

Mr. J. Gordon Seymour
Secretary
Public Company Accounting Oversight Board
1666 K Street, N.W.
Washington, D.C. 20006-2803

18 November 2011

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

Dear Mr. Seymour:

Ernst & Young LLP (Ernst & Young) is pleased to submit comments to the Public Company Accounting Oversight Board (PCAOB or Board) on its concept release on auditor independence and audit firm rotation (the Concept Release).

Summary of our views

We believe auditor independence, objectivity and professional skepticism are of paramount importance as underpinnings of confidence in the audit profession. Such attributes are central to who we are and what we do.

As a general matter, we believe that audit quality and the application of objectivity and professional skepticism by auditors have improved considerably since the passage of the Sarbanes-Oxley Act of 2002 (SOX or the Act) and the creation of the PCAOB. This is not to say that further progress cannot be made, but it is to emphasize that our firm is fully focused on and invests continuously in actions to reinforce the independence, objectivity and professional skepticism of our people. It is essential that we and other firms work with the PCAOB to explore actions that would further improve audit quality and better serve the interests of investors.

Auditors approach their duties with an application of principles and ethics and a strong sense of professional skepticism. We have confidence in the performance of our audit professionals and in the healthy level of skepticism we regularly employ when executing our responsibilities. Unfortunately, many individuals underestimate or do not have a high degree of visibility into the extent of skepticism that is involved in a typical audit. Challenging the accounting and financial reporting decisions of the companies we audit is a required, and expected, part of the job, and it happens every day in practice.

We believe that alignment should and does exist among independent auditors, independent audit committees, independent audit oversight authorities (such as the PCAOB) and public company shareholders regarding the objectives of a public company audit. SOX, the European Commission's Eighth Company Law Directive, and other policy-making efforts have sought to foster this alignment in

many jurisdictions worldwide. This alignment continues to evolve and is becoming increasingly strong and effective. Rather than imposing mandatory firm rotation, the interrelationships among auditors, audit committees, audit oversight authorities and shareholders should be examined to determine whether their alignment can be strengthened even further.

The audit profession and audit committee community should work closely with the PCAOB and, to the extent necessary, the Securities and Exchange Commission (SEC) in exploring the matters raised in the Concept Release. We believe there are certain ideas that should be further explored to address the Board's objectives and benefit the public interest. In this regard, we advance the following:

- ▶ We support efforts to strengthen the role of independent audit committees as a means to further promote audit quality and auditor skepticism. Among other things, audit committee transparency might be increased through additional proxy statement disclosure regarding the appointment and oversight of the independent auditor.
- ▶ We support the adoption of a formal practice under which the PCAOB could recommend rotation of an audit firm in instances where it has been demonstrated, through the PCAOB's enforcement process against a firm, that professional skepticism or objectivity was significantly lacking in the firm's audit of a particular issuer.
- ▶ We support increased interaction between the PCAOB and audit committees on issues related to standard setting and other aspects of audit policy. In addition, we support direct communications between the PCAOB and audit committees related to specific inspection findings, when warranted.
- ▶ We support the Board's continued efforts to analyze the root causes of common audit deficiencies.
- ▶ We support engagement with private sector groups to highlight and share with audit committees leading practices that might promote auditor skepticism and objectivity.
- ▶ We support a PCAOB review of audit firm implementation of recently issued PCAOB engagement quality review and risk assessment auditing standards and the planned issuance of new quality control standards.

Mandatory audit firm rotation, in our view, is not a necessary or constructive means to promote auditor skepticism. There is no evidence that we are aware of suggesting that mandatory firm rotation will improve audit quality. Moreover, there are many identifiable and known downsides to such a policy with little to no certain benefit. A mandatory audit firm rotation model would not only give rise to substantial costs and disruptions, but also would, we believe, impair audit quality, undermine sound corporate governance, and detract from the ability to maintain a robust accounting profession – all to the ultimate disadvantage of the interests of investors. We believe the mandatory retendering approach suffers from the same or even greater disadvantages.

We urge the Board instead to (1) consider the ideas outlined in this letter, which we believe will advance our mutual objective in this important area and (2) help further the alignment of independent auditors, independent audit committees, independent audit regulators and shareholders.

In this letter, we outline:

1. Our insights on the current state of professional skepticism, which we broadly believe to be sound
2. Our views on the many negative consequences of a mandatory audit firm rotation model and why we believe it is not in the investing public's interest
3. Our support for the PCAOB efforts that are underway to analyze the root causes of inspection findings
4. Our thoughts in relation to the benefits that recent and planned PCAOB standards will have in furthering the important objectives of independence, objectivity and professional skepticism in the execution of audits, and why the Board should consider the positive effects of these enhancements
5. Our ideas on measures that should be considered by the Board to better achieve its objectives
6. Our views on the other ideas outlined in the Concept Release (mandatory retendering, joint audits, consideration of the audit firm payment model and the further limitation of non-audit services) that we believe would have negative consequences to audit quality and investor interests

1. Auditor skepticism is at the core of the audit process

a. The importance of auditor skepticism

Auditor skepticism, independence and objectivity are essential to the audit process and the audit profession. Our profession is supported by strong and robust independence standards, ethics requirements, audit standards and independent regulatory oversight, all of which enhance confidence in the audit profession. We take our responsibilities under these requirements seriously and believe professional skepticism is fundamental to audit quality. We view our professionalism, our reputation and our people as our most important assets.

