

Technical Line

PCAOB – concept release

Respondents to PCAOB overwhelmingly oppose mandatory audit firm rotation

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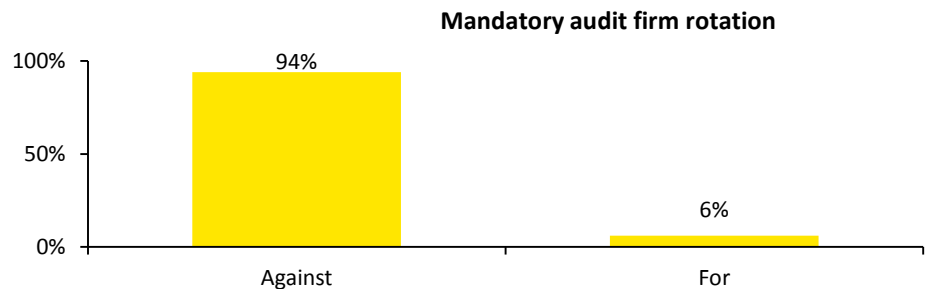
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What you need to know

- ▶ About 94% of the letters the PCAOB received in response to its concept release on possible ways to enhance auditor independence, objectivity and professional skepticism oppose mandatory audit firm rotation.
- ▶ Audit committee members, who currently choose independent auditors and oversee their work, submitted the most comments.
- ▶ The PCAOB plans to hold a roundtable to gather more feedback in March 2012.

Overview

An overwhelming 94% of the roughly 600 letters¹ the Public Company Accounting Oversight Board (PCAOB or Board) received on its concept release on possible ways to enhance auditor independence opposed mandatory audit firm rotation. It was the second-largest number of responses the Board has received on a rule-making project since it was created by the Sarbanes-Oxley Act of 2002.² Only 6% of the respondents – mostly individuals who didn't disclose an affiliation – favor mandatory audit firm rotation.

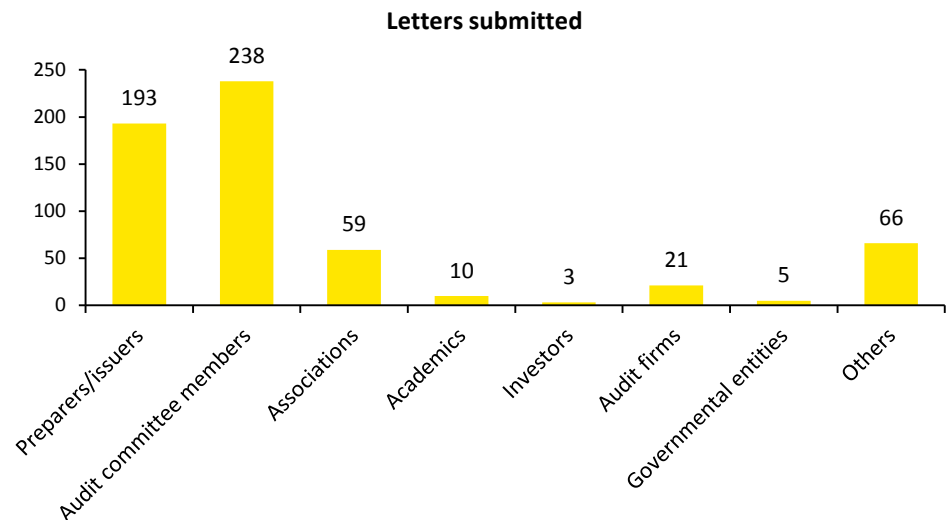


Of particular note was a letter from the US Government Accountability Office (GAO), which was required by Congress to study mandatory audit firm rotation in 2003 and at that time raised questions about whether mandatory audit firm rotation would be the most efficient and effective way to enhance auditor independence and audit quality. In its recent comment letter, the GAO did not support mandatory audit firm rotation and suggested that additional evidence was needed to show that rotation would improve audit quality before moving forward with such a requirement.³

The PCAOB's August 2011 concept release, which discussed mandatory audit firm rotation, was based on a perception that mandatory audit firm rotation might enhance auditor independence and improve audit quality. In the wake of the global financial crisis, regulators in other jurisdictions are also exploring this concept. While opposing mandatory audit firm rotation, many respondents to the PCAOB's concept release expressed support of the PCAOB's effort to enhance auditor independence, objectivity and professional skepticism.

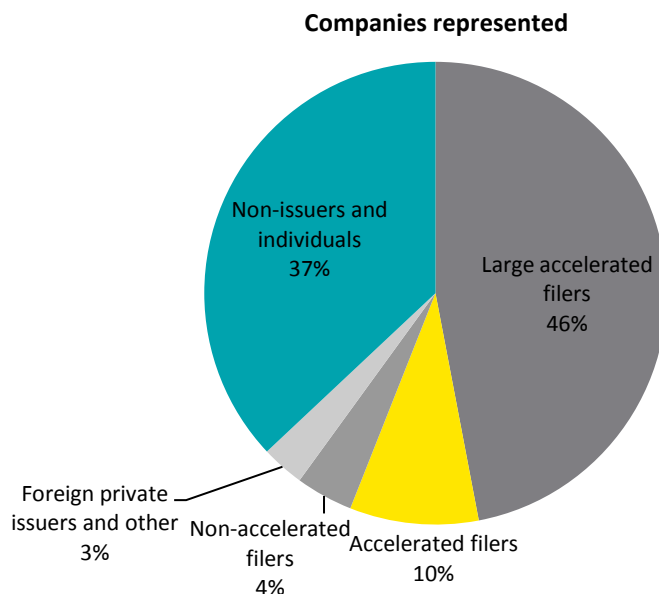
Summary of responses

Companies and audit committee members sent about 72% of the letters, representing mostly large public companies, known as large accelerated filers with the Securities and Exchange Commission (SEC). Foreign companies that file with the SEC also commented.



