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**Date:** December 14, 2011

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Office of the Secretary  
PCAOB  
1666 K Street N.W.  
Washington, D.C. 20006-2803

Re: PCAOB Rulemaking docket matter No.37: Concept Release on Auditor Independence and Audit Firm Rotation

Dear Board Members:

Eli Lilly and Company (“Lilly”) appreciates the opportunity to comment to the Public Company Accounting Oversight Board (“PCAOB”) on the Concept Release No. 2011-006 on Auditor Independence and Audit Firm Rotation. Lilly is a large, multinational pharmaceutical company, with presence in over 50 country jurisdictions, and creates and delivers innovative medicines that enable people to live longer, healthier, and more active lives.

Lilly commends the PCAOB for working to enhance auditor independence, objectivity and professional skepticism. We share the PCAOB’s interest in ensuring the continued high quality and reliability of audits conducted by independent public accounting firms. However, we strongly disagree with the concept of mandatory audit firm rotation as outlined in the PCAOB’s concept release as the optimal solution to the above issue. In our response, we discuss why we do not believe the mandatory audit firm rotation is the most efficient or effective way to enhance auditors’ objectivity and ability and willingness to resist management pressure. We also identify and comment on alternative approaches that we believe would better address auditor independence, objectivity and professional skepticism. We address each of our concerns and our suggestions for consideration in detail in the following sections below.

### **Link between Audit Failures/Audit Quality & Mandatory Audit Firm Rotation**

We challenge the notion that there is an actual link between audit failures and audit firm tenure. We are not aware of any relevant data or evidence linking lengthy audit firm tenure to audit failures. In the release, the PCAOB attempts to draw a line between the numbers of audit failures identified as part of their inspection process and the tenure of the audit firm. In evaluating this relationship, it is important to note that the sample of audits that the PCAOB inspects is not a representative sample as a risk-based approach is utilized so that the board can focus their review on the most error-prone situations. In addition, a number of the failures have resulted from differences of professional opinion or the root causes are still being studied. We are in alignment with the comments that PCAOB board member, Daniel Goelzer, made at the open meeting on the concept release. He stated, “There is a lot we don’t know yet about what Board inspection findings might indicate regarding the connection between auditor tenure and

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specific audit deficiencies that appear to stem from a lack of professional skepticism”. Mr. Goelzer further commented: “Generalizing from numbers of inspections’ findings and client tenure statistics to conclusions about whether tenure causes deficiencies is simplistic and misleading. It may be possible to draw relevant conclusions about the impact of tenure on audit quality from our inspections records, but the necessary analytical work has not yet been done.” We believe that the evaluation of this topic as a concept release is premature without the existence of any factual data to establish a clear link between mandatory audit firm rotation and increased independence, objectivity and professional skepticism on the part of the auditor.

Although there is no direct evidence to link mandatory audit firm rotation to improved audit quality, there is significant evidence that suggest the contrary. The release even states that “preliminary analysis of [the Board’s own inspection] data appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports”. The PCAOB release goes on to say that there are a number of studies that “tend to support the view that engagements with short tenure are relatively riskier”. This trend appears to be linked to the fact that over a period of time the auditor is able to develop a deep knowledge and understanding of the intricacies of the client’s business which enhances audit quality from year to year and creates efficiencies. This lends support to the explanation that audit failure rates are higher with new auditors as a result of a lack of knowledge of the client’s business which can be very difficult to grasp during the first couple of years of an audit of a large multi-national client. If one of the goals of the PCAOB is to increase professional skepticism, then it is important that the PCAOB consider the notion that professional skepticism is best exercised by knowledgeable parties which evidence appears to support.