It is fundamentally important that auditors approach their work with a seriousness of purpose and professional skepticism. This is what we are trained to do, and our firm reinforces this purpose with ongoing focus and training.

This continued focus is evident in the numerous tools and resources we make available to help engagement teams analyze, evaluate and resolve accounting and auditing matters in an objective and professionally skeptical manner. Among other things, we have expanded our formal network of highly qualified professionals in our national professional practice office. These audit professionals work closely with engagement teams and management of the companies we audit on difficult accounting and auditing issues.

Similarly, we devote substantial amounts of resources toward required annual firm-wide training to continually emphasize the importance of audit quality and in exercising independence, objectivity and professional skepticism in everything we do.

We want to stress our confidence in the performance of our audit professionals and in the healthy level of skepticism we regularly employ when executing our responsibilities. Persons outside the profession do not generally have visibility into the extent of skepticism that is involved in a typical audit. Challenging the accounting and financial reporting decisions of the companies we audit is a required, and expected, part of the job, and it happens every day in practice. These are a few observations in this regard:

- ▶ Our auditors regularly exhibit skepticism in the day-to-day, persistent questioning of personnel of the companies we audit, requesting documentation to verify assertions and pushing for more information and elevating issues when, for example, facts, trends or management's explanations do not seem to make sense.
- ▶ Our auditors regularly challenge management's assertions and accounting positions, often with significant implications for the company, such as potential restatements or effects on earnings. Moreover, such challenges are undertaken with the full support of our firm, including circumstances involving a recognized risk (whether implied or expressed) of losing the engagement with a company we audit.
- ▶ We have had situations where companies we audit have suggested that they might request proposals from other audit firms for future work if an audit partner did not reconsider his or her position on a certain accounting issue, or if a particular audit partner was not removed from the engagement, even though the partner was applying the proper judgment. Our practice, as would be expected, is to support the position of our audit partners and decline such requests, regardless of consequences.
- ▶ As part of our normal course of audit work, we also often discuss with management and the audit committee concerns about the quality and competency (and in some cases the integrity) of certain management personnel. As part of this process, there have been situations where the response to such concerns was not satisfactory and we discontinued the audit client relationship.

We believe that these illustrations reflect what we know to be true – that auditors generally approach their everyday tasks with considerable skepticism. This does not mean there isn't room for improvement. We recognize that deficiencies have occurred in some audit engagements where an insufficient level of objectivity or professional skepticism has been cited by the PCAOB. In our firm's experience, we have not found such deficiencies resulting from "efforts to avoid displeasing management" or stemming from "a level of coziness" between the firm and management. Rather, we have found that the root causes underlying such deficiencies usually relate more specifically to factors such as insufficient review by more senior audit personnel, lack of relevant knowledge or the effect of workload time pressures on the resolution of an accounting or auditing matter. We do, of course, evaluate such incidents critically and take appropriate remedial steps. We do not believe a mandatory audit firm rotation model will be responsive to these occurrences or further our shared objectives in the important area of professional skepticism.

b. Substantial improvements in audit quality have taken place in recent years

We believe that the level of skepticism and the quality of audits have increased significantly over the past decade, in large part due to the passage of the Act and the resulting independent oversight by the PCAOB.

The Act imposed a range of new requirements with respect to audits and the regulation of the audit profession, including the following:

- ▶ The Act requires audit committees to be independent of company management, and companies must disclose whether audit committees include a financial expert.
- ▶ The Act strengthens the audit committee's oversight of the independent auditor by requiring that the committee appoint and determine the compensation of the auditor.
- ▶ The Act limits the range of non-audit services that can be provided, thereby providing safeguards against potential impairments of auditor independence.
- ▶ The Act's audit partner rotation requirements (and the required rotation of other engagement partners, including the engagement quality reviewer) have meant that every five years, audit firms have a new set of eyes and a new experiential lens through which to review accounting and auditing strategies and conclusions, the audit process and the audit client's financial statements.
- ▶ The Act created the PCAOB as the independent regulator of the auditors of public companies.

The requirements of the Act, particularly with regard to the audit committee and the establishment of the PCAOB, have had a significant and positive effect on audit quality.

