



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

14 December 2011

**RE: PCAOB Rulemaking Docket Matter No. 37, *Concept Release on Auditor Independence and Audit Firm Rotation***

Dear Sir:

We appreciate the opportunity to respond to the Public Company Accounting Oversight Board's ("PCAOB" or "Board") *Concept Release on Auditor Independence and Audit Firm Rotation* ("Concept Release"). We recognize that almost a decade after the enactment of the Sarbanes-Oxley Act of 2002 ("Sarbanes-Oxley"), and in the aftermath of the financial crisis, the time is right for the PCAOB to consider whether further reforms to the role of the public company auditor are warranted. Our approach to the questions posed by the Concept Release is shaped by two fundamental principles:

- Any proposal for reform must be evaluated against the standard of whether it will improve overall audit quality and the reliability of financial reporting and thereby benefit investors; and
- Objectivity, independence and professional skepticism are fundamental to audit quality, which also depends on many other important elements, including a deep understanding of the company and industry expertise of the auditor.

We agree with the Board's assessment that the reforms included in Sarbanes-Oxley "have made a significant, positive difference in the quality of public company auditing."<sup>1</sup> These include measures enacted with the intent of improving auditor independence and objectivity, such as the audit committee's oversight of the auditor, limitations on the provision of non-audit services to audit clients, audit partner rotation requirements and the creation of the PCAOB. There have also been regulatory and other developments since the passage of Sarbanes-Oxley that have improved audit quality, including the adoption by the Board of its own auditing standards, the development of the PCAOB's inspection program and initiatives by the profession to enhance audit quality. The shared challenge for the Board and the profession is how best to continue to build on these improvements.

We also support ongoing consideration by the Board of improvements to the audit process. For example, the Board recently completed two significant standard-setting projects by adopting the Engagement Quality Review standard (AS 7) and the suite of risk assessment standards (AS 8-AS 15). AS 7 just became effective for 2010 audits and should enhance audit quality by requiring an engagement quality reviewer for all audits and reviews of interim financial information that are conducted under the Board's standards. In essence, AS 7 requires an objective second look at the significant judgments and conclusions made by the engagement team. The eight risk assessment standards are designed to improve the effectiveness of the auditor's assessment of and response to the risks of material misstatement, and affect all phases of the audit — planning, execution and completion. In addition to these already adopted standards, the Board

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<sup>1</sup> See page 2 of the Concept Release.



has set out a standard-setting agenda for additional reforms aimed at enhancing audit quality, including with respect to the quality control standards applicable to audit firms. We believe the effects of the standards recently adopted by the Board, as well as the reforms it has planned in its standard-setting agenda, will continue to improve audit quality in the years to come.

It is in this context of effective and ongoing reform that mandatory audit firm rotation should be evaluated. As the Concept Release acknowledges, mandatory audit firm rotation would change dramatically the framework within which audit committees select audit firms, and “would risk significant cost and disruption.”<sup>2</sup> The benefits and costs of such a change therefore should be carefully examined.<sup>3</sup> A detailed understanding of the anticipated costs and benefits of a proposed reform would also be consistent with the requirement imposed on the Securities and Exchange Commission (“SEC”) to “consider, in addition to the protection of investors, whether the action will promote efficiency, competition, and capital formation.”<sup>4</sup> These considerations are especially important given the current economic environment.

In our view, mandatory audit firm rotation does not pass a cost-benefit test. It has been examined in the U.S. several times but has not been implemented. That is because its costs — the most significant of which go beyond direct costs, and relate to diminished audit quality and less reliable financial reporting — have repeatedly been viewed as outweighing any anticipated benefits. As the General Accounting Office concluded in 2003, after its own careful, independent, study (the “GAO Report”): “[M]andatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company’s previous auditor of record. The potential benefits of mandatory audit firm rotation are harder to predict and quantify.”<sup>5</sup> The GAO Report’s conclusion is even more relevant today, given the benefits of the key reforms of Sarbanes-Oxley and the imperative that many audit committees face today to choose the most knowledgeable and experienced auditor, while they have become more complex and global than they were even just a decade ago.