Audit committee members submitted the most letters (40%), followed by chief financial officers (16%).

The rest of the letters were submitted by associations, academics, investors, audit firms, governmental entities or other organizations and individuals (including individuals who did not provide an affiliation).⁴



Opponents of mandatory audit firm rotation

Company executives and audit committee members most frequently pointed to an increase in costs as the reason for their opposition. They expressed concerns about both the cost of the audit and the cost in management and audit committee time that would be required to bring a new audit firm up to speed so it could perform a high-quality audit.

Other common concerns included:

- ▶ Audit firms would lose institutional and industry knowledge, which takes time to develop and enhances audit quality.
- ▶ Mandatory audit firm rotation would decrease audit quality.
- ▶ Audit committees are in the best position to make auditor appointments.
- ▶ Mandatory firm rotation would limit audit committees' ability to identify an auditor with appropriate specialization, geographic reach or industry knowledge.

Opponents also said mandatory rotation could be even more complex for multinational companies and more challenging if the rotation were to coincide with a planned business transaction or financing.

Proponents of mandatory audit firm rotation

Proponents of mandatory audit firm rotation generally cited reasons including:

- ▶ A fresh set of eyes would improve the quality of audits and financial reporting.
- ▶ Long-standing audit firm relationships can cause the audit firms to be "too cozy" with their clients.
- ▶ Auditors would have an incentive to exercise greater objectivity, independence and professional skepticism and would be more diligent in identifying problematic accounting knowing their judgments would be reviewed by another audit firm.

Proponents of mandatory audit firm rotation also cited increased competition among audit firms and potentially lower costs.

Other alternatives presented

Most respondents did not propose alternatives to mandatory audit firm rotation, and suggested instead that existing auditor independence rules, mandatory audit partner rotation and developments such as the PCAOB inspection process are effective in improving audit quality and enhancing auditor independence. There was overwhelming support to retain audit committee oversight of the auditor, with many respondents saying the audit committee is in the best position to identify and engage the auditor that best meets the needs of the company.

Alternatives that were suggested fell into two broad categories:

- ▶ Further strengthen audit committees
 - ▶ Enhance communication and interaction between audit committees and the PCAOB, including sharing inspection results in defined circumstances
 - ▶ Engage private sector groups to share best practices with audit committees
 - ▶ Enhance audit committee reporting (e.g., additional proxy or annual statement disclosures)
- ▶ Improve the PCAOB inspection and enforcement process
 - ▶ Conduct a root-cause analysis of inspection findings to further strengthen regulatory oversight and consider performing a cost-benefit analysis of mandatory audit firm rotation before moving forward with a proposal
 - ▶ Allow recent audit standards to take effect and consider proposing additional standards to enhance the inspection and auditing process
 - ▶ Consider recommending rotation in instances when an audit firm demonstrates a significant lack of skepticism

Many respondents said the audit committee is in the best position to identify, engage and oversee the auditor that best meets the needs of the company.

How we see it

We believe audit quality and the independence, objectivity and professional skepticism of auditors has improved considerably since the passage of the Sarbanes-Oxley Act of 2002 and the creation of the PCAOB.

We do not believe that mandatory audit firm rotation would improve audit quality and have opposed the concept in our response to the PCAOB⁵ and as a policy matter in other jurisdictions around the world. We believe that mandatory audit firm rotation would negatively affect investors by weakening the governance responsibility of audit committees.

We believe independent audit committees and boards, as part of their role as representatives of shareholders' interests and with statutorily mandated responsibility for audit oversight (including the selection and compensation of auditors), are best positioned to appoint and retain the audit firm they believe best meets shareholders' needs.

Next steps

- ▶ Interested parties should continue to express their views and consider participating in the public roundtable meeting the PCAOB plans to convene in March 2012.

Endnotes:

- ¹ Our analysis includes 595 of the 608 letters posted on the PCAOB website by 5 January 2012. Thirteen of the letters were withdrawn after submission to the PCAOB or did not express an opinion regarding mandatory audit firm rotation and are excluded from our analysis.
- ² PCAOB Docket #17, *Ethics and Independence Rules Concerning Independence, Tax Services and Contingent Fees*, received more than 800 comment letters.
- ³ The GAO response letter is at http://pcaobus.org/Rules/Rulemaking/Docket037/390_GAO.pdf
- ⁴ Comment letter respondents are categorized based on how they identified themselves within their respective letters.
- ⁵ Our response letter is at http://pcaobus.org/Rules/Rulemaking/Docket037/063_EY.pdf, and a summary of our response letter is at [http://www.ey.com/Publication/vwLUAssets/Our_views_on_strengthening_auditor-independence/\\$FILE/EY%20Key%20Messages.pdf](http://www.ey.com/Publication/vwLUAssets/Our_views_on_strengthening_auditor-independence/$FILE/EY%20Key%20Messages.pdf)

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