When SOX was enacted nearly 10 years ago, Congress made audit committees directly responsible for oversight of the audit process at public companies. This role was entrusted to audit committees because the Act required them to be independent from management. SOX essentially designated the audit committee to serve as an empowered shareholder ally in the room with management and the independent auditor. Consequently, audit committees have become the primary arbiters of the company's relationship with and governance of the auditor and auditing process. This was a key reform that has significantly improved independence of auditors and overall audit quality. For this reason, we support a policy direction designed to further strengthen audit committees, not undermine them.

The PCAOB's oversight of the audit profession also has contributed to improvements in audit quality. In particular, the PCAOB inspection process facilitates improved audit performance. Each time we receive an annual inspection report from the PCAOB, we prepare a firm-wide summary of the significant items identified during the PCAOB inspection process and distribute that summary to all audit teams. This enables our professionals to improve their performance and facilitates communications between our audit partners. When issues are noted in external or internal reviews, remediation plans are implemented. Findings are used to provide continuous training in areas where practice reminders and improved skills are needed. We also make appropriate changes in our audit methodology when warranted.

We believe that the measures taken in recent years by the U.S. Congress, regulators, the profession and public companies have and will continue to have a favorable effect on audit quality and auditor independence, objectivity and professional skepticism.

c. Natural turnover at audit firms and companies prevents over-familiar relationships and enhances skepticism

Although audit firms often audit the same company for long periods of time, the people who conduct the audits, as well as the management of those companies, change frequently. The current mandatory five-year audit partner rotation requirements (and other rotation requirements) and natural staff turnover within our audit engagement teams provide for new perspectives on accounting matters and our related audit approach. Moreover, the turnover of company personnel keeps relationships between the audit firm and the company fresh. For example, according to a recent study analyzing executive volatility for companies in the 2011 Fortune 500 and the S&P 500, the average tenure of a CEO and CFO is 6.8 years and 5.1 years, respectively.¹

2. Mandatory firm rotation is not in the investing public's interest

We believe mandatory firm rotation would harm corporate governance and investor interests and the ability to maintain a robust, highly skilled independent accounting profession performing high-quality audits. The Concept Release notes that the PCAOB has found numerous audit deficiencies through its inspection program. But we do not believe these findings point to a systemic lack of auditor skepticism that would support mandatory audit firm rotation as a remedy. The significant short- and long-term costs and implications of such a policy are not warranted or even fully known. Consequently, in our view, the mandatory rotation concept is a blunt instrument with negative effects that should be avoided.

Length of audit firm tenure, in and of itself, is not a threat to either auditor independence or audit quality. In fact, there is currently no evidence that we are aware of linking audit firm tenure to audit shortcomings. While the PCAOB has pointed to specific findings from its inspections of certain audit engagements that appear inconsistent with the objectives of auditor independence, objectivity and professional skepticism, we do not believe these inspection findings establish an adverse link between audit tenure and audit quality.

The U.S. Congress previously considered the idea of mandatory rotation and rejected it. In debating the Act, the U.S. Congress deliberately opted for mandatory audit partner rotation, the establishment of independent standard-setting and independent oversight by the PCAOB, and the strengthening of independent audit committees. With the significant improvement in audit quality since the enactment of SOX – due in large part to the PCAOB's activities and the enhanced role of audit committees – it seems anomalous to consider mandatory rotation as an option now.

¹ "The Volatility Report 2011," Crist Kolder Associates, 2011.

a. Negative effect on shareholders, corporate governance and audit committees

Mandatory firm rotation would negatively affect shareholders by weakening the U.S. corporate governance structure, which recognizes and seeks to enhance the alignment among shareholders, independent audit committees, independent auditors and independent audit oversight authorities in promoting high-quality audits. The fundamental purpose of corporate governance is to make sure companies operate in the interests of their owners – the shareholders. Boards have a duty to act in the interests of shareholders. This duty extends to audit committees, including when they retain the independent auditor believed to best suit shareholder needs. Mandatory firm rotation would limit the authority of the audit committee to carry out this duty, thereby working against the extensive investment made in corporate governance since SOX that we believe is so important to the public interest.

The audit committee is charged with evaluating the auditor's performance and determining whether and when a change in auditor would be in the best interests of shareholders. The audit committee is well positioned to make this judgment because it is aware of the audit needs of the company. It works closely with the audit firm and can evaluate its quality, as well as the firm's application of independence, objectivity and professional skepticism. An effective audit committee will dismiss an audit firm if it determines that the auditor lacks these traits. A mandatory rotation requirement would override the audit committee's knowledge, perspective and statutory responsibility.

Another limitation that would result under a mandatory firm rotation model is that audit committees would have fewer options from which to choose the audit firm that best meets the needs of the company. Audit firms can have different skill sets, industry expertise and geographical reach, all of which contribute to producing a high-quality audit and are important considerations for an audit committee in selecting an independent auditor. Mandatory firm rotation would automatically disqualify the current audit firm from the pool of candidates, thereby restricting the audit committee's ability to choose the firm it believes is best suited to conduct a high-quality audit for the company's shareholders.