As discussed herein, the available learning since 2003 is in agreement with the GAO Report’s conclusion. It consistently demonstrates that mandatory audit firm rotation is more likely to harm rather than enhance audit quality, and at the same time carries with it the risk of undermining reforms that have improved audit quality, such as the role of audit committees in governing the audit firm-public company relationship.

We support the Board’s consideration of other steps that could be taken to enhance auditor independence and objectivity. Alternatives that could be considered to enhance audit quality, including with respect to auditor independence, objectivity and professional skepticism, should seek to build on the reforms that

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<sup>2</sup> See page 3 of the Concept Release.

<sup>3</sup> See Jay D. Hanson Statement on Concept Release (Board must “weigh carefully whether [the] benefits [of a mandatory audit firm rotation rule] would outweigh its costs and potential unintended consequences”); Lewis H. Ferguson Statement on Concept Release (noting the need to determine whether, “taking fully into account the costs of change,” alternatives to the current model “would yield a net improvement in auditor independence and audit quality”); Daniel L. Goelzer Statement on Concept Release (action appropriate only if “the evidence is clear that the benefits will outweigh the costs.”).

<sup>4</sup> 15 U.S.C. § 78c(f).

<sup>5</sup> General Accounting Office, “Public Accounting Firms: Required Study on the Potential Effects of Mandatory Audit Firm Rotation,” GAO-04-216 (Nov. 2003), page 8.



have proved to be successful. While we recognize that they would require PCAOB and in some cases SEC rulemaking efforts, examples of possible reforms that could be considered include:

- a. A requirement that all firms auditing the financial statements of more than 100 public companies publish an annual report describing the firm's system of quality control, steps it takes to safeguard independence, the basis for audit partner compensation, and the firm's governance and legal structures;
- b. Establishing standards to promote the consistency of communications with audit committees by the independent accounting firm of any PCAOB inspection results, together with any remediation related thereto, pertaining to their public company;
- c. Moving forward with changes to the auditor's report, particularly on the greater use of emphasis of matter paragraphs;
- d. Increased disclosure by companies to shareholders concerning a change in the independent accounting firm beyond the current requirement to report on disagreements between the audit firm and the company to include more information on the audit committee's decision to change; and
- e. Disclosure in the proxy material provided to shareholders as to whether the company's audit committee considered selecting an independent accounting firm other than the incumbent.

These potential disclosure and communication reforms are intended to stimulate debate on the issue of auditor independence, objectivity and professional skepticism. We recognize that others may present different alternatives, and we stand ready to consider those proposals within the principles set forth above.

**I. There is no reason to believe that mandatory audit firm rotation will enhance audit quality or the reliability of financial reporting.**

Before the Board makes any significant changes that would impact public company auditing, it should determine whether the overall effect of the change would improve audit quality and the reliability of financial reporting. Mandatory audit firm rotation is no exception, and we agree with the Board's statement that "views that rotation would have the opposite effect from that intended by the Board warrant very serious consideration."<sup>6</sup> We believe mandatory audit firm rotation will likely reduce audit quality and the reliability of financial reporting.

Academic studies suggest that rather than being beneficial, mandatory audit firm rotation might well result in diminished audit quality. While all academic studies have inherent limitations, and the direct applicability of any study to mandatory audit firm rotation should be assessed carefully, what is striking about these studies is the lack of strong, consistent data linking a change in audit firm to enhanced audit quality.