The United States is not the first country to consider mandatory audit firm rotation; in fact other countries have even adopted such policies. One such model is that of Italy, which began requiring audit firm rotation in the 1970’s. In Italy, firms are required to rotate within 9 years of their appointment as the auditor of a company. It is important to note that the Italian market is not directly comparable with that of the US, mainly as there are significantly fewer listed companies in Italy and investors often have less access to information about the market than in the United States; however, we can still gain insight from the Italian model. Bocconi University in Italy performed studies in 2001 and 2004 on mandatory rotation in Italy noting that, “Our results...suggest that the mandatory rotation of audit firms does not raise the market value of client companies; in fact, their market value declines under such a system. The superficial attractions of a policy that would seem to make auditors more independent of their clients are more than offset by the increased costs and effect on audit quality. Other countries considering a similar regime would do well to study the Italian experience before making a similar leap of faith.” We urge the PCAOB to review and utilize this study and others that have been conducted in countries that have or have had similar policies to determine if mandatory rotation would actually foster improvements in audit quality and if the significant cost could be justified.

### **Impact of Sarbanes-Oxley Act of 2002 Provisions**

Another concept that we believe is important and should be considered by the PCAOB as part of this process is to allow the requirements that were implemented as part of the Sarbanes-Oxley Act of 2002 (Act) to have enough time to effect the changes for which they were intended. One

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of the provisions that was adopted as part of the Act was mandatory partner rotation: a five-year period for the lead audit partner and concurring partner and a seven-year period for other partners serving on the engagement team. These requirements became effective for fiscal years after May 31, 2003. As such, the end of fiscal year 2010 was the end of the first full cycle of partner rotation under the new rules. Based on this, we believe that more time is needed to understand the full impact of this rule. The PCAOB inspection process was also an integral change that occurred as part of the Act. Even though the inspection process findings are a main driver of the concept release, we believe that this process has been effective in enhancing independence, objectivity and professional skepticism. From our own experience, we have noticed more scrutiny from our auditors based on PCAOB reviews and findings and believe that this process can continue to add value and drive improvements. We encourage the PCAOB to continue to enhance their current inspection process, to be more transparent with the public and audit committees on findings and to use the process as a tool to drive change within the firms themselves.

### **Current State of Auditor Integrity, Independence, Objectivity and Professional Skepticism**

The PCAOB acknowledges the issue of audit quality in the first years of an engagement within the concept release but question whether audit firm rotation could actually help address these concerns. The PCAOB associates the higher failure rates in the first years of a non-mandatory rotation to the auditor being less inclined to challenge management due to the auditor focusing on the establishment of the long term relationship. The other area that is cited as an example is that some auditors will low bid on engagements with the assumption that they will lose money in the first years but recoup the money over the course of the audit relationship which could impact audit effort and resources at the initial stages of the relationship. The PCAOB suggest that these issues would not exist if mandatory audit firm rotation were required. However, this rationale implies that auditors are willing to stake their reputations on a client relationship. It is our experience that auditors highly value investors' interest, their professional obligations, and reputations above that of preserving an audit relationship out of self-interest. There are also a number of SEC independence rules, PCAOB standards which include peer reviews and concurring partner reviews, as well as internally developed standards that promote auditor independence, ethics and professional skepticism. In addition to the auditor integrity and rules that are already in place, there are criminal, civil, administrative sanctions and financial penalties for those who do not abide by the rules and standards.

The release also questions whether a "fresh look" at a company's financial statements through mandatory rotation would enhance quality because the auditor would know that its work would be scrutinized by a competing firm in the near future, which would decrease the likelihood that the firm would be willing to accept financial reporting that was not in conformity with Generally Accepted Accounting Principles ("GAAP"). Again, we feel that this really questions the integrity of auditors, who in the vast majority of cases do act on behalf of financial statement users. If the PCAOB really believes that auditors are willing to accept accounting treatment that does not comply with GAAP to preserve relationships and because they don't think they will get caught, then there is a whole other underlying issue that needs to be addressed by the PCAOB. If the issue is with auditor integrity, then mandatory audit firm rotation aimed at addressing the issue of independence, objectivity and professional skepticism doesn't seem like it would

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address the core issue. To reiterate, we do not in any way believe that auditor integrity in general is an issue, but based on the remarks and concerns in the release, we urge the PCAOB to consider what issue they are actually trying to address before moving forward with a proposal that would risk significant cost and disruption for companies. To the PCAOB's original point of widely improving audit quality, we feel that the possibility that an audit firm may be selected by the PCAOB for inspection seems to be more of a compelling reason to do quality work than knowing that a competitor would be reviewing the work in the future.