We further note that shareholders generally support the audit committee's appointment of the independent auditor. For example, in the 2011 proxy season, 92% of Russell 3000 companies placed auditor ratification on the ballot at annual meetings.² An average of 98% of votes were cast in favor of the audit committee's choice of auditor, regardless of the length of tenure of the auditor. Although these votes are advisory in nature, shareholders have used ratification votes on other topics to express displeasure with boards and company management.³ These statistics suggest that shareholders are not dissatisfied with the current corporate governance system for selection of auditors.

² Data comes from Ernst & Young's corporate governance database, based on SEC public filings.

³ For example, as of 31 October 2011, the shareholders of at least 40 companies in the Russell 3000 Index voted against ratifying the pay packages for executives approved by boards. Data comes from Ernst & Young's corporate governance database, based on SEC public filings.

Perhaps of greatest interest to shareholders, there is no compelling evidence that the many negative effects of mandatory firm rotation on corporate governance would be outweighed by any improvements in audit quality. Researchers who looked at mandatory firm rotation in Korea and Italy did not find significant increases in audit quality as a result of mandatory audit firm rotation requirements.⁴ At the same time, audit quality has not been shown to decrease as auditor tenure lengthens.⁵

b. Negative effect on auditor's knowledge of the company being audited and the effectiveness of audits

A significant advantage of longer audit firm tenure is that the auditor attains significant knowledge and understanding of a company over time, as well as an awareness of its risks, which can enhance audit quality.⁶ Among other things, long tenure with a particular company allows the audit firm to build up experience and credibility with the entity by demonstrating, over time, its technical accounting expertise, its historical audit work and its knowledge of the client's business. As a result, the likelihood is greater that the management team and the audit committee will increasingly trust and respect the professional, objective judgment of the audit firm. In our experience, benefits of such built-up capital include:

- ▶ Readily gaining acceptance of the auditor's position when the auditor suggests improvements, including improving disclosures, booking audit adjustments or adopting other ways to improve accounting, controls or financial reporting
- ▶ The enhanced ability to gain adoption of a more reasoned accounting position when the accounting literature may not point to a clear answer or when the company's other outside advisors support a less-reasoned position
- ▶ Increased credibility with the company's audit committee, which enhances its confidence in supporting the audit firm when the audit firm challenges a member of management on a financial reporting matter

This institutional capital, built up over time, leads in our view to improved audit quality, rather than an inappropriate willingness to accept management positions, as has been suggested by some.

Similarly, we feel strongly that the institutional knowledge that an audit firm gains in long-term audit relationships can enhance professional skepticism and give the audit firm a strengthened position in other ways, including the following:

- ▶ Experience with and knowledge of the personalities and technical abilities of the entity's various employees helps inform audit planning and may prompt increased skepticism in specific areas of the audit (or, in some instances, about certain members of management).

⁴ "Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?" Working Paper, Bocconi University and IE Business School, M. Cameran, A. Prencipe, M. Trombetta, 2010 (Bocconi Working Paper); "Mandatory Audit Firm Rotation and Audit Quality: Evidence from the Korean Audit Market," Soo Young Kwon, Youngdeok Lim, and Roger Simnett (19 November 2010).

⁵ "Exploring the Term of the Auditor-Client relationship and the Quality of Earnings: A Case for Mandatory Auditor Rotation?" *The Accounting Review*, Vol. 78, Issue 3, J.N. Myers, L.A. Myers and T.C. Omer (July 2003).

⁶ "Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality?" Working Paper, Bocconi University and IE Business School, M. Cameran, A. Prencipe, M. Trombetta, 2010 (Bocconi Working Paper).

- ▶ Detailed knowledge of historical accounting positions or particular transactions enables the auditor to assess consistency in approach and to better assess management motivations.
- ▶ Institutional knowledge helps the audit firm identify broader issues and emerging risks, or connect the dots between what might otherwise appear to be isolated issues in different company divisions.

One question that arises from these observations is, if mandatory partner rotation has seemed to work – and we believe partner rotation has had a positive effect on audit quality – why wouldn't mandatory firm rotation also be effective or even more effective? We believe the benefit that results from audit partner rotation exists in the context of the historical and institutional knowledge that other audit team members, and in some cases members of the firm's national office, can continue to provide. In other words, a partner who is new to the engagement can take advantage of other engagement team members' historical knowledge of the entity. This important benefit would be lacking if entire firms were required to rotate after a set number of years.

c. Negative effect on public companies and the interests of their shareholders

Public companies would not only likely see costs rise as a result of mandatory audit firm rotation, but they would face repeated distraction and disruption with a forced auditor change model.

Due to the learning curve that audit firms face with any new audit, audits can be less efficient at the beginning of an engagement.⁷ Senior personnel at the audited company would have to make a significant time commitment to help explain the business, internal control environment, accounting and business processes and corporate structure to the new auditor. In addition, the required changing of an audit firm by a company could be challenging if the timing coincides with a significant transaction such as a merger or acquisition or with volatile market conditions.