A recent review of academic literature on mandatory audit firm rotation found that the majority of research suggests that the costs of mandatory rotation outweigh the potential benefits. These costs include

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<sup>6</sup> See page 16 of the Concept Release.



reduced audit quality and a reduction in the amount of useful information available to investors. The review explains that several studies that used various proxies for audit quality provide evidence that mandatory auditor rotation has negative effects on both actual and perceived audit quality. The study concluded that "the majority of evidence does not support the implementation of a mandatory audit firm rotation regime in the U.S."<sup>7</sup>

Further, in the important area of fraudulent financial reporting, studies have found that public companies that changed audit firms had a higher incidence of fraudulent reporting than companies that did not change. A recent study, published in May 2010 and covering the period 1998 to 2007 showed that 26 percent of the companies with instances of fraudulent reporting changed auditors between the last clean financial statements and the last fraudulent financial statements, whereas only 12 percent of no-fraud companies switched auditors during that same time. Sixty percent of the fraud companies that changed auditors did so during the fraud period, while the remaining 40 percent changed in the fiscal period just before the fraud began.<sup>8</sup> Although the studied companies had no requirement to change auditors, we believe the Board should consider whether mandatory audit firm rotation would have the unintended consequence of creating an environment where the incidence of fraudulent financial reporting could increase.

A rationale often given for mandatory audit firm rotation is that extended auditor tenure is necessarily incompatible with desirable standards of independence, and a lack of independence harms audit quality.<sup>9</sup> In considering inspection findings, however, there does not appear to be evidence of a correlation, much less causation, between audit tenure and a decrease in audit quality. The PCAOB acknowledges in the Concept Release that based on a preliminary analysis of its findings, there appears to be no correlation between auditor tenure and the number of comments in PCAOB inspection reports.<sup>10</sup> On an anecdotal basis, PwC's own inspection results are consistent with that observation. Without some basis beyond presumption for linking audit tenure to diminished audit quality, it is difficult to see how declaring a firm "not independent" solely by reason of tenure can form the basis of good public policy.

Mandatory audit firm rotation has also been suggested in the past on the theory that it would provide a "fresh look" at the public company's audit and financial reporting, which also could serve as a deterrent to poor auditor performance. We believe that the PCAOB inspection process provides a better "fresh look" mechanism and a superior deterrent function. The PCAOB inspection process is not only more focused on the quality of the audit itself, but also involves a level of dialogue and analysis of complex auditing and accounting judgments that typically does not occur in the context of audit firm change. Although naturally each firm remains responsible for its own audit quality, as stated in the Concept Release, "the Board's findings have led to numerous and significant improvements in firm audit methodologies, processes and related quality control systems."<sup>11</sup> With respect to deterrence, we firmly believe that there are existing incentives for auditors to perform high quality audits, such as professional pride and reputation and the risk of losing a client when poor audit quality translates into financial reporting issues, which are more effective than any potential "fresh look" by another audit firm. But if the deterrence argument has validity,

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<sup>7</sup> "The Causes and Consequences of Auditor Switching: A Review of the Literature" by C. Stefaniak, J. Robertson, and R. Houston, *Journal of Accounting Literature*, Vol. 28, pages 47-121 (2009), page 108.

<sup>8</sup> "Fraudulent Financial Reporting 1998-2007: An Analysis of U.S. Public Companies," by M. Beasley, J. Carcello, D. Hermanson, and T. Neal, Committee of Sponsoring Organizations of the Treadway Commission (2010), page 37.

<sup>9</sup> See page 16 of the Concept Release.

<sup>10</sup> See page 16 of the Concept Release.

<sup>11</sup> See page 5 of the Concept Release.



we submit that the possibility of a critical PCAOB inspection and any resulting improvements implemented must be seen as more powerful than the views of a successor audit firm.

Proponents of mandatory audit firm rotation also assume that there are no differences among audit firms. Largely in response to market demands, the largest audit firms and their global networks in fact have developed expertise in particular industries, as well as across various geographies. In many industries, for example those operating in a complex regulatory environment, developing and maintaining an in-depth industry expertise are essential to performing high quality audits. Mandatory rotation may restrict choice and force these companies to select audit firms which do not have the same industry expertise as their current auditors, which can have a negative impact on audit quality. Instead of allowing the development of deep knowledge and expertise in auditing certain industries, mandatory audit firm rotation could diminish the positive impact on audit quality which comes from specializing in certain areas and, more generally, not allow companies to retain the services of an audit firm that has favorably differentiated itself in terms of audit quality.

