to medium audit firm tenure (4-8 years) is associated with lower financial reporting quality); M. Geiger and K. Raghunandan, "Auditor Tenure and Audit Reporting Failures," *Auditing: A Journal of Practice & Theory* 21 (2002): 67-78 (finding that auditors with tenures of less than four years are less likely to issue going concern opinions prior to bankruptcy than long-tenured auditors).



Mandatory rotation divorces decisions about auditor appointment from the circumstances of the individual company and does not allow for situations in which it may be important not to change the auditor, such as when there are major changes underway at a company like a merger or acquisition or implementation of new financial reporting software.

### *Concluding Remarks*

We support the Board's initiation of this dialogue on auditor independence, objectivity, and professional skepticism, and whether mandatory audit firm rotation might be an effective policy measure for enhancing the independence in mental attitude that auditors should embrace on every audit.

We believe that reforms which have taken hold over the last decade – inspections by the Board, new professional standards, stronger audit committees with more responsibility for financial reporting and audit oversight, enhancements to firms' internal systems of quality control, and partner rotation – have been effective at providing powerful incentives for auditors to maintain objectivity and appropriately apply professional skepticism. We believe that the enhancements described in this letter would further strengthen and reinforce these incentives. Conversely, we believe that mandatory audit firm rotation could undermine the effectiveness of this architecture and present risks to audit quality as well as significant costs and practical problems for auditors and public companies. Independence, objectivity and professional skepticism are bedrocks of audit quality and as such are primary areas of focus for KPMG in developing our audit partners and staff and audit methodologies. We share the Board's objective in seeking to improve audit quality through reinforcing auditor objectivity and professional skepticism and look forward to continuing to work with the Board and other stakeholders on finding ways to continue to strengthen audit quality.

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We appreciate the Board's careful consideration of our comments.

Very truly yours,

**KPMG LLP**



Cc:

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