In addition, the first few years of a new audit relationship can present a higher level of audit risk. We are aware of this heightened risk and take steps to reduce it. While companies and audit firms obviously can and do manage transitions and new audit client risks, the volume of such transition activity today is significantly less than what would occur under a mandatory rotation model.

In the Board's open meeting announcing the Concept Release, a reference was made to a Glass Lewis & Co. (GLC) 2007 study that noted 52% of all public companies changed auditors between 2003 and 2006.⁸ We caution against concluding that this statistic means that a mandatory rotation model across all public companies could be implemented without significant difficulties. First, the study captured significant auditor transitions resulting from the closure of Arthur Andersen in August 2002. At Ernst & Young, we transitioned many of the former Arthur Andersen clients to our firm during this period. The transition was challenging and required an unprecedented level of effort. More importantly, this effort was aided significantly by the many former Arthur Andersen professionals who joined our firm and helped manage the transition. This benefit or enabler of associated personnel

⁷ In Italy, Big 5 controllers reported that hours spent on new audit engagements could be up to 40% higher than in following years. "A Survey of the Impact of Mandatory Rotation Rule on Audit Quality and Audit Pricing in Italy," unpublished research by the SDA Bocconi School of Management (2003).

⁸ "Speak No Evil," *Yellow Card Trend Alert*, Glass Lewis & Co., 21 May 2007.

mobility will not exist under a mandatory audit firm rotation model. In addition, it is important to note that after the passage of SOX, many smaller audit firms chose to cease auditing public companies rather than register with the PCAOB, resulting in numerous public companies changing audit firms during the time frame of the GLC 2007 study. Furthermore, the majority of the 52% measure captured in the GLC 2007 study is comprised of smaller company changes.⁹ The challenges associated with audit firm rotations are compounded for complex global companies with operations in multiple countries, which is why they occur relatively infrequently. In this regard, we note the 2007 GLC report was updated in 2010 to focus on auditor changes for larger companies and reported changes of less than 5% per year from 2005 to 2009.¹⁰

Overall, the economic costs and audit risks associated with a mandatory firm rotation model would be significant. In our view, mandatory firm rotation should only be considered after a careful cost-benefit evaluation. In the event the Board undertakes such a review, we are confident it will clearly demonstrate that the costs and risks of such a model, including its adverse effect on audit quality, will far outweigh any perceived benefits.

d. Negative effect on the audit profession

Mandatory firm rotation would have many negative consequences for the audit profession. Constant rotation could make it difficult for audit firms to plan and provide career-enhancing assignments for their personnel in certain circumstances. For example, we believe that if an audit professional is assigned to an audit engagement at or toward the end of the mandatory rotation timetable, there is a risk that the professional will question his or her prospects for further development and career opportunities at the audit firm and within the profession. In addition, if rotation were required, audit firms could face significant capacity and utilization uncertainty as they seek to assign appropriately qualified teams to new engagements. Managing transitions to multiple new engagements – which would include complexities such as the geographic relocation of a significant number of personnel – would increase the challenges and costs all audit firms already face in recruiting and retaining qualified personnel. The willingness of partners to relocate under the current mandatory five-year rotation arrangement applicable to partners is challenging but manageable. Trying to apply forced rotation to entire teams of auditors would be extremely difficult and could cause professionals to seek other careers to avoid repeated geographic relocations. As a result, mandatory audit firm rotation could result in higher turnover of staff and could ultimately make the profession less attractive.

Another negative effect of mandatory rotation would be the multiple of effort (relative to what we experience today) required by audit personnel in preparing proposals for new audit engagements. The time, effort and resources required to manage the significantly increased number of new audit pursuits will be a significant challenge, and the adverse effect of such efforts on audit quality could be substantial.

⁹ In the GLC study, the 52% represents 6,543 auditor changes and includes 2,304 companies that changed auditors due to the closure of Arthur Andersen. In addition, 3,887 of the company changes related to smaller companies (3,309 of the companies had a market capitalization of less than \$75 million, and 578 companies had a market capitalization between \$75 million and \$250 million).

¹⁰ The 2010 study focused on auditor changes of companies with market capitalization over \$250 million. "Year End Trend Report," *Trend Report*, Glass Lewis & Co., 29 January 2010.

Requiring the rotation of audit firms could also discourage specialization in particular industries, to the detriment of audit quality. Currently, auditors obtain in-depth knowledge of companies and their industries during the course of their engagements, and invest significant resources to obtain and maintain industry expertise. At Ernst & Young, we have auditors who spend their careers concentrating and gaining expertise in particular industry sectors such as retail, technology, financial services, energy and transportation. This specialization increases the auditor's ability to perform high-quality audits in an industry sector.¹¹ Mandatory firm rotation, however, would discourage industry specialization by inhibiting firms from building a long-term client base in specific sectors.