The data described above are consistent with the fundamental principles embedded in the Board's auditing standards, which require an understanding of the business and industry, including institutional knowledge obtained through prior audits.<sup>12</sup> The value of institutional knowledge was also recognized by public companies, as reflected in the GAO Report, which noted that “about 79% of ... Fortune 1000 public companies are concerned that changing public accounting firms increases the risk of an audit failure in the initial years of the audit as the new auditor acquires the knowledge of a public company's operations, systems, and financial reporting practices.”<sup>13</sup> The GAO Report thus concluded that “mandatory audit firm rotation may not be the most efficient way to enhance auditor independence and audit quality considering the additional financial costs and the loss of institutional knowledge of a public company's previous auditor of record.”<sup>14</sup>

Mandatory audit firm rotation also would involve considerable disruption, which could further impact audit quality and the financial reporting process. In the initial years of an auditor's tenure, there is significant and dedicated effort from all parties in the financial reporting process to assist the audit team in understanding the business and internal control over financial reporting. There is also significant effort in proposal and selection efforts for audit committees, management, finance teams and auditors alike. In a voluntary environment these factors can be managed as companies and auditors have made affirmative decisions to make these investments. In a mandatory audit firm rotation environment, not only would the volume of such transitions increase substantially, but the decision to expend these resources would be forced upon all parties based upon the expiration of an arbitrary time period.

The challenges raised by these transitions are magnified in today's more complex global marketplace, where engagements are larger and increasingly span across borders. For large engagements there are significant transition costs in simply rotating the lead engagement partner as currently required under Sarbanes-Oxley. These transition costs would be far greater if a change of the audit firm is mandated. For

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<sup>12</sup> AS 12, “Identifying and Assessing Risks of Material Misstatement” discusses the auditor’s responsibilities related to obtaining an understanding of the company, its environment and the industry. AS 12 also requires the auditor to incorporate knowledge obtained during past audits into the auditor’s process for identifying risks of material misstatement, including when identifying significant ongoing matters that affect the risks of material misstatement.

<sup>13</sup> See page 14 of the GAO Report.

<sup>14</sup> See page 8 of the GAO Report.



certain engagements there can be a hundred partners and a thousand or more staff involved worldwide. Forcing the audit firm to change at the expiration of an arbitrary statutory period will substantially increase the costs and disruption these changes bring, and have a negative impact not only on audit quality but on the overall financial reporting process.

Many of the concerns relating to mandatory audit firm rotation also apply to mandatory retendering, which has been suggested as an alternative to mandatory rotation. Some believe mandatory retendering would bring additional rigor to the audit committee's oversight process. However, we believe it would create increased costs and disruption with little anticipated benefit and is inconsistent with enhancing auditor independence, objectivity and professional skepticism. Mandatory retendering would significantly increase the number of audit proposals, requiring firms and company personnel, including those in the financial reporting chain, to devote significantly more time and resources to proposal efforts. Indeed, companies with diverse operations or that operate in certain specialized industries may have a limited choice of audit firms capable of performing the audit. For those companies, retendering will be a potentially expensive and time consuming exercise that does not produce other viable candidates. Mandatory retendering may also exacerbate the difficulties associated with the audit being viewed as a commodity, in so far as cost, rather than audit quality, may come to be viewed as a more important criterion for evaluating and selecting an auditor.