From our own experience, we have not seen issues with auditor independence, objectivity or professional skepticism. We believe that this is in part, attributed to the integrity and professionalism that is highly regarded by the auditing profession. In addition, we believe that a certain level of auditor independence is already inherent to the profession due to the level of staff turnover and attrition that occurs regularly with auditing firms. We see this turnover on our external audit teams at the corporate level and at our significant affiliates. Not only is there audit staff turnover, the lead and concurring audit partners as well as other partners that assist on the engagement are required to rotate every 5 or 7 years depending on their role. This structure, as well as normal attrition, ensures that there are new people at various levels working on the engagement each year. In addition, the assumption appears to be that new partners are not taking a fresh look at the audit approach and accounting when they roll onto the engagement. In our experience, this is definitely not true as the new partner is taking a fresh look at all areas as they learn our business and risks. We believe the PCAOB should not discount the rotation of the partners within a firm in their assessment to improving overall quality as our experience has been it is a very robust and important process.

Another important practice that acts as a check on objectivity and professional skepticism is that for almost all complex accounting treatments our auditors are required to consult with their national office to get buy in and approval. The national office does not have the same motivations that cause the PCAOB concern with respect to the audit partner and team. It is our understanding that it is common practice for all of the large public accounting firms to consult with their national offices on complex accounting matters and would urge the PCAOB to take this practice into consideration when evaluating the need for mandatory rotation. In addition, this is an area that the PCAOB may want to focus on from a perspective of implementing standards or guidance to promote these consultations.

### **Impact of Mandatory Audit Firm Rotation on Global Companies**

During the last Standing Advisory Group ("SAG") meeting there was a discussion which implied that changing auditors is not that complex of a process, pointing to the fact that over 3,000 companies had changed auditors over the past several years. This figure could be more relevant if it were accompanied by empirical data that would provide information including the size of the companies, whether they are solely domestic or multinational and reasons behind the auditor changes, i.e. mergers, an initial public offering, outgrowing the firm, etc. We believe that the challenges, complexities and costs associated with a large multi-national company changing auditors compared to that of a domestic small to mid-size company are much higher, and do not believe that blanket information such as the figure provided above take this into account. In 2010 Glass Lewis & Co ("GLC") reported less than 5% per year of larger companies changed

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auditors between 2005 and 2009. In addition, over the past ten years only four out of a total of 45 member companies of the Financial Executives International (“FEI”) Committee on Corporate Reporting (“CCR”), which is comprised mostly of companies with large market capitalization, have changed auditors; only two of which were multi-national companies. While one commentator suggested that over 3,000 companies rotated auditors recently, this information suggests that auditor rotation occurs at much lesser rate for large multi-national companies for which the challenges, complexities, and costs are much broader and more difficult to manage.

As indicated above, Lilly is a large, multinational pharmaceutical company, with presence in over 50 country jurisdictions. The current level of effort it takes to coordinate between our corporate audit team and the various local audit teams at the affiliate locations for purposes of supporting the consolidated audit or for statutory audit purposes is significant. If rotation were mandatory, we believe that the level of audit inefficiency related to the coordination effort and to the learning curve that would be faced by the new audit firm would substantially increase, leading to business interruption as well as potential impairments to audit quality. A significant amount of time would need to be spent by the client addressing questions and providing explanations due to the lack of knowledge the new auditor has about the clients business, internal control environment, accounting and business processes, and corporate structure. This steep learning curve would likely lead to lesser degree of reliance on the internal audit group as it would take significant time and effort to get the new auditor up to speed with internal audit’s testing approach and for them to gain comfort around the competence and objectivity of the internal audit group. These issues would be compounded at multinational companies that would have to deal with the orientation of the new auditors at the corporate headquarters as well as at the many local and regional locations. This would be further compounded the more frequent the period of the rotation requirement.