Overall, we are concerned that many who express support for mandatory firm rotation do not appreciate the resource challenges posed by such a model, the resulting impact on the professionals involved, and the long-term negative impact the model would likely have on audit quality, and we urge the Board to consider such effects.

e. Effect on audit fees

Mandatory firm rotation would significantly increase the cost of the audit process as a whole, and the audit firm's costs as part of that process. Audit fees might actually decrease in the short term due to fee pressures in an environment where every firm must continuously compete to replace the audits lost as a result of forced rotation. Because of the commitment firms make to delivering high-quality audits, the negative return on the investment eventually would either necessitate higher audit fees or threaten the quality of the audit.

3. The root causes of the Board's inspection findings should be further analyzed

In conjunction with gathering data from the engagements selected for inspection, we believe it is critically important that the Board continue its efforts to analyze the root causes of common audit deficiencies. To date, the Board's inspection findings have not tied an auditor's tenure to audit quality. As stated in the Concept Release, "[p]reliminary analysis of [inspection] data appears to show no correlation between auditor tenure and number of comments in PCAOB inspection reports."¹² Moreover, as noted above, we have not found engagement deficiencies to be driven by a pro-client bias or from efforts to avoid displeasing management on a substantive accounting or auditing issue.

4. The effects of recent and planned changes in PCAOB standards should be considered

a. Effect of recent standards

The Board's standards and the SEC independence rules are designed to promote independence and skepticism. The most recent examples are the standards the Board issued on engagement quality review and the auditor's risk assessment process.

¹¹ A 2009 study indicates that an auditor's expertise in a particular industry can reduce the negative impact of shorter auditor tenure on earnings quality. "Earnings Quality: Some Evidence on the Role of Auditor Tenure and Auditors' Industry Expertise," *Journal of Accounting and Economics*, Vol. 47, Issue 3, F. Gul, S. Fung and B. Jaggi (June 2009).

¹² PCAOB Release No. 2011-006, p. 16, 16 August 2011.

Auditing Standard No. 7, *Engagement Quality Review* (AS No. 7), provides a framework for the engagement quality reviewer to objectively evaluate the significant judgments made and related conclusions reached by the engagement team in forming an overall conclusion. The engagement quality reviewer's attention on the audit areas that are most likely to contain a material misstatement increases the likelihood of identifying and correcting those material misstatements before the audit report is issued. We believe this standard has increased an auditor's objectivity and professional skepticism. However, because AS No. 7 was effective for audits of fiscal years beginning on or after 15 December 2009, the Board has not had the opportunity to fully observe the positive effect this standard has had on audit quality.

In addition, Auditing Standards No. 8 through No. 15, (Risk Assessment Standards)¹³, were issued by the PCAOB in part to address the risk assessment process of audit planning, including the risks of material misstatement due to fraud or error and for the proper supervision of the audit planning process. The Risk Assessment Standards are effective for audits for fiscal years beginning on or after 15 December 2010. Therefore, the Board also needs time to consider the effect of these standards, which we believe will be shown to have a positive effect on audit quality.

b. Effect of planned standards

With the Board's plan to propose new quality control standards in the third quarter of 2012, we expect to see additional changes that respond to the Board's inspection findings. The quality control standards address requirements for maintaining independence, exhibiting professional skepticism and monitoring the firm's compliance with auditing standards and relate directly to the objectives the PCAOB cites in its Concept Release.

These expected enhancements to existing quality control standards will likely strengthen the focus on independence, objectivity and professional skepticism by audit professionals. For example, providing increased accountability of a person's responsibility for audit quality and the quality control function at audit firms (such as evaluating the consultation practices of audit firms) will help ensure that adequate policies and resources are in place to address higher-risk areas of the audit. The frequency of internal compliance reviews and level of senior executive involvement in certain aspects of the audit also could be impacted. Evaluating the monitoring aspect of the quality control standards could help further the performance of specific remediation efforts relative to inspection findings and are also expected to address "tone at the top" issues and promotion of a culture that promotes audit quality and professional skepticism.

Consequently, we believe that the Board should permit the many recent and planned changes to PCAOB audit standards noted above to take hold and then assess their effectiveness in making further improvements to audit quality. We do not believe mandatory audit firm rotation should be considered before this occurs.

¹³ AS No. 8 – *Audit Risk*, AS No. 9 – *Audit Planning*, AS No. 10, *Supervision of the Audit Engagement*, AS No. 11 – *Consideration of Materiality in Planning and Performing an Audit*, AS No. 12 – *Identifying and Assessing Risks of Material Misstatement*, AS No. 13, – *The Auditor's Responses to the Risks of Material Misstatement*, AS No. 14 – *Evaluating Audit Results*, and AS No. 15 – *Audit Evidence*.

5. There are approaches other than mandatory rotation that would address the Board's objectives and therefore deserve further consideration

a. Further strengthening audit committees

We believe efforts to support the profession's underpinnings of independence, objectivity and professional skepticism should center on the interrelationship of corporate management, independent audit committees, independent external auditors and shareholders.

In recent years, we have seen significant changes in audit committee engagement and performance and the rigor with which the audit process and auditor relationship is overseen and evaluated. Audit committees are asking the auditor probing questions, meeting with the audit firm's subject-matter experts and senior leadership, and challenging management on the appropriateness of its accounting and disclosure, all of which positively affect the tone and results of the audit. In our daily experiences, examples of actions being taken by leading audit committees to set the right tone (i.e., to further promote auditor independence, objectivity and professional skepticism) for the auditors include:

- ▶ Establishing expectations about the nature and method of communications and the exchange of insights with the auditor, and evaluating auditors against those expectations
- ▶ Reviewing the proposed audit plan and scope of work; audit committees ask auditors to perform more work if they would like the audit scope to be increased at specific locations or in particular risk areas, especially in multilocation environments
- ▶ Engaging in a regular dialogue outside scheduled meetings with the audit team
- ▶ Setting an annual agenda with the auditor to deliver not only efficient and effective audits but also to go beyond the compliance aspects of the audit and engage in discussions regarding key business initiatives in an increasingly global environment
- ▶ Focusing on independence, including a robust preapproval process for audits and permissible non-audit services
- ▶ Considering the findings from the financial statement audit and reviews, as well as the audit of internal control over financial reporting, and determining that management responds appropriately to the findings
- ▶ Seeking the auditor's views on the effectiveness of the company's governance process
- ▶ Asking auditors about PCAOB inspection findings and the findings of their firm's internal quality reviews
- ▶ Providing formal evaluations and regular feedback to the auditor

Beyond these functional responsibilities and actions, audit committees also operate under statutory obligations pursuant to the Act. Effective audit committee performance within this framework includes:

- ▶ Acting autonomously and independently of management
- ▶ Being sufficiently resourced, with requisite financial expertise and such funding as they determine necessary to execute their responsibilities
- ▶ Weighing quality as the key factor in appointing, compensating and overseeing the work of auditors
- ▶ Serving as an effective counterbalance to any undue management pressures on the audit process while fostering an independent and skeptical auditor mindset

In general, we believe audit committees execute these overriding responsibilities effectively and in a manner aligned with shareholder interests. However, we believe consideration should be given to the following to further shareholder alignment and consistency in practice:

- ▶ Enhance audit committee reports included in the company's annual proxy statements to include discussion of the committee's process to evaluate the independent auditor's performance, including the actions it has taken to assess and protect the auditor's application of professional skepticism.
- ▶ Increase transparency and communications to shareholders regarding the audit committee's execution of its responsibilities, including decisions on the appointment, re-appointment or dismissal of auditors.
- ▶ Engage with private sector groups to highlight and share with audit committees the leading practices, including those that promote auditor skepticism and objectivity, that we observe every day in the performance of our audits.

In summary, we believe that consideration of methods to enhance audit committee effectiveness and communication would further align the audit process with shareholder interests.

b. Selective rotation

One of the proposals discussed at the PCAOB open meeting considering the Concept Release was selective rotation, whereby the PCAOB could require firms to cease service as the auditor for companies in specific situations.

Although we expect this action would be an infrequent occurrence, we support the PCAOB considering the adoption of a formal practice to recommend rotation of an audit firm in instances where it has been demonstrated, through the PCAOB's enforcement process against a firm, that professional skepticism or objectivity was significantly lacking in the firm's audit of a particular company. Note that we suggest having the PCAOB recommend, rather than require, auditor rotation in this circumstance – we do so because shareholders' interests are best served by the independent audit committee being directly responsible for the ownership and oversight of the independent auditor relationship.

c. Sharing information between audit committees and the PCAOB

We meet frequently with audit committee chairs and members in a variety of forums, and we have heard some level of frustration raised over a lack of opportunity for direct audit committee interaction with the PCAOB staff on both significant inspection findings, and audit policy matters and standard setting more broadly.

We support enhanced interaction between the PCAOB and audit committees regarding standard setting and other audit policy matters and believe such interaction will further the alignment of shared interests we have previously referenced. We encourage the PCAOB to enhance its efforts to engage with audit committees on matters of audit policy and believe increased interaction between the PCAOB and audit committees would be in the public interest.

With regard to inspection findings, as a matter of practice, we do share information about specific inspection findings with the companies we audit and their audit committees. However, audit committee members have expressed interest in communicating directly with the PCAOB about some of these matters. We believe there should be further consideration given, in defined circumstances, to allowing audit committees to have a direct dialogue with the PCAOB on inspection findings. We recognize that the Act affords strong and constructive statutory protections to the confidentiality of the inspection process, and attention would need to be given to maintaining confidentiality considerations while promoting discussions between the PCAOB and audit committees.

6. Our thoughts on the other ideas outlined in the Concept Release

We support the Board's efforts to solicit views on ideas other than mandatory audit firm rotation that might further enhance auditor independence, objectivity and professional skepticism. The following are our views on certain ideas, that we do not support, specifically cited in the Concept Release and by PCAOB board members during the open meeting.

a. Mandatory retendering

The Board sought comments on the concept of mandatory retendering of audits, whereby audit committees would be required to solicit bids on an audit after a specified number of years. Some may believe such an approach could be a reasonable alternative to mandatory rotation as a softer and less disruptive alternative capable of achieving positive results with respect to auditor skepticism.

We disagree, and believe that the drawbacks to mandatory retendering are considerable. In our view, a mandatory retendering policy would not only share many of the challenges of mandatory audit firm rotation, but could have even more disadvantages in practice. Similar to mandatory firm rotation, mandatory retendering could result in audit firms having to continuously market their capabilities, with diversion of focus by their audit professionals. In addition, it would cause disruptions and distractions and consume management and audit committee resources.

We also believe that mandatory retendering might be used by some public companies as a means to reduce audit fees rather than to improve audit performance. The audit proposal process is highly price-competitive among the major accounting firms. In this regard, mandatory retendering would

reinforce the “audit as a commodity” risk that the audit profession has been working against for decades. Audits are not commodities, and professional services firms should likewise not be viewed as commodities lacking in distinctive skills or particular areas of expertise.

Moreover, mandatory retendering suffers from the same defect of mandatory rotation: it takes decision-making responsibility with respect to audits away from the audit committee. There is nothing now that prevents audit committees from putting an audit engagement out for tender. Indeed, our impression is that most audit committees – in particular, most thoughtful and effective audit committees – consider annually whether the independent audit firm should be re-appointed or, instead, tenders should be solicited. Taking away this standard practice of good audit committees and replacing it with a regulatory mandate would be broadly inconsistent with basic principles of corporate governance.

b. Joint audits

Compulsory joint audits have significant disadvantages, and we do not believe such a requirement would enhance auditor independence, objectivity and professional skepticism or improve audit quality. Mandating joint audits would mean that the audit committee, acting on behalf of shareholders, would not make the decision about whether a joint audit is appropriate for a particular company. Companies today may opt for a joint audit if it suits their needs, but they rarely do so. Joint audits present challenges in effective coordination between two audit firms, including the risk of gaps in audit execution. In addition, companies could put joint auditors in possible and unnecessary competition with each other in regard to accounting and auditing issues. Joint audits also result in additional costs from duplication of efforts.

c. Consideration of the audit firm payment model

We do not believe that changing the current payment model would improve auditor independence, objectivity and professional skepticism. The principal counterbalance to the concern with the issuer-pays model is the independent audit committee, which oversees the audit relationship for the benefit of shareholders.

As previously noted, SOX created a series of statutory obligations for audit committees, including the obligation to select, retain, oversee and compensate the auditor, all the while being independent of management. Audit committees are also charged with serving as arbiters of management-auditor disputes.

We do not support proposals that would remove important decisions from the control of the boards and audit committees, which are responsible to shareholders and are best positioned to appoint and compensate the audit firm they believe best meets shareholder needs. Instead, we would support proposals that would further enhance the role of the audit committee, based on the practices of leading audit committees.

d. Further limitations on non-audit services

We do not believe there should be further limitations on non-audit services that independent auditors may provide to companies they audit. We have strong internal governance practices to make sure that we do not provide non-permissible services to audit clients or non-audit services that could give an appearance of impairing our independence. Having auditors perform appropriate, permitted non-audit services can further the public interest because such services enhance our audit work, improve audit quality and help us attract and retain the best talent and specialized expertise. In our view, delivering the most complete range of permissible services increases a firm's knowledge of a company and its risks and processes, all of which favorably contribute to audit quality. Moreover, aspects of this issue were examined by the SEC in 1999-2000, by the U.S. Congress in 2002, by the SEC again in 2002-2003 and by the PCAOB in 2008. We know of no reason to revisit the issue again now.

Concluding remarks

While we believe there will always be a need to bring fresh ideas to the topic of audit quality and the protection of auditor independence, objectivity and professional skepticism, we do not believe further consideration of mandatory audit firm rotation is in the public interest. We do support ideas that would further enhance audit quality, and we have discussed several of those ideas above.

We intend to continually engage with the Board and others to be certain that the audit services we provide remain valuable to the capital markets and the wider public interest and that we continue to carry out our responsibilities with a high level of independence, objectivity and professional skepticism.

The PCAOB, SEC, independent external auditors, independent audit committees, corporate management and all other stakeholders must remain committed to the importance of auditor independence and the measures established to support it. Among other things, we urge that the role of the independent audit committee in this regard be respected and enhanced, not undermined.

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We would be pleased to discuss our comments with members of the Board or its staff.

Sincerely,

Ernst & Young LLP