Finally, the experiences from other countries do not support a link between mandatory audit firm rotation and increased audit quality. When considering the experiences of other countries which have adopted or experimented with mandatory audit firm rotation, it is important to consider the corporate governance model in place there, including with respect to oversight of the auditor. The available studies of other countries' experience with mandatory audit firm rotation have found, similar to the conclusions reached in the GAO Report, that the costs, including foremost the impact on audit quality, outweighed any perceived benefits. For example, in 2008 the Brazilian banking regulator abandoned the mandatory audit firm rotation requirement which had been applicable to the entities it regulates and in 2011 the Brazilian securities regulator agreed to further mandatory firm rotation retrenchment by extending the allowable audit tenure from five to ten years. At a minimum, the mixed experiences of other countries which have attempted to implement mandatory audit firm rotation should caution against adopting such a significant reform in the U.S. without convincing evidence that its benefits would exceed its costs. This is especially true given the corporate governance model in the U.S. and continuing trajectory of improving audit quality since Sarbanes-Oxley.

We agree that in consideration of mandatory audit firm rotation, as any change, the Board's primary objective should be to "first, do no harm."<sup>15</sup> We believe mandatory audit firm rotation has the potential to reduce audit quality and be a costly and disruptive distraction to management and audit committees.

## **II. Mandatory audit firm rotation would diminish audit committee effectiveness.**

We believe that mandatory audit firm rotation would diminish audit committee effectiveness. A critical achievement of Sarbanes-Oxley was placing the responsibility for the appointment, compensation and oversight of a company's independent auditor with an audit committee composed of directors who are independent from the company. These reforms directly addressed some of the core concerns that animate the Concept Release with respect to auditor objectivity, independence and professional skepticism.

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<sup>15</sup> See Lewis H. Ferguson Statement on Concept Release.



Mandatory audit firm rotation would supplant the important judgments exercised by audit committees in their discharge of these responsibilities and put in their place a blanket rule.

One of the most important tasks an audit committee performs is the exercise of business judgment in the selection and evaluation of an audit firm. Audit committees are effective in this regard when they are able to exercise that judgment after assessing the particular facts and circumstances applicable to their company. Gaining an understanding of the relative strengths and weaknesses of the available firms and networks is an indispensable element of that process. As described above, even among the largest accounting firms, there are significant differences in industry expertise, and in the global networks in which the firms are members. Mandatory audit firm rotation would improperly impede the audit committee's judgment in this regard.

Indeed, there will no doubt be many circumstances in which the audit committee determines that retaining the existing audit firm beyond the statutory period (whatever its chosen length) would be the best alternative for achieving the highest quality audit. For example, when a board of directors has decided to change key management roles, the audit committee might well conclude that the additional disruption of audit firm change is not in the best interests of the company and its shareholders, and that the highest level of audit quality would be delivered by its current audit firm. The same might be true if the company has just completed or is about to embark on a major restructuring or acquisition. Audit committees, by virtue of their interactions with the auditors, also have an enhanced ability to be effective by discussing and leveraging the insights of an audit firm which has cumulative knowledge of the company and industry. Mandatory audit firm rotation would prevent the audit committee from making the judgment to retain its existing firm in some circumstances, and require it to choose a firm which it does not believe would be in the best interest of its company's shareholders.

Mandatory audit firm rotation also would present significant corporate governance implications. Audit committees are charged with the responsibility of acting in shareholders' best interests. This responsibility is grounded in a well-recognized principle of corporate law governance that the internal operations of the corporation, including the powers and duties of directors, are governed by state law, except to the extent federal law specifically overrides it. In passing Sarbanes-Oxley, Congress undertook to modify this important state law principle to a limited extent by assigning the audit committee responsibility for the public company-auditor relationship. However, Congress wisely stopped short of imposing rules regarding how that responsibility should be discharged. The success of that fundamental reform was that it reaffirmed rather than displaced the basic corporate law principle that the power to select auditors, like other decisions regarding management of a corporation, is entrusted to the discretion of the board of directors.