Additionally, at corporate and throughout our many affiliate locations we utilize all of the “Big Four” firms to some degree for various tax and other non-audit services. None of our affiliates are allowed to contract with our current auditor without pre-approval from the audit committee; however, the other three firms can be utilized as needed. In some countries, only one of the large firms offers the non-audit services that the affiliate needs in order to conduct business without disruption. If audit firm rotation were required, it would make it extremely difficult for companies such as ours that operate large, multi-national companies, to ensure that we are contracting with specific firms so as not to impair independence when it is time to rotate. There may also be situations where another firm is engaged in a non-audit project, and these projects would have to be finalized or stopped in order for the firm completing the project to be a candidate for rotation. In addition, if the auditor that completed the project was selected as the new auditor and it was necessary to audit the project as part of the audit testing procedures, the new audit firm would not be independent. These issues may further narrow the already very limited field of firms from which we can select our auditor. When selecting an audit firm it is also important that the appropriate level of industry expertise exist locally within the regions where we have significant affiliate operations to facilitate high quality audits from a consolidated and statutory perspective, which mandatory audit firm rotation may hinder.

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## **Cost versus benefit of Mandatory Audit Firm Rotation**

We urge the PCAOB to carefully consider the cost benefit of mandatory audit firm rotation before proceeding any further with this proposal. The release notes that the concern of a significant increase in costs does merit discussion during the current period of economic weakness and heightened global competition. We highly agree with this statement and share the PCAOB's concern. The 2003, GAO report indicated that large firms estimated that first year audit costs would increase by more than 20%. This figure is very high and would impose significant cost on companies yet the figure only represents the actual cost of the initial audit and does not incorporate other incremental internal and external costs associated with rotation that also need to be considered. Below are just a few of the indirect costs of mandatory rotation that the PCAOB should consider.

- Additional internal administrative costs would be incurred to select the replacement auditor. This would include time spent by upper management and the audit committee preparing invitations for bids, providing information to bidders and evaluating and interviewing bidders in order to make a selection.
- Substantial amounts of Senior Management time on both the client and auditor side would be spent revisiting significant accounting decisions that were previously vetted.
- As discussed earlier, first and even second year audits lead to a number of inefficiencies including additional coordination efforts for both the client and the auditor and more time addressing questions and providing explanations due to the lack of knowledge the new auditor has about the client. This issue is exasperated by multinational companies that would have to deal with the orientation of the new auditors at the corporate headquarters as well as at the many regional locations.
- Frequently there is one firm within a geographic region that has greater expertise for specialized industries. Requiring mandatory rotation could have the effect of either prohibiting the firm that is best equipped to perform the audit from doing so or to further increase costs by requiring firms to develop that industry expertise in new regions or bring the experts into the area. Again, this issue would be even more of a concern within a multinational company as the audit firms would need to have industry knowledge within the various countries in which the client company operates.

These are just a few of the additional internal and external factors that would be impacted by mandatory audit firm rotation and add to the 20% fee increase that was estimated in the GAO report. We believe that these costs along with the potential decrease in audit quality far outweigh any of the perceived benefits of requiring audit firm rotation.

## **Alternative Options and Approaches**

While we strongly oppose mandatory audit firm rotation, we do understand and support the PCAOB's initiative to enhance auditor independence, objectivity, and professional skepticism.

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In response to the PCAOB's request to comment on other alternatives on how to best address the objectives we have noted some alternative measures and suggestions for the PCAOB to consider.

We believe that the audit committee is in the best position to evaluate auditor independence or the lack thereof. It is an integral part of the audit committee oversight function, and in order to remain effective, the audit committee should retain the authority to oversee the audit, appoint the auditor, compensate the auditor and remove the auditor as deemed appropriate in order to best meet the shareholder's needs. We are supportive of actions that would advance the current role of the audit committee and encourage their strength and independence. One suggestion would be for the PCAOB to issue more detailed guidance on the role of the audit committee in auditor oversight. We would also encourage the PCAOB to share the results from their inspections with the audit committee of the company that was inspected. Through this process the PCAOB could make recommendations to the audit committee and raise concerns while the ultimate decision making and oversight would remain with the company's audit committee. This would allow for the audit committee to retain their role of oversight while still ensuring that they have the applicable information to make an informed decision.

Due to the important role of the audit committee in ensuring that the external auditors are independent and objective and since the financial reporting world has become even more complex in the past decade with fair value accounting, new definitions of businesses, and variable interest entity issues just to name a few, we believe that it is important that the audit committee members participate in training. We believe that if audit committee members participated in training it could foster more robust conversations with management and with the external auditors, leading to higher quality financial statements and improving audit committee oversight.

Another point that we feel is important is for companies to have their own internal policies to promote independence. We know that many companies including ourselves already have policies and procedures in place to address concerns related to independence. One of the main components of our internal policy around independence is outlined within our Global Policy on Conflicts of Interest. Among other items, the policy prohibits all employees from accepting gifts, complimentary entertainment or favors from any person or business that does or seeks to do business with the company. This rule includes but is not limited to tickets to sporting or cultural events and invitations for participation in activities. We feel that this internal policy helps to further protect the company from independence violations, in fact or in appearance, with our auditor. We believe that policies such as this could be promoted or required by the PCAOB as a means of enhancing independence.

Within the area of audit activities, we would encourage the PCAOB to consider further limiting the scope of non-audit services that the audit firm can provide to its audit clients. We do not believe that these limitations should be applied to tax services due to the fact that the audit and tax services are closely linked, as well as due diligence and integration efforts which can identify issues which impact the future financials and provide the auditor with a head-start to better equip themselves with the company being acquired. We believe it is beneficial from a quality and overall business perspective to have the same firm perform these identified services. However, we do believe that it could be beneficial for the PCAOB to be more prescriptive on all other non-

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audit services that can be provided; potentially limiting all advisory services. We believe that action in this area may address the PCAOB's concern that the auditors are attempting to maintain good client relationships at the expense of performing a quality audit in order to engage in more lines of business and provide additional services to the Company.

### **Conclusion**

Again, Lilly supports the PCAOB's efforts to ensure the continuing high quality and reliability of audits conducted by independent public accounting firms through enhancing auditor independence, objectivity and professional skepticism. However, we are very concerned that implementing a policy that would require audit firm rotation could result in a number of unintended consequences including negatively impacting audit quality, causing significant business disruptions and being highly costly. While these consequences are concerning, an even bigger issue that deserves merit is that there is currently no evidence to support the notion that lengthy audit firm tenure causes audit failures. We urge the PCAOB to step back and do more research on the audit failures that they have identified to determine the root cause before moving forward with this initiative. We also urge the PCAOB to focus on the broader issue of enhancing auditor independence, objectivity and professional skepticism through evaluating various alternatives as opposed to such a focus on audit firm rotation. In our response we have offered a number of alternative solutions that we feel would better address auditor independence, objectivity and professional skepticism which we hope the PCAOB will thoughtfully consider.

We appreciate the opportunity to express our views and concerns regarding the concept release. If you have any questions regarding our response, or would like to discuss our comments further, please call me at (317) 276-2024.

Sincerely,

ELI LILLY AND COMPANY

/s/Arnold C. Hanish

Arnold C. Hanish  
Vice President, Finance and  
Chief Accounting Officer

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