Simply put, the audit committee is in the best position to determine whether auditor rotation is appropriate. This was true in 1978 when the Commission on Auditors' Responsibilities (the "Cohen Commission") made that determination<sup>16</sup> and, as forecast by the GAO Report, even more relevant today in light of the increased complexities of the global marketplace and the key reforms enacted by Sarbanes-Oxley. As the GAO Report observed, "[I]f audit committees regularly evaluate whether audit firm rotation would be beneficial, given the facts and circumstances of their companies' situation, and are actively involved in helping to ensure audit independence and audit quality, many of the intended benefits of audit

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<sup>16</sup> "The Commission on Auditors' Responsibilities: Report, Conclusions, and Recommendations" (1978), page 109.



firm rotation could be realized at the initiative of the audit committee rather than through a mandatory requirement."<sup>17</sup>

We agree with the GAO Report and believe that since the passage of Sarbanes-Oxley audit committees on the whole have embraced their responsibility as independent stewards of the auditor relationship and function effectively in discharging those responsibilities. Audit committee effectiveness, and in particular, effectiveness in bolstering audit firm objectivity, independence and professional skepticism, is of course difficult to measure.

Nevertheless, audit committee effectiveness plays a key role in reliable financial reporting, which can be measured in part by the number of public company restatements over time. According to Audit Analytics, restatements have decreased by more than 50% from 1795 to 735 between 2006 and 2010. Another insight into the impact of audit committee oversight can be drawn from audit committees' focus on the level of non-audit services being provided by their chosen auditor. Based on proxy data available up to 2009, the level of non-audit fees as a percentage of total auditor fees declined from approximately 53% in 2001 to 10% in 2009 for the Fortune 100 companies and from approximately 47% in 2001 to 11% in 2009 for the Fortune 1000 companies. We believe that these overall data suggest, and our firm's experience confirms, that audit committees have been involved in making comprehensive and thoughtful decisions relating to the provision of non-audit services by their audit firm. While these signs are encouraging, as described herein, we believe more can be done to enhance audit committee effectiveness, including with respect to monitoring auditor independence and objectivity.

### **III. Conclusion**

We are supportive of the Board's objective to enhance auditor's independence, objectivity and professional skepticism and we agree that in the aftermath of the financial crisis, the time is right for the PCAOB to consider whether further reforms are warranted. However, we believe that mandatory audit firm rotation would be detrimental to audit quality and the reliability of financial reporting.

Looking ahead, we believe that the roundtable scheduled for March 2012 provides a unique opportunity to assess the effectiveness of the reforms mandated by Sarbanes-Oxley. In particular, we suggest that the agenda include the following:

- a. The PCAOB has recently enacted and is currently engaged in implementing numerous reforms relating to the conduct of the audit and the auditor's reporting. How and at what intervals should the changes proposed by the PCAOB be assessed for effectiveness?
- b. Audit committees are key stakeholders in the financial reporting model, especially since the enactment of Sarbanes-Oxley. What can be done to enhance the relationship between audit committees and shareholders, and what can audit firms do to support that relationship?
- c. If empirical studies suggest that audit tenure does not correlate to diminished audit quality or an absence of auditor objectivity, independence and professional skepticism, what should be done by the key players in the corporate reporting model to address the perception that such a correlation exists?

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<sup>17</sup> See page 52 of the GAO Report.





In short, we urge the Board to use this roundtable as an opportunity to broadly assess its reform efforts as a comprehensive package, including assessing the role of the auditor in a holistic manner. In this regard, any additional measures to be considered should focus on improving overall audit quality. We would welcome the opportunity to work with the Board in developing proposals that meet this principle.

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We appreciate the opportunity to express our views and would be pleased to discuss our comments or answer any questions that the PCAOB staff or the Board may have. Please contact Tim Ryan (617-530-7376), Michael J. Gallagher (646-471-6331), or Brian R. Richson (973-236-5615) regarding our submission.

Sincerely,

*PricewaterhouseCoopers